



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.11.2003
COM(2003) 692 final

REPORT FROM THE COMMISSION TO THE COUNCIL

**on the preparedness of Bosnia and Herzegovina to negotiate a Stabilisation
and Association Agreement with the European Union**

TABLE OF CONTENTS

A.	INTRODUCTION	5
1.	Objective of the Report.....	5
2.	Background: Relations between the European Union and Bosnia and Herzegovina	5
B.	KEY ISSUES IN PREPARING FOR NEGOTIATIONS ON A STABILISATION AND ASSOCIATION AGREEMENT	6
1.	POLITICAL CRITERIA	6
1.1	Democracy and the Rule of Law	6
1.1.1	Presidency.....	6
1.1.2.	Legislature	7
1.1.3	Executive	8
1.1.4	Public administration	9
1.1.5	Relations with the international community.....	10
1.2	Human Rights	12
1.2.1	Civil, political, social and economic rights	12
1.2.2	Minority rights and refugees.....	13
1.3.	General Evaluation	14
2.	ECONOMIC CRITERIA	14
2.1	Economic Situation and Fiscal Sustainability	14
2.2	Price and Trade Liberalisation.....	15
2.3	Privatisation Process.....	16
2.4	Financial Sector Reform	16
2.5	General Evaluation	16
3.	ABILITY TO ASSUME THE OBLIGATIONS RESULTING FROM A SAA	17
3.1	Political Dialogue	17
3.2	Regional Co-operation.....	18
3.3	Free Movement of Goods	19
3.3.1	Trade in industrial goods	20
3.3.2	Trade in agricultural goods.....	20

3.4	Movement of Workers, Establishment, Services, Capital	21
3.4.1	Movement of workers.....	21
3.4.2	Establishment.....	21
3.4.3	Trade in services	22
3.4.4	Current payments and movement of capital	22
3.5	Approximation, Implementation and Enforcement of Legislation.....	23
3.5.1	Competition	23
3.5.2	Intellectual, industrial and commercial property	24
3.5.3	Public procurement.....	24
3.5.4	Standardisation and conformity assessment	24
3.5.5	Consumer protection.....	25
3.6	Justice and Home Affairs.....	25
3.6.1	Reinforcement of institutions and rule of law	25
3.6.1.1	Police	25
3.6.1.2	Judiciary.....	26
3.6.1.3	Prison system	27
3.6.2	Visa, border control, asylum and migration	27
3.6.3	Combating money laundering.....	28
3.6.4	Preventing and combating crime, combating illegal trafficking and illicit drugs	28
3.7	Co-operation Policies.....	30
3.7.1	Economic, monetary and statistical co-operation	30
3.7.2	Investment promotion and protection, industrial co-operation, small and medium-sized enterprises, tourism	31
3.7.3	Agriculture and agro-industrial sector	31
3.7.4	Customs and taxation.....	32
3.7.4.1	Customs	32
3.7.4.2	Taxation	33
3.7.5.	Employment, social policy, education and training, research and technological development (RTD)	33
3.7.5.1	Employment and social policy.....	33
3.7.5.2	Education and training, RTD	34

3.7.6 Culture, audio-visual, telecommunications and postal services, information society35

3.7.6.1 Culture and audio-visual.....35

3.7.6.2 Telecommunications, information society, postal services35

3.7.7 Transport.....36

3.7.8 Energy37

3.7.9 Environment37

3.8 Financial Co-operation38

3.9 General Evaluation38

C. CONCLUSION39

LIST OF ABBREVIATIONS43

A. INTRODUCTION

1. OBJECTIVE OF THE REPORT

This report has been compiled to assess progress made by Bosnia and Herzegovina (BiH) within the Stabilisation and Association process (SAP). In 2000, an EU "Road Map" identified eighteen initial "Steps to be taken by Bosnia and Herzegovina to prepare for a Feasibility Study on opening Negotiations on a Stabilisation and Association Agreement". The Road Map steps were "substantially completed" in September 2002. The European Commission thus herewith presents its study. The study investigates BiH's current situation, identifies the requirements inherent in a Stabilisation and Association Agreement (SAA) and judges whether BiH has progressed sufficiently to allow it to negotiate meaningfully and subsequently implement successfully such an agreement.

2. BACKGROUND: RELATIONS BETWEEN THE EUROPEAN UNION AND BOSNIA AND HERZEGOVINA

BiH is one of the five countries of south east Europe participating in the SAP. This process supports national and regional stabilisation by integrating each of the five participating countries progressively into European structures and holding out the prospect of EU membership. In each case progress on integration depends on the merits of each individual country. This Feasibility Study therefore refers exclusively to BiH.

Relations between BiH and the EU have greatly developed in recent years. From 1996 BiH benefited from PHARE and OBNOVA assistance. In 1997 the EU established its Regional Approach and the Council of Ministers established political and economic conditionality for the development of bilateral relations. In 1998 an EU Declaration on "Special Relations between EU and BiH" led to the establishment of the EU - BiH Consultative Task Force (CTF) to assist in the preparation of contractual relations. In 1999 the SAP offered the prospect of integration into EU structures and in 2000 the EU Road Map identified the first concrete steps on this journey. Initially thought to be a short-term exercise, their "substantial completion" was achieved only in September 2002. Meanwhile, in 2000 the Community's Autonomous Trade Measures (ATMs) had extended duty-free access to the EU market for most BiH goods and the CARDS regulation foresaw financial support tailored to SAP priorities. The 2000 Feira European Council stated that BiH, like its neighbours, was a potential candidate for membership, a message reinforced at subsequent summits in Zagreb (November 2000) and Thessalonica (June 2003). Indeed, Thessalonica gave practical expression to this perspective by developing for Western Balkan use some of the instruments which proved effective in the central and southern European candidate countries.

BiH's relationship with the EU has been short, but intense. From limited beginnings the relationship has intensified speedily, to the point where contacts are now routine at both political and working levels. The objective must now be to create expeditiously the foundation for contractual relations through a SAA.

B. KEY ISSUES IN PREPARING FOR NEGOTIATIONS ON A STABILISATION AND ASSOCIATION AGREEMENT

1. POLITICAL CRITERIA

Respect for democratic principles and human rights as proclaimed in key international documents such as the Universal Declaration of Human Rights, and respect for the principles of international law and rule of law in general should form the basis of the domestic and external policies of parties to a SAA. The consolidation of international and regional peace and stability and the development of good neighbourly relations would be the shared objective of both the EU and BiH in the context of a SAA.

1.1 Democracy and the Rule of Law

The constitution of BiH specifies (article I.2) that BiH is a democratic state operating under the rule of law with free and democratic elections. The constitution incorporates the European Convention on Human Rights. **Democratic systems** have begun to function in BiH. This is a testimony to progress made since the 1992 - 1995 war which killed thousands, displaced half the population, ruined public and private infrastructure and poisoned inter-communal relations. The **rule of law** has been gradually re-established: the country is generally peaceful; there is freedom of expression and peaceful assembly. Freedom of movement is guaranteed and the right to property has in most cases been enforced. Given recent history, these and other rights are no small achievement.

The constitutional basis for the establishment of democracy and the rule of law is annex 4 of the General Framework Agreement on Peace (GFAP) agreed at Dayton in December 1995. Annex 4 of the Agreement, the BiH constitution, created a highly de-centralised state designed to accommodate the disparate preferences of estranged peoples. In practice, this has meant the establishment of a large number of governments and related administrations. The constitution also provides a system of checks and balances; these balance legislative and executive power and guarantee the rights of each ethnic group. State and Entity constitutions provide blocking mechanisms protecting the "vital interests" of BiH's constituent peoples. This blocking mechanism may guarantee the rights of each people, but may also make legislative progress difficult and can lead to deadlock. In terms of European integration, however, it is important that partner countries are able to function properly; their various institutions must produce the results expected in a modern democratic country. The complexity of the existing Dayton order could hinder BiH performance.

The system established at Dayton has frequently been questioned both within and without BiH. Certainly, from a perspective of European integration it is difficult to argue that the current constitutional order is optimal. Whatever the arguments for and against, article X of the constitution provides the possibility of **amendment**. In fact, some argue that BiH has already begun to address these issues through the "constituent peoples" case and through reform of indirect taxation and defence, etc. These reforms suggest that incremental, issue-based reform may be a way to progress. At any rate, the constitution is no insuperable obstacle to reform or to European integration.

1.1.1 Presidency

BiH has a directly elected **tri-partite Presidency**. The presidency is responsible inter alia for conducting foreign policy, proposing annual budgets and representing BiH in international and

European organisations. In the Entities, presidencies also exist and, since the 2002 Entity constitutional changes, are complemented by vice-presidents (although the latter have in some cases struggled to identify and assert meaningful roles for themselves).

Particularly in the early post-war years the BiH presidency played an influential role in comparison with other State-level institutions. However, as the Council of Ministers has grown in authority, the Presidency has concentrated more on its constitutionally defined functions. Although, it has generally functioned well, the presidency inevitably **reflects some of BiH's challenges** and difficulties. In contrast with the Council of Ministers, with its fixed chairmanship, the presidency remains subject to an eight-month rotation. Several past presidency members have left office because of activities considered incompatible with the Dayton agreement, and relations within the Presidency have sometimes been strained over different views on BiH's constitutional order and future. Persistent thinking in ethnic categories is reflected in the fact that the presidency at one stage advocated reintroducing separate (i.e. ethnically divided) secretariats, a move contrary to Road Map recommendations. Also, the presidency's appointment of ambassadors still reflects criteria of ethnic balance.

Finally, it should be noted that despite progressive integration, BiH presidential elections are still based (as mandated by the constitution) on **ethnic / territorial principles** - i.e. Bosniac and Croat members are elected "from the territory of the Federation" and a Serb "from the territory of the Republika Srpska" (constitution, article V). This procedure has been criticised as anachronistic and incompatible with the principle of the "constituent" identity of each people.

1.1.2. Legislature

BiH is a **parliamentary democracy**. The powers and procedures of the State parliament are described in article IV of the constitution. At Entity, Brcko and cantonal levels parliaments also exist.

Over the years **parliamentary performance at State level has improved**. By contrast with the 1996 - 1998 and 1998 - 2000 legislative periods, three times more laws proposed by the Council of Ministers were adopted in 2000 - 2002. Although seriously hampered by a lack of technical resources and qualified personnel, the State parliament has gradually developed technical competence. A number of technical committees have been formed to provide specialised scrutiny of legislation. Particularly noteworthy is the creation of a Committee on European Integration, the first joint committee of the two State-level houses of parliament. The gradual emergence of a culture of compromise within parliament, reported by some observers, would also be welcome. The decline of the "zero-sum politics" which characterised the immediate post-war era would, if confirmed, benefit all BiH peoples and would constitute a welcome step towards more normal European parliamentary practice.

Of course, **deficiencies persist**. Often parliament meets for less than two days per month and during the ten months up to September 2003 the BiH parliament adopted only 19 laws or amendments to laws. The pace and quality of legislative output is affected by slow through-put from the Council of Ministers and by the lack of an adequately qualified and organised parliamentary administration. Although a greater willingness for principled compromise may be developing, it is by no means universal. Members of the State Parliament still often vote along ethnic lines or owe their first allegiance to their Entity, occasionally leading to blockage. This difficulty is compounded by the existence of sometimes competing centres of legislative authority at Entity and cantonal levels. Only recently did State and Entity parliamentarians

agree in principle to create a permanent inter-parliamentary committee. This will in future need to ensure better co-ordination of legislative programmes between all levels of authority.

Since the war BiH has held numerous **elections**. General elections were last held in October 2002 on the basis of an Election Law adopted only in August 2001 after considerable international pressure. In the context of European integration, it is significant that all the major contending parties in this election reportedly accepted BiH as the common state, supported "reform" and identified their major political goal as joining the European Union. For the first time in post-war BiH, the 2002 elections were organised and run not by the OSCE, but by BiH itself. They were efficiently run, peacefully conducted and unmarred by excessive nationalism. The successful transfer to BiH of responsibility for the conduct of elections demonstrates latent BiH capacity and may constitute a model for the transfer of further responsibilities.

On the negative side, voter turn-out at the elections was low: 54% (although electoral fatigue is understandable given that this was the sixth major election in six years). Significantly, BiH was unable to meet the costs of the 2002 elections itself; it depended on international financing for around 70% of the total cost - and the funding of future elections, including the autumn 2004 municipal elections, remains unsecured. The sustainability of democracy in BiH may be in question if its **financial foundations** remain so weak.

1.1.3 Executive

Whatever the party-political composition of government, BiH needs an **executive** able to deliver reform and give content to the reformist policies proclaimed in successive election campaigns. Starting from a low base-line, BiH has made some progress.

The first post-war State-level administrations were characterised by ethnic division and were generally ineffective in terms of reform. The record has improved, but a number of important structural deficiencies persist. In a country of around four million people, there are 14 governments: State government co-exists (and in some cases competes) with two Entity governments, a district government in Brcko and ten cantonal governments in FBiH. Despite the efforts of a high-level Co-ordination Board for Economic Development and EU Integration and a number of ad hoc and sector-specific committees, **co-ordination** between these bodies is **far from optimal**. Overlapping functions, duplication of effort and uncoordinated initiatives remain a problem.

Within State government, the record of adopting and advancing legislation to parliamentary procedure is poor. This sometimes reflects a lack of political will and diverging national interests, but also structural weaknesses such as under-developed legislative drafting abilities and support structures that are not yet fully functional. The Council of Ministers has consistently failed to produce an annual work programme by the beginning of the calendar year as required. New ministries created by the Law on the Council of Ministers remain under-developed. In remedying these and other shortcomings, at least two factors will be decisive: improved **institutional capacity and political will**.

With the 2002 Law on the Council of Ministers important **institutional innovations** were introduced. The post of Chairman of the Council of Ministers is no longer subject to eight month rotation, but may be held for the whole legislative period. The chairman can thus develop authority, becoming effectively a prime minister. This should encourage long-term planning and facilitate policy consistency. The law also created a number of auxiliary bodies such as a General Secretariat, a Legislative Office, an Economic Committee and an Internal Policy Committee which should help manage government business more effectively. However,

these are not yet fully established. New State ministries were created, including those for Justice and Security (important departments under any future SAA). Particularly notable was the replacement of the Ministry of European Integration by a Directorate for European Integration (DEI) under the authority of the Chairman of the Council.

In terms of **political will**, there also seems to be improvement. Admittedly, support for reform is not universally shared. However, the Council of Ministers has worked to promote consensus. Governments at both State and Entity levels have taken part in meetings of the Steering Board of the Peace Implementation Council (PIC) and have adopted strategic policy documents ("Reform Agendas") covering issues such as judicial and economic reform, public administration, education and defence. Governments have recently transformed these commitments, and SAP reform requirements, into an Action Plan for the Implementation of Priority Reforms from August 2003 to March 2004. This may effectively constitute a government work plan. As such, it would give direction over six months, but medium-term planning and oversight tools are still needed. BiH would need to continue to improve its executive capacities further if it were to implement a SAA successfully.

1.1.4 Public administration

The administrative capacity required by a SAA is less than that expected of an EU Member State or a country negotiating membership. Nevertheless, if BiH is to make progress towards a SAA, it must develop a stable **public administration** based on a clear legal framework and characterised by efficiency, professionalism and independence.

In this respect, BiH faces a major challenge. In the March 2003 agenda for "Reforming the Public Administration", BiH governments recognised that the BiH public administration does not yet meet the expectations of all citizens. The administration is slow, unpredictable and absorbs too much public money. It is multi-layered, with (sometimes competing) bureaucracies at State, Entity, cantonal and municipal levels. Its system of remuneration needs to be clarified and standardised. Staff are poorly trained and ill-equipped to meet the new challenges a SAA would imply. In administration, as in government, strategic planning and co-ordination capacities are limited. These weaknesses are compounded by a history of governments seeing public administration as a patronage resource. The notion of a **professional, non-political civil service** with recruitment and promotion based on experience and merit has had a difficult birth. At present, there are still inadequate safeguards against political interference in public administration. Moreover, independence needs to be balanced by accountability. Although a Law on Conflicts of Interest provides a first basis, a clear legal framework setting out responsibilities and establishing systems of accountability within the civil service is still missing.

Within BiH, there is now a growing appreciation of the need to develop administrative capacity. A significant step in this direction was taken with the adoption of Civil Service Laws at State and Entity levels, establishing a legal framework for public administration. Further, Civil Service Agencies responsible for recruitment, training, discipline, etc. were created at State level and in RS; in FBiH the Agency has not yet been fully established. A review of State-level civil servants has begun. Importantly, in March 2003, BiH governments endorsed five public administration reform pledges at the PIC. The resulting agenda underlined the need for structural reform leading to an efficient, non-discriminatory and affordable administration. Moreover, the agenda acknowledged the need to pull together existing achievements with functional reviews in order to produce a comprehensive and cost-estimated Action Plan for public administration reform by autumn 2004 – a timetable which should be maintained. As

follow-up, an inter-governmental Task Force at State and Entity levels was created. So far the latter has met on a number of occasions, but practical results have been limited.

In terms of European integration, particular needs appear. In general, there is a low level of understanding of the integration process and of SAA requirements in particular. A SAA would require the co-ordination of a large number of ministries. Here the leading role has been taken by the new **Directorate for European Integration** which, though under-developed, performed commendably well in co-ordinating BiH responses to the Feasibility Study questionnaire. Only in September 2003 did the Directorate receive approval of its Rule Book. This should allow it to reallocate staff and hire new personnel, better to address its responsibility for strategic analysis, legal harmonisation and aid co-ordination. The DEI must expeditiously formulate overall policy on integration, communicate a strategy to other ministries and ensure a coherent national approach through the adoption of a European Integration Strategy. The Directorate's full ability to function is a requirement of considerable urgency.

1.1.5 Relations with the international community

On the basis of the Dayton mandate, the **international community** has been deeply involved in BiH since the war. A NATO-led Implementation Force (IFOR) and later a Stabilisation Force (SFOR) promoted military stabilisation. OSCE oversaw confidence and security-building measures and put in place an election programme. The UN agencies concentrated inter alia on refugee returns and police reform. The international financial institutions supported macro-economic stabilisation and development. Eight years from the war, some international bodies have completed their mandates and withdrawn. Those remaining have adapted to changing and generally improving circumstances. In most cases, BiH input has been positive and has contributed to general improvement.

Of course, some issues need further attention. The work of the **International Criminal Tribunal for former Yugoslavia** (ICTY) continues. BiH co-operation with ICTY has been less than satisfactory. In FBiH there are serious inadequacies on the part of the Bosnian Croats. In RS there has been some, but still inadequate, access to documents and individuals. To date, RS has not located or arrested one indicted fugitive. Karadzic and others are still at large and reportedly have large and well organised systems of support.

Police reform progressed well under the UN-led International Police Task Force (IPTF) and now with good BiH co-operation is being consolidated through the work of a three-year **EU Police Mission** (EUPM).

As BiH progresses towards a SAA, it must demonstrate that the role of the international community within its borders is moving towards one more typical of other countries in transition. Nowhere is this requirement more relevant than in the case of the Office of the High Representative (OHR), whose head, the "double-hatted" **High Representative and EU Special Representative**, plays a particular role in BiH. In addition to his Dayton-mandated (annex X) responsibilities, a December 1997 meeting of the PIC gave the High Representative the authority to impose legally binding decisions in BiH. This has, in practice, been used in three ways: (i) to enact legislation, (ii) to remove officials from office and (iii) to impose other binding decisions. Decisions taken in the context of the Bonn Powers have been instrumental in achieving reform that might otherwise have been delayed or never effected. The number and nature of these decisions reflect a persistent BiH unwillingness or inability to make progress under domestic procedure. They certainly raise justified questions about BiH's ability to sustain a SAA. Nevertheless, while the "Bonn Powers" are certainly anomalous among EU

partner states, their existence in BiH need not automatically exclude that country from moving towards SAA negotiations. To make this case, BiH needs to give evidence that the powers are generally declining in relevance and that their use occurs ever less within core SAA areas.

In the period 1997 to late summer 2003 nearly 500 decisions by the High Representative are recorded. Their number peaked in 2002 with 153 decisions. (Note, however, that the absolute number of decisions may not be a reliable guide - one policy decision has often required multiple implementing decisions covering various levels of governance.) Interestingly, while the period June 2002 to January 2003 saw a total of 101 decisions, the following eight months (February to September 2003) saw only 68 - and that without notably slowing the pace of reform. This constitutes a significant reduction on the previous eight months. More importantly, BiH seems to be working increasingly with the High Representative, as opposed to simply accepting impositions. This is evidenced inter alia by weekly meetings between the Chairman of the Council of Ministers and the High Representative, daily co-ordination meetings between the two offices and even by multi-lateral meetings of concerned political leaders with the High Representative on specific issues (e.g. reform of the Council of Ministers). This co-operation has brought a **gradual shift towards "soft" decisions**, i.e. decisions which merely follow up policies already agreed in advance. Further, there is recent evidence that BiH may now be using OHR decisions to facilitate the domestic resolution of problems. For example, the High Representative's decision to create commissions on indirect tax policy, on defence and on intelligence has allowed BiH parties to develop draft legislation enjoying the confidence of all sides. The timely adoption of this legislation by parliament would be an important indication that a culture of political consensus-seeking may be beginning to take hold.

Further, while a SAA clearly requires overall competence in decision-making, it is particularly important that national decision-making predominate in core SAA sectors such as trade, the single market and justice and home affairs (JHA). Significantly, the level of imposition in economic reform is low. A growing appreciation within BiH of the need for economic reform, combined with international pressure from the EU, the international financial institutions and others, appears to have been enough to motivate at least moderate reform. In this, BiH is little different from many other (pre-) transition countries. Indeed, OHR records indicate that in the first nine months of 2003, apart from decisions blocking the bank accounts of those suspected of assisting indicted war criminals, only three decisions were imposed in the field of economic policy. In the field of rule of law, the rate of imposition is moderate with 21 decisions taken between January and early October 2003, although around a half of these related to the appointment of international judges and / or prosecutors. Here, it should be noted that reform is putting in place a politically independent framework which will in many cases adjudicate on issues relevant to a SAA. As this structure consolidates, politicians, businessmen and ordinary citizens should be increasingly constrained by due process and rule of law. **The need for OHR intervention, e.g. in the removal of criminal networks, should therefore also decline.**

To be a competent SAA partner BiH would need to demonstrate that the Bonn Powers are rapidly becoming redundant, permitting the High Representative to become at most a facilitator and mediator. Current evidence suggests that this may be happening and that **the "push" of the Bonn Powers is gradually being replaced by the "pull" of European (and euro-Atlantic) institutions.** BiH must now ensure that if imposition occurs, it is "soft" and that the total number of OHR decisions continues to decline.

1.2 Human Rights

Formally, BiH citizens enjoy all the **human rights** and freedoms identified in the European Convention for the Protection of Human Rights and Fundamental Freedoms and its Protocols. According to the BiH constitution (Art. II.2), these apply directly in BiH and have priority over all other law. Equal treatment of men and women is guaranteed by law. Also, BiH has ratified a number of international conventions on human rights (although, its record of reporting to the international monitoring bodies is poor). In 2002 BiH acceded to the **Council of Europe**. This demonstrated progress in establishing democracy and securing the rule of law, but accession was accompanied by post-accession requirements on which BiH is still working. It is a concern that in contravention to BiH commitments, the RS constitution (Art. 11) allows the death penalty for capital crimes. This is not compatible with EU policy.

1.2.1 *Civil, political, social and economic rights*

War in BiH led to massive abuse of human rights. Eight years after the war, thousands of human rights abuses, including disappearances, remain un-investigated and unpunished. Gradually, however, the return of refugees and the implementation of property legislation have undone some of the injustices perpetrated in war.

In a landmark decision in summer 2000 the Constitutional Court decided that changes needed to be made to Entity constitutions in order to protect the rights of BiH **constituent peoples**. Subsequently, constitutional mechanisms were introduced in the Entities to equalise and protect the rights of each constituent people. Each should now enjoy equality and proportional representation in political, administrative and judicial institutions. In fact, although legislation imposing such changes was introduced by the High Representative in 2002, neither Entity has yet enacted all the required amendments; provisions specifying proportional representation in public bodies have often been ignored. This can be interpreted as inadequate commitment by regional government to constitutionally defined civil and political rights.

The Dayton agreement, too, made institutional provision for the protection of rights: an international **Ombudsman**, a **Human Rights Chamber** (HRC) and a **Commission for Real Property Claims** (CRPC). According to Ombudsman reports, the most frequent violations of human rights relate to equality before the law, property rights and right to work. Compliance with decisions of the human rights institutions remains mixed: FBiH has the best record, while State and RS authorities still do not execute decisions satisfactorily. Over a protracted period, the human rights bodies have had problems securing domestic funding. The mandates of the HRC and CRPC expire at end 2003. The database of the latter will be taken over by the State Ministry of Human Rights and Refugees and undecided claims will be handled by domestic bodies. In the case of the former, responsibilities will be transferred to the Constitutional Court (which, it should be noted, will need additional funding to meet its new responsibilities). Likewise the international Ombudsman should be replaced in 2004 by an institution with three BiH nationals and funded by the BiH budget. It is expected that the Entity Ombudsmen will be merged with the State Ombudsman.

The **social and economic rights** of BiH citizens remain limited by continuing economic debility. Officially, up to 40% of the population is unemployed. Around 20% live below the poverty threshold, with a further 30% close to it. In part this reflects a failure of (admittedly rudimentary) social security systems to address the needs of the economically most deprived. The right to belong to independent **trade unions** is respected, but trade unions have been weakened by war, ethnic division and high unemployment. Numerous strikes have been organised, reflecting mostly grievances over unpaid wages or pensions. The **health** sector in

both Entities remains weak with inadequate funding. Large numbers are not covered by health insurance, and even for those who are, coverage is unreliable. Many rural areas are without effective medical cover. Parallel health systems persist in FBiH.

BiH operates a law on the **freedom of information** obliging governments to disclose information to the public. Despite some isolated incidents, the independence of the **media** and freedom of expression are largely respected. The electronic media are overseen by the independent Communications Regulatory Authority (although the latter has been under threat from financial and staff shortages). The print media are self-regulated and largely divided along ethnic lines. Political influence-peddling is limited, but can be exercised by financial donations to favoured outlets or legal challenges to unfriendly ones. The politically motivated abuse of libel laws against critical journalists was limited only through new civil laws on defamation.

The war and post-war economic weakness have disrupted the development of **civil society**. Following the war, the sector developed mostly on a regional basis, serving local rather than BiH-wide needs. Non governmental organisations (NGOs), while numerous, are usually only locally active and often dependant on international funding. Deficiencies in their advocacy skills constrain their effectiveness and thus also their influence on government. On the other hand, a number of illiberal NGOs of dubious provenance have been accused of supporting terrorist activity. Improved inter-NGO co-operation was evidenced by participation in consultations for the Poverty Reduction Strategy Paper. The role and influence of think-tanks remains small.

1.2.2 Minority rights and refugees

A peculiar dynamic of BiH society results from the fact that none of its constituent peoples (Bosniacs, Serbs, Croats or Others) makes up more than 50% of the population. To protect the “vital interests” of Bosniacs, Serbs and Croats, complex constitutional provisions have been established; there is no such provision for “Others”. Among BiH's “Others”, Roma and Jews figure prominently. Roma are the largest group. They have long faced hardship and exclusion, but the 2002 Law on the **Rights of National Minorities** and the creation of consultative fora should safeguard their rights, facilitate political participation and protect minority languages.

BiH is further notable in having guaranteed to refugees and displaced persons the right to reclaim and / or return to their property after the war. Although resistance to returnees persists in some areas, BiH has recorded some of the most impressive successes in refugee returns in the region. 14% of the population is still displaced and the effects of “ethnic cleansing” persist in some areas, but around one **million refugees and displaced people** have returned to their pre-war homes. Of these, just under half are minority returnees. The establishment of sustainable economic and social conditions for these returnees is a continuing challenge. Over 90% of all **property claims** have now been resolved (with RS catching up with FBiH). As a result, all property claims could be dealt with by end 2003.

In January 2003 BiH presented to the PIC an "Annex VII (GFAP) Strategy" detailing a transfer of responsibilities for refugee returns to domestic institutions. The realisation of the strategy and the sustainability of the return process will depend on political will and the availability of funding. Worryingly, a number of legislative deadlines have been significantly delayed, affecting, for example, the establishment of a **BiH Return Fund**. A further determinant is a regional dynamic: refugees are still scattered throughout the region and in some cases, the return of displaced people to homes within BiH is frustrated by the presence of refugees from other countries. It is essential that BiH brings the return process to a successful conclusion -

both on moral grounds and for reasons of self-interest. Failure to complete the process would send a negative signal concerning BiH ability and will to protect property and investment.

1.3. General Evaluation

BiH's political weaknesses are numerous and easily rehearsed. The divisions that were so clearly and tragically demonstrated during the 1992 – 1995 war have not yet been entirely overcome. Dealing with these divisions and securing a functioning state is important in the context of a SAA, as **only coherent, functioning states can successfully negotiate an agreement with the EU**. SAA negotiations would require BiH to mediate its own internal options and preferences in order to present a single, coherent national position to EU counterparts. This requirement underlines BiH's need to create internal consensus and pursue with urgency and determination further reform of government and administration.

If reform has in the past moved slowly, this has been the result of a failure of political will and lack of reform "ownership". While, it is not clear that this has been definitively overcome, there is some evidence that **a new dynamic may be emerging** within the BiH body politic. BiH's contribution to the preparation of this Feasibility Study demonstrated a unity of purpose and will which seemed earlier lacking. Further, the work of the reform commissions on indirect taxation and other issues, if successful and crowned with legislative approval may be evidence of an emerging culture of political consensus. This is a prerequisite for self-sustaining, BiH-driven reform.

2. ECONOMIC CRITERIA

Respect for market economy principles should be the basis for the domestic and external policies of the parties to a SAA. This entails a stable macro-economic environment supported by reliable macro-economic institutions, a comprehensive liberalisation of prices and trade and the creation of a strong private sector on the basis of a stable legal and regulatory framework.

2.1 Economic Situation and Fiscal Sustainability

After the war, which left BiH GDP at around 20% of its pre-war level, a significant economic recovery set in. Between 1996 and 1999 real GDP growth, fuelled by external reconstruction aid of about €5 billion, averaged above 30%. However, BiH has been unable to mobilise adequately domestic sources of growth, particularly private sector activity, and since 2000 annual growth has slowed to around 5%. For 2003 it is estimated at 3.5%, with **GDP still at around 60% of the pre-war level**. Even assuming continued average growth of 6%, the pre-war GDP level would be reached only in 2011. BiH economic data should, however, be interpreted cautiously, as statistics are unreliable and a large informal economy distorts the picture.

On the external sector side, BiH has always shown large imbalances since the war. Between 1996 and 1999 **trade deficits** averaged around 50% of GDP and about 34% between 2000 and 2002. During reconstruction such deficits may be justified by imports linked to reconstruction aid. However, continuing large imbalances may indicate a structural problem, e.g. inadequate productive and export capacity. Current account deficits also persist: on average above 25% of GDP in 1996 - 1999, and 16% of GDP in 2000 - 2002 despite large remittances from abroad (at around 10% of GDP annually). For 2003, owing to some monetary policy tightening agreed with the International Monetary Fund (IMF), the current account deficit should be around 17.5% of GDP. In the past, BiH has not attracted large flows of foreign direct investment (FDI

- only around €100 million per year until 2001); however recent efforts to improve the investment climate by increasing transparency and reducing administrative barriers led in 2002 to a **doubling of FDI** (to around €200 million), and this should continue in 2003.

As foreseen by the Dayton agreement, a **currency board arrangement** was established in 1997. This has moderated inflationary pressures and led to general acceptance of the common currency, the Convertible Mark (KM) which is pegged to the euro. BiH inflation is estimated at around zero in 2003. An earlier significant inflation differential between the Entities has converged at a low level: in FBiH inflation has been below 2% for the past three years and has consistently decelerated in RS owing to increased economic integration between the Entities. In line with the current IMF programme the Currency Board will remain in place.

Fiscal policy has evolved positively. From high government deficits, poor revenue performance, large off-budget expenditures, payment arrears and high military spending, BiH (essentially the Entities) has achieved significant fiscal consolidation. The consolidated fiscal deficit (including grants) fell from 7.8% of GDP in 1998 to 2.2% in 2002, and should be almost balanced in 2003. Foreign financing of the budget, mostly through grants or concessional loans thus fell from 17% to 9% of GDP over the same period (still the highest share in the Western Balkans). **Public spending** as a percentage of GDP remained very large at 51% in 2002, although declining. The revenue base of the Entities is narrow, deriving mostly from indirect taxes (sales and customs). The tax burden is one of the highest in Europe. The State budget, lacking own revenues, has depended largely on Entity transfers to meet its main responsibility, foreign debt service.

As for **public finances**, the reform of tax and customs administrations with assistance from the Customs and Fiscal Assistance Office (CAFAO), has improved collection and led to the harmonisation of indirect tax rates. Some effort has been made to fight corruption, but much more needs to be done. The management of public expenditure has improved. In 1999 a Medium Term Expenditure Framework system was introduced (although this highlighted under-developed programming capacities). The closure of the Payment Bureaux in 2001 paved the way for the gradual introduction of a Treasury system, currently being implemented and extended to sub-Entity administrations, while the Supreme Audit Institutions (SAI) established in 2000 at all levels have gradually improved the transparency of operations in budgetary institutions. Nevertheless, the fiscal situation remains fragile and needs further attention. Off-budget fiscal resources and expenditures persist, especially in cantons and municipalities. Payment arrears still occur, and the extremely decentralised administrative structure is both cumbersome and costly. The SAI reports recently revealed weaknesses with some of the internal control functions of the budgetary process; these have to be addressed. The institutional capacity for medium-term (multi-annual) budgetary planning needs to be reinforced.

2.2 Price and Trade Liberalisation

Price liberalisation, an Entity responsibility, has progressed. Most prices, including interest rates but excepting some selected public services and primary products (such as wheat and medicines), have been liberalised. More than 95% of prices for goods and services are apparently set by the market. Full exchange rate convertibility was achieved in 1998 with the creation of the Currency Board.

Trade liberalisation has progressed. BiH applied for WTO membership in May 1999 and this process is ongoing. It has also concluded bilateral Free Trade Agreements (FTAs) with all the western Balkan countries, plus Slovenia, Rumania, Bulgaria and Moldova (while talks with the

UN Mission in Kosovo are under consideration). The EU is the main trading partner, accounting for more than 50% of BiH's external trade.

2.3 Privatisation Process

The institutional and legislative framework for **privatisation**, managed at Entity level, was completed as early as May 1998. However, privatisation gathered momentum only in 2000, with most progress limited to small-scale enterprises. As of 2002, 70% of FBiH companies had been sold and 47% in RS. In terms of method, voucher privatisation has now been completed. For large enterprises (with more than 50 employees or around €260,000), privatisation has been slower: at end 2002 only 24% in FBiH and 42% in RS. The greater difficulty has been with large **strategic enterprises** (mining, refineries, tobacco plants, car parts). Notwithstanding international support, at end 2002 only 17 of 56 strategic companies had been sold in FBiH and 4 out of 52 (80 if holding companies are counted) in RS. Lack of political will, social concerns, large enterprise debt, problems of corporate governance and corruption have all discouraged potential foreign investors (who have been more attracted by potential privatisation in Croatia or Serbia and Montenegro). As a result, in 2001 only 40% of GDP was in private hands, well below the 53% average for the western Balkans. This helps explain the lack of domestically generated growth in BiH.

2.4 Financial Sector Reform

Banking sector reform was initially slow, but has recently progressed faster. Legislation on privatisation and liquidation of insolvent banks has been in place since 1998, but due mostly to political resistance and limited interest from foreign investors, the target of privatising all (63) banks by August 2000 was missed (but extended to end 2002 and again until August 2003). The Payment Bureaux were abolished in January 2001. Bank privatisation is now complete in RS, while the six remaining state-owned banks in FBiH are currently in resolution procedures. Due to consolidation and increased competition, the banking sector now comprises 37 banks (27 in FBiH and 10 in RS). It has a large foreign presence (around two thirds of total private capital in FBiH), notably from Austria, Croatia and Slovenia. Starting in 2001 with a gradual increase in minimum capital requirements to ensure viability and subsequently with the creation of a State Deposit Insurance Agency operational from August 2002, the banking sector's legal, regulatory and supervisory framework has improved.

Despite this encouraging record, **long-term lending to the private sector remains very low** in part due to the short-term nature of deposits. Thus, banks still have an under-developed inter-mediation role, although their potential is considerable. Moreover, although interest rates have fallen, they remain high by European standards and the spread between deposit and lending rates is large (around four times EU figures and twice those of candidate countries). High bank commissions reflect a strong risk perception and indicate that banking sector efficiency could be improved. In early 2002 stock exchanges opened in both Entities, but market capitalisation remains insignificant.

2.5 General Evaluation

In general, BiH has developed **sound macroeconomic policies** and made some progress with structural reform. Nevertheless, risks to macro-economic stability remain. Against the background of declining foreign assistance, high current account deficits and a persistent lack of self-sustaining domestic growth (hampered by weak corporate governance and labour market rigidities) could endanger currency stability with potential effects on inflation and the sustainability of debt servicing. On the fiscal front, public expenditure still concentrates on

current rather than investment spending. Also, external public debt is on a downward trend, but domestic public debt, which includes arrears, war damages and frozen currency deposits, has not yet been fully quantified.

Eight years after the end of the war BiH has not reached its pre-war level of GDP. With around €1,300 per capita, GDP is still one of the lowest of the region after Kosovo. The major challenge in the coming years is to achieve **self-sustaining economic development** based on strong private sector growth, increased exports and further fiscal consolidation, especially as foreign assistance declines. Economic growth coupled with the reduction of wasteful expenditure would provide the resources for the institutional reform BiH needs. Although BiH is still not a fully functioning market-economy, it has taken important steps in economic reform and gone some way to meeting the prerequisites for starting SAA negotiations.

3. ABILITY TO ASSUME THE OBLIGATIONS RESULTING FROM A SAA

The SAP has been in operation in BiH since 1999. BiH's initial response to the process was slow and low-key. BiH had difficulty even in completing the relatively undemanding Road Map. In some cases, legislation when adopted was not properly implemented. Recently, fresh determination seems to be in evidence. BiH seems to have taken seriously the annual SAP reports and their recommendations concerning priority areas needing attention. Progress has been made in meeting these recommendations.

3.1 Political Dialogue

Political dialogue in the context of a SAA would aim to increase convergence between EU and BiH foreign policies and promote common views on security and stability in Europe.

In many **foreign policy** areas EU and BiH positions are already comparable and compatible. On major contemporary issues such as regional security and development, anti-terrorism, etc. BiH and EU positions converge. Further convergence seems probable given ongoing parliamentary contacts and the June 2003 Thessalonica decision to establish a high-level EU-Western Balkans Forum and the invitation to BiH and others to align themselves with EU demarches, declarations and Common Positions. In September 2003, as follow up to Thessalonica proposals, a Joint Declaration on Political Dialogue between the EU and BiH was also adopted. Its implementation will intensify political relations and should reinforce the convergence of positions. There will be a number of substantive issues to discuss.

Recently, differences have arisen over policy vis-à-vis the **International Criminal Court** (ICC). BiH is a party to the agreement on the Court, but in June 2003 it also acceded to a bilateral agreement with the US granting all US citizens and all serving and former US military personnel in BiH (including non-US citizens) immunity from extradition to the ICC. The agreement failed to meet the terms of the relevant September 2002 EU Common Position. A pattern of policy choices such as this which do not follow established EU policies would be difficult to reconcile with the privileged position implied by a SAA.

Other developments will in future figure in dialogue. In 2002 the RS military were found to be maintaining illegal surveillance on SFOR; similar activities are suspected on the part of FBiH intelligence services. During 2002 and 2003 it became clear that RS, in contravention of a UN weapons embargo, had commercial contacts with the Ba'athist regime in Iraq. These actions were both in contravention of existing commitments and incompatible with BiH's wider political and diplomatic policies. They suggest that BiH's undoubted official will to converge

with EU positions still needs to be reinforced by structural and systemic adjustment. It is the convergence of individual positions rather than simple declarations which will indicate the extent to which BiH is committed to **alignment with the EU CFSP**.

3.2 Regional Co-operation

Under the SAA Bosnia and Herzegovina would commit itself to active promotion of regional co-operation. It would be required within two years of signature to conclude with all other SAA signatories bilateral conventions with provisions on free trade, political dialogue, mutual concessions on the movement of workers and supply of services, co-operation in justice and home affairs, etc.

As a small state surrounded by neighbours which have in the past had pretensions on its territory and with whom it shares ethnically identical populations, BiH's domestic politics remain unusually sensitive to regional attitudes and developments. Arguably, more than in other states, BiH profits from a benevolent regional environment and suffers from a negative one. Certainly, the demise of the Milosevic and Tudjman regimes has created a more favourable macro-environment for BiH. "Active and constructive development of relations with neighbouring countries", with a focus on Serbia and Montenegro and Croatia, is unsurprisingly one of BiH's foreign policy priorities. In this context, BiH can justifiably claim progress: there is a clear **trend towards normalisation**. In July 2002 the first summit of heads of state of BiH, Croatia and the Federal Republic of Yugoslavia took place in Sarajevo. The meeting resulted in a joint declaration reaffirming the inalterability of borders and further efforts to develop regional co-operation.

Regime change in **Serbia and Montenegro** has facilitated improved relations with Belgrade. Both countries now meet regularly in an Inter-State Co-operation Council. They have reached agreement on issues such as economic co-operation, infrastructure, the protection of citizens' rights and double citizenship. A free trade agreement is in force, consolidating Serbia and Montenegro's position as a leading trade partner. Unsurprisingly, some tensions persist: a case against the Federal Republic of Yugoslavia (now Serbia and Montenegro) for alleged genocide continues at the International Court of Justice, and leading Serbian politicians have (despite the 2002 Sarajevo summit) occasionally questioned BiH's territorial integrity. A "special parallel relationship" between RS and Serbia continues, but does not seem to hinder inter-state relations. Following the murder of Serbian Prime Minister Djindjic in 2003, tensions arose between Belgrade and Banja Luka over follow-up. This contributed to a growing realisation that the interests of Belgrade and Banja Luka are not identical.

Relations with **Croatia** are no less important. An indication of connection, inter-dependence and regional dynamics can be seen in the fact that some 21,000 Croatian Serbs with refugee status still reside in BiH, occupying property in RS. The return of these refugees to Croatia would facilitate a resolution of the problems of remaining internally displaced people within BiH. In general, relations with Croatia have stabilised and gradually improved. The latter has renounced all territorial claims on BiH (including any "special parallel relationship") and has discouraged BiH Croat separatism. Croatia has taken a robust and supportive attitude to the prosecution of corruption (cf. Hercegovacka Banka). A FTA with Croatia, which accounts for 25% of BiH exports, became effective in January 2001. An outstanding issue relates to the port of Ploce and transit through Neum.

Similar improvements have been noted in relations with other countries of ex-Yugoslavia. BiH has met its Stability Pact commitment to negotiate free trade agreements with all its western Balkan neighbours by December 2002 - thus already meeting a future SAA requirement

(although technical incapacities could yet cause difficulties – cf. section 3.3.) Other SAA requirements in relation to bilateral conventions, particularly the requirement for **regional co-operation**, should not pose great difficulties, as BiH has assiduously promoted co-operation within the region. In 2003 BiH assumed the chair of the South East Europe Co-operation Process (SEECOP) and has placed particular emphasis on issues of justice and rule of law. BiH also participates in the Southeast Europe Co-operation Initiative (SECI), the Central European Initiative (CEI) and other regional initiatives.

3.3 Free Movement of Goods

Ensuring free movement of goods is one of the main objectives of an association agreement with the EU. In the framework of a future SAA, BiH would need gradually to establish a free trade area with the Community within a transitional period to be determined during negotiations. The free trade area would have to be in conformity with relevant WTO provisions. In particular, BiH would have to abolish any quantitative restrictions or measures having equivalent effect and progressively dismantle tariffs on essentially all trade with the EU. BiH customs would need to be able to police and safeguard the trade regime.

BiH would forego the introduction of any new duties, restrictions or measures with equivalent effect in trade with the Community. Under the EC's autonomous commercial preferences currently granted to BiH, the latter is already subject to a standstill obligation on import duties and measures having equivalent effect. BiH would also be required to abolish any domestic tax measure or practice discriminating directly or indirectly against EU products. Moreover, BiH's trade arrangements with third parties would have to be conducted in such a way that they did not result in discrimination against the EU.

The free movement of goods has at least two dimensions for BiH - one internal and the other external. It is significant that while almost all BiH political leaders favour access to the EU market, some have been less enthusiastic about advancing the integration of BiH's own internal market. "Removal of all trade barriers between the Entities" was a Road Map requirement, but an **integrated BiH market** has evolved only slowly. While the most egregious physical barriers to trade have been eliminated, further effort is needed to deal with constraints such as multiple customs regimes, differing technical requirements, double registration requirements and differing technical specifications.

Trading relations with the EU are currently defined by the Community's September 2000 Autonomous Trade Measures (ATMs - Council Regulation (EC) No. 2007/2000). This allows more than 95% of all imports (including agricultural produce) originating in BiH to enter the EU duty- and quota-free. In some ways, BiH is well positioned to accommodate a FTA with the EU: a unified customs tariff has applied since 1999; most quantitative restrictions have been eliminated and the BiH nomenclature of goods is fully harmonised with that of the EU. The tariff structure consists of four tariff categories (from 0% to 15%) with a simple average of 6.4%. Given the FTAs which BiH has already concluded and the fact that a SAA would be concluded with an enlarged EU, 90% of BiH trade would in fact be free at the end of a SAA transition period. (Customs revenues would consequently be significantly reduced unless measures were taken to differentiate the revenue basis.) Despite the above, available data suggest that trade with the EU over 2001 - 2002 remained fairly static: BiH exports to the EU were worth around €0.6 billion and EU exports to BiH around €1.3 billion. In other words, over these years BiH was unable to take full advantage of the EU's liberalised trading regime to increase exports.

Technical capacities are part of the problem. BiH cannot yet adequately certify potential exports as meeting Community minimum standards. Even in the case of the FTAs which it has already signed, BiH may have difficulties. In some cases these agreements specify WTO standards and state-level certification capacities which BiH does not yet possess. Other technical adjustments are required: BiH needs to complete customs reform (cf. section 3.7.4.1) and improve its ability to ensure the authenticity of its certificates of origin. It needs to implement the TIR agreement which it signed in the mid 1990s. Further, inconsistencies in the formulation and operation of legislation need to be addressed: the sometimes mutually contradictory provisions of the laws on Foreign Trade Policy, on Customs Policy and on Free Zones need to be tackled. BiH must ensure that free zones no longer provide unregulated back-door entry to the BiH market, potentially undermining any preferential access that would be granted to the Community.

More generally, BiH still lacks a clear and **comprehensive trade policy**. There is a lack of proper analysis because of the absence of reliable data on domestic production, supply needs, etc. There also appears to be little appreciation of the implications of WTO membership. The Ministry of Trade and Foreign Economic Relations (MOFTER) lacks human and material resources. Co-ordination of trade policy with the Entities is inadequate. BiH would have to make significant further progress to meet the exacting standards implied by a SAA.

3.3.1 Trade in industrial goods

BiH has a **trade deficit** with the EU. Declining manufacturing has meant falling export capacity even in traditional products such as clothing, textiles, leather and wood products. Since BiH exports tend to have lower value-added and concentrate mostly on raw materials, BiH is exposed to global commodity price changes over which it has little or no control. Conversely, the trade deficit is made worse by limited and poor quality domestic production. This, combined with strong domestic demand, has driven up import volumes.

The fact that, even with the asymmetrical ATMs, BiH has not been able to take full advantage of liberalised trade with the EU, indicates the extent of the challenge BiH faces. Beyond remedying the technical weaknesses mentioned above, BiH needs to improve industrial competitiveness through better corporate governance, better access to finance and better skills. It needs infrastructure providing information and support services to potential exporters. Also, like other countries in transition, it needs to effect a **structural change** towards an economy with higher value-added in export goods and services, especially in intra-industry trade with EU companies.

3.3.2 Trade in agricultural goods

Agriculture is an important component of the BiH economy, accounting for roughly 12% of GDP. With favourable climatic conditions and fertile soil, BiH should be able to develop significant export potential. Unfortunately, however, agricultural infrastructure is weak, the quality of many BiH products low and marketing capacities limited. These difficulties were, until recently, compounded by the absence of a State Veterinary Office; this has now been created but is not yet fully operational. The framework and system for implementing sanitary and phyto-sanitary standards is weak. Since BiH has been unable to comply with EC Food and Veterinary Office recommendations, it has been unable to export animals or animal products to the EU.

To accommodate the challenges of a SAA in the agricultural sector, BiH needs a programme of **structural adjustment** based on a coherent agricultural policy which identifies and prioritises reform. To realise its export potential and exploit the EU's open market, BiH needs to align its veterinary and phyto-sanitary legislation rapidly on that of the EU. It needs laboratories and certificate bodies able to certify compliance of agricultural goods with EU acquis in this domain. Also, given ongoing WTO accession preparations, BiH must ensure that it can live with minimum duty levels on sensitive agricultural imports in line with WTO rules, while at the same time developing its own agricultural sector.

3.4 Movement of Workers, Establishment, Services, Capital

3.4.1 Movement of workers

A SAA would require both the EU and BiH to ensure non-discrimination as regards working conditions, remuneration and dismissal of workers who are legally established in their respective territories. The legally resident spouse and children of a worker legally employed in the EU or BiH would have access to the labour market during the period of the worker's authorised stay. Furthermore, the EU would be required to apply rules on co-ordination of social security systems to BiH nationals legally employed in the EU and to members of their family legally residing with them. For certain rules, BiH would also have to grant similar treatment to EU nationals legally employed in BiH and to their family members residing with them.

Under separate Entity laws, foreign nationals legally residing in BiH may have access to employment. Nevertheless, such access may be subject to the granting of a work permit and in most cases preference is given to nationals. Thus, BiH does not yet ensure complete non-discrimination for EU workers legally residing in BiH. Moreover, the requirement to apply co-ordinated rules on social security for EU workers could be a challenge, insofar as the BiH social security system remains rudimentary and fragmented.

3.4.2 Establishment

Under a SAA BiH would be required to grant EU companies the right of establishment. This right would be reciprocal. EU companies established in BiH should be granted either national treatment or MFN treatment, whichever is more favourable. Following a transition period, the issue of extending these rights to EU or BiH nationals wishing to establish themselves as self-employed persons would be examined. Notwithstanding the provisions governing the free movement of workers under the agreement, special establishment provisions could be introduced for "key personnel".

Formally, BiH operates a liberal regime on **establishment**. EU companies may already establish themselves and operate within BiH on the basis of national treatment. They have the right to acquire land and property on the same basis as BiH nationals. That more EU companies have not established reflects lingering concerns over stability, a perceived lack of business opportunity and the fact that business registration is complicated - for everybody. Under the "Jobs and Justice" reform agenda, BiH pledged to cut business registration to 15 days by establishing a single business registry system. This reform needs to be complemented by further reforms such as the introduction of harmonised land registry systems which would build confidence in ownership.

A SAA could include provisions allowing a future Stabilisation and Association Council to establish modalities extending the right of establishment to nationals of both Parties, including the taking up of economic activities as self-employed persons. The eventual negotiation of this right would have to take account of migratory pressures.

3.4.3 Trade in services

A future SAA would provide for the progressive and reciprocal liberalisation of trade in services, consistent with relevant WTO rules, in particular Article V of GATS. Companies not established in the territory of the other party would gradually acquire the right to provide services, in accordance with the GATS provisions and taking account, in particular, of progress in legal approximation in the various fields. The implementation of this liberalisation would be monitored under the agreement, notably as regards financial services.

The BiH Law on Foreign Trade Policy specifies national treatment for foreign **service providers** on the BiH market, although this may be subject to the requirement to establish a legal entity within the country. Established foreign service providers are, however, subject to the same regulation and tax regime as BiH nationals. The only other formal constraint on foreign investment in services relates to media (where foreign ownership is restricted to 49%). BiH's relatively liberal approach to service provision is demonstrated by the extent of foreign banking within BiH and the presence of foreign companies in the transport and courier services sector.

While service provision is in theory liberalised, in practice service provision has been complicated by an economy still divided, in some sectors, along Entity lines. For example, while there is a supervisory banking agency at State-level and a BiH independent deposit insurance agency, there is **no unified capital market**. Further, the insurance market is fragmented: FBiH has an independent Insurance Office with supervisory function, while in RS supervision is conducted by the Ministry of Finance. BiH would need to address these limitations if a SAA is to become fully operational.

3.4.4 Current payments and movement of capital

In the framework of a SAA, BiH would commit itself to progressive liberalisation of both inward and outward movement of capital, in particular for direct investments. Protection of investors as regards liquidation and repatriation of investments and profits would also need to be covered. After a transition period the Stabilisation and Association Council could determine modalities for the full application of Community rules on the movement of capital.

Foreign investment in BiH is governed by a Law on Foreign Direct Investment Policy. This eliminates barriers to most investment in BiH, the exception being a limit of 49% of share capital for foreign investment in military-related companies or the media sector. These residual restrictions would not be a problem in an SAA context (and the former is a legitimate exception to the respective freedom within the EU). Moreover, foreign investment in BiH is governed by a "Stability Clause" which allows investors to select the legal regime that will apply in the event of amendments to laws or regulations on foreign investment. This ensures that investor rights cannot be abolished, only enhanced.

The **clearing system** in BiH has advanced to a point where it is comparable to that of modern international banking. Domestic payment transactions within BiH are effected through commercial banks and the Central Bank as the settlements agent. Foreign transactions are conducted through commercial banks. While there are some constraints on foreign transactions

by individuals and non-residents, legal entities may effect transfers abroad and may transfer funds following the partial or complete liquidation of investments in BiH – although this is subject to "the necessary documentation". In addition, it appears inconsistent that exchange rate policy is set by the Central Bank, while exchange control authorisation operates at the Entity level. In SAA negotiations this would complicate the task of identifying which operations are free and which not.

3.5 Approximation, Implementation and Enforcement of Legislation

A SAA would include provisions on the gradual approximation of existing and future BiH legislation to that of the Community. BiH would have to ensure that from the date of SAA signature, approximation would begin to extend to all elements of the Community acquis referred to in the agreement. This would apply particularly to key areas of internal market legislation and trade. BiH would thus have to agree binding deadlines for harmonisation in areas such as: competition, intellectual, industrial and commercial property, public procurement, standards and certification and consumer protection.

Although BiH has already expressed a willingness to approximate to, implement and enforce EU legislation, its ability to do so is complicated by the division of powers between State, Entities and cantons. To implement properly a SAA, BiH would need to ensure an adequate mechanism for co-operation and co-ordination between the Entities in areas of responsibility not vested in the State. In each case there would need to be a unified position vis-à-vis the EU. In terms of implementation and enforcement, this would need to be both effective and consistent in all parts of BiH.

3.5.1 Competition

Under a SAA, BiH would refrain from any measures adversely affecting fair competition. In particular, it would prohibit: (i) all agreements between undertakings and concerted practices which prevent, restrict or distort competition; (ii) abuse by one or more undertakings of a dominant position, (iii) any public aid which distorts or threatens to distort competition by favouring certain undertakings or certain products. BiH would commit itself to ensure transparency in the area of state (i.e. public) aid inter alia by establishing a comprehensive inventory of aid schemes and by reporting annually on the total amount and the distribution of the aid given. It would also provide, upon request, information on particular cases.

The implementation of **competition** legislation has been on the BiH agenda since at least early 2000 when the Road Map advocated the adoption of a Competition Law. The law, now compatible with Community models, was finally enacted in December 2001. Since then the law has, however, remained inoperative because a Competition Council and related units at Entity level have not yet been established.

In the area of **state (public) aids**, BiH falls significantly short of future SAA requirements. The existing competition law contains no provisions on state aid - and indeed no aid is given at State level. Nevertheless, the Entities provide public assistance either to enterprises or sectors (e.g. mining in F BiH and agriculture in RS). So far there is no authority overseeing this assistance, no inventory of aid and no systematic reporting. Under a SAA this would need to be rectified.

3.5.2 Intellectual, industrial and commercial property

Before the end of a transition period, BiH would need to ensure effective protection and enforcement of intellectual, industrial and commercial property rights, including protection against counterfeiting and pirating. BiH would need to guarantee a level of protection similar to that existing in the Community. It would also need to accede to a number of multilateral conventions to which EU Member States are party or which are applied in the Community de facto.

Although BiH has already acceded to a number of international conventions (e.g. the World Intellectual Property Organisation), it is currently poorly placed to meet the requirements of a future SAA. Laws on **industrial property** and on **copyright and related rights** exist and an Institute for Standards, Metrology and Intellectual Property is partly operational. Nevertheless, forgery and piracy are widespread. Unhelpful popular attitudes toward piracy, imprecision in existing laws, a lack of qualified institutional staff (nobody currently covers copyright issues), limited technical resources, a lack of specialised courts and poor co-ordination with enforcement agencies mean that BiH is currently unable to provide acceptable protection in this area. This weakness already contributes to BiH's persistent failure to attract foreign investment. On current form, BiH would find it difficult to meet this SAA requirement.

3.5.3 Public procurement

Under a SAA, BiH would be required to ensure that EU companies could bid for public contracts on the same basis as those from BiH. BiH would need progressively to align its public procurement legislation on that of the EU. It would also need to strengthen the relevant institutions and judiciary in order that public procurement procedures are properly implemented.

BiH still lacks State-level **public procurement** legislation. Currently, procurement is carried out on the basis of separate State, Entity and Brcko District legislation. Separate legal instruments with differing legal status mean that BiH's public procurement framework is insufficiently robust to provide for a clear, rules-based environment compatible with EU acquis. However, a State-level Public Procurement Law compatible with EU legislation is in preparation. The law foresees a new public procurement agency and a procurement review body. In this area BiH would need to ensure that legislation is complemented by adequate financial and technical resources that can ensure effective implementation. Trained personnel would be required for both the agency and the review body. An adequately trained and specialised judiciary would also be necessary.

3.5.4 Standardisation and conformity assessment

To comply with a SAA, BiH would need gradually to achieve conformity of its legislation with EU technical regulations and with practices of European standardisation, metrology, accreditation and conformity assessment. In particular, it would be required to: (i) foster the development of a standards, certification and quality infrastructure, (ii) promote the use of technical regulations and conformity assessment procedures compatible with Community rules and procedures, (iii) promote BiH participation in the work of relevant European and international organisations, (iv) when appropriate, conclude agreements with the EC and the European Economic Area (EEA) on conformity assessment and the acceptance of products.

BiH inherited legislation from the former Yugoslavia, but after independence the Entities initially developed laws and regulations and established new institutions independently of each

other. Now, BiH has a Metrology Law based on European models; a State Law on Measuring Units has been introduced and a legal basis for standards has been created through a State Law on **Standardisation**. Under these laws a new BiH Institute for Standards, Metrology and Intellectual Property was established. While the institute handles certification and conformity assessment, it has neither the facilities nor the power to conduct market surveillance and it remains under-developed in terms of organisation. It still has no permanent director and in all sectors, resources are limited and staff few. A State-wide law on conformity assessment and related regulations is required.

Reportedly, only four BiH companies currently have the capacity to attach the CE marking necessary for industrial exports to the EU. Others use original EU directives and **conformity assessment** infrastructure within the EU Member States. BiH needs to develop technical capacity in this field.

3.5.5 Consumer protection

Effective consumer protection is needed to ensure that the market economy functions properly and that its benefits are maximised for consumers. This depends on the development of an administrative infrastructure which can ensure market surveillance and law enforcement. In order to meet obligations under an SAA, BiH would need to: (i) develop active consumer protection policies, in accordance with Community law, (ii) harmonise legislation on consumer protection, (iii) establish independent and effective administrative structures and enforcement powers to ensure essential health and safety requirements, and (iv) ensure consumer representation, information and education.

State-level **consumer protection legislation** has existed in BiH since 2002 - this was a Road Map requirement. Nevertheless, effective consumer protection remains more an aspiration than a reality as the requisite organisational and administrative infrastructure remains incomplete. The Council required under the 2002 legislation has not yet been established. Consumer associations are, however, beginning to emerge.

3.6 Justice and Home Affairs

With significant international input and support, BiH has begun to address the weaknesses of its various system(s) of justice and home affairs. For too long, ethnicity, geography and personal contacts were the major determinants of justice in a fractured legal system. Crime, both opportunist and organised, became widespread, and corruption put deep roots into the social, economic and political fabric of society. The full implementation of the **legal and judicial reforms** currently underway will determine whether BiH can establish rule of law and due process. The guarantee of a reliable and predictable legal space is a pre-condition for the operation of an effective SAA.

3.6.1 Reinforcement of institutions and rule of law

Under a SAA the contracting parties would attach particular importance to the consolidation of the rule of law and the reinforcement of institutions at all levels in the areas of administration in general and law enforcement and the machinery of justice in particular.

3.6.1.1 Police

Police forces in BiH are organised on a number of levels: there are 10 FBiH cantonal police forces, one Brcko, one FBiH and one RS police force, the SBS, the State Information and Protection Agency (SIPA), judicial police and financial police. Thus, in a country of under four

million inhabitants, **police forces** consist of around 17,000 staff, costing around €180 million per year. Obviously, the complexity of the existing multiple police forces increases costs and complicates co-ordination and effectiveness. Police co-operation has improved (e.g. RS police co-operation in bringing an important trafficking case to the State Court was good), but numerous operational difficulties persist: police forces in one Entity have no right of "hot pursuit" into another; there is no central data base, different Entity forces use different information systems. Costs are high because of duplication in areas such as training and equipment. Financial and technical constraints limit crime fighting abilities.

In both Entities and Brcko District, police **reform is ongoing**. Since January 2003 an EU Police Mission (EUPM) has worked to establish and consolidate sustainable policing arrangements under BiH ownership in accordance with best European and international practice. The EUPM mentors, monitors and inspects with the aim of enhancing police managerial and operational capacities. The exercise of appropriate political control over the police is monitored. In operational terms, EUPM priorities are to develop an intelligence-led approach to fighting organised crime and to reinforce returnee security. As a result, BiH policing has improved: professionalism has increased, management capacity has grown and co-operation between police services and other enforcement agencies (e.g. SBS and customs authorities) has developed. The creation in 2003 of a new State-level Ministry of Security is also welcome. Though still in its infancy, the ministry will have responsibility for State-level concerns such as border control and counter-terrorism (i.e. SBS, SIPA and Interpol). The ministry should facilitate inter-Entity co-operation; its full operational capacity must be quickly ensured.

However, to fight crime, **further reform and enhanced State-level enforcement capacity are needed**. Intelligence gathering needs to be improved, for example by quickly making SIPA fully operational. Also, BiH must now consider further restructuring and rationalising police services in order to enhance efficiency and improve crime fighting capabilities.

A reform leading to the creation of a State-level intelligence and security service is underway.

3.6.1.2 Judiciary

The **judicial system** in BiH was long sub-standard. In contrast with Brcko District where the entire legal and judicial system was relatively quickly overhauled, both FBiH and RS persistently accommodated incompetence and corruption within their legal and judicial systems. Judges and prosecutors were subject to pressure both from political leaders and from criminals. Basic judicial infrastructure was poor, lacking proper equipment, records and access to information and modern legal practice. Moreover, since the BiH legal space was split between Entities and Brcko, justice was easily avoided; judicial decisions in one jurisdiction were seldom enforced in another.

Reform has begun. In February 2002 a comprehensive **judicial reform strategy** was inaugurated. Despite a constitutional challenge by the RS National Assembly, High Judicial and Prosecutorial Councils (HJPCs) at State and Entity levels with both national and foreign members were established with the task of overseeing the appointment of judicial staff. Simultaneously, a reform of the court structure and of prosecutors' offices was inaugurated, cutting the number of courts and judges. If it wishes to demonstrate full ownership of this reform, BiH must proceed with the establishment of a single BiH HJPC and must properly support the centres for judicial and prosecutorial training.

A further important reform was the creation of a **BiH State Court and State Prosecutor** (again initially challenged by the RS). The State Court has criminal, administrative and appellate divisions and a number of Special Panels, including those for Organised Crime, Economic Crime and Corruption. It is staffed by both national and international judges. First cases have already been transferred to the Court. The Court will fill a legal lacuna by dealing with issues (e.g. asylum and immigration cases) which are within the competence of the State. Also, it should create a further bridge between the judicial and legal systems of the Entities. The 2003 creation of the State Ministry of Justice charged with ensuring international and inter-Entity co-operation on legal matters is also significant, although this ministry also faces personnel and resource shortages.

The highest level of judicial authority is the **BiH Constitutional Court**. Despite Road Map recommendations, the Constitutional Court has been persistently short of resources and for more than a year it was reduced to inactivity because of the failure of RS to appoint Serb members. Despite these difficulties, the Court enjoys authority and has become a respected arbiter.

Since the EU is a community governed by rule of law, it is essential that in the context of a SAA BiH be able to guarantee the operation and effectiveness of an impartial judicial system. The currently ongoing reform must therefore be adequately resourced and quickly and successfully completed.

3.6.1.3 Prison system

The rule of law can be guaranteed only if BiH has a reliable system of sanctions. Imprisonment is currently the only real sanction foreseen in BiH, although alternatives such as community service are under consideration. Despite the introduction of a State Court dealing with State-level crime, no **prison** arrangement exists at State level.

3.6.2 *Visa, border control, asylum and migration*

Both bilaterally and at regional level, BiH would need a framework for co-operation in the fields of visa, border control, asylum and migration (legal and illegal). A central element of co-operation in the area of preventing and controlling illegal immigration would be the inclusion of provisions on readmission.

In summer 2003 BiH adopted a new Law on the Movement and Stay of Aliens and Asylum, replacing an unclear 1999 Law on Immigration and Asylum. Effective implementation of the legislation requires the establishment of a responsible unit or sector dealing with these issues under the Ministry of Security. The current **visa regime** determines countries whose citizens need / do not need visas for entry. Currently, the nationals of 38 countries may enter BiH with only ordinary passports. Other nationalities may enjoy temporary visa-free regimes, for example to promote tourism during the summer months. In general, BiH visa policy has been gradually aligned on the Community visa list (e.g. introduction of visa requirements for Iran and Saudi Arabia), although some important differences remain (e.g. nationals of Russia, Qatar, Kuwait and others may still enter visa-free). Further, the operation of the BiH visa regime faces important administrative challenges: it is not clear that the technical infrastructure for checking visa applications is foolproof.

The enforcement of a visa regime is impossible without effective **border control**. Here, BiH has made progress, notably since the creation of the SBS. In September 2002 SBS assumed control of all BiH's official international border crossing points. SBS has co-operated with

interior ministries and police and with customs administrations to improve border management. It has addressed and, reportedly, significantly reduced human trafficking and illegal migration through BiH. The comparative effectiveness and efficiency of the SBS distinguishes BiH favourably from some of its regional partners.

Asylum is a new challenge for BiH; until recently, the focus was almost exclusively on refugee returns and their reintegration into BiH society. The country is by succession a party to the 1951 Convention relating to the Status of Refugees and its 1967 Protocol. Asylum issues are now governed by the new Law on the Movement and Stay of Aliens and Asylum. The unit dealing with asylum issues within the BiH Ministry of Security foreseen by the law is not yet operational. BiH therefore does not yet have a functioning asylum system. It is the United Nations Refugee Agency (UNHCR) which conducts refugee status determination. UNHCR hopes to hand over this responsibility to BiH by the end of 2004.

Under a SAA contracting parties would agree to co-operate to prevent illegal immigration. To that end BiH would have to agree to re-admit any of its nationals illegally present on the territory of an EU Member State and conclude an agreement as regards third country nationals and stateless persons. EU Member States would accept similar obligations. **Readmission negotiations** have been completed with Italy and opened with Sweden, Denmark, Slovenia, Rumania and Serbia and Montenegro.

3.6.3 *Combating money laundering*

BiH would need to establish a framework for co-operation aimed at preventing the use of its financial systems for laundering the proceeds of criminal activities. Co-operation in this area would include administrative and technical assistance aimed at establishing appropriate standards to counter money laundering equivalent to those adopted by the Community and other international bodies in this field, in particular the Financial Action Task Force (FATF).

Money laundering is a serious problem, but one which BiH is only beginning to address. BiH figures suggest that €1.5 billion may be laundered annually through fictitious companies and dedicated bank accounts. The BiH Criminal Code identifies money laundering as a crime (but only recently has FBiH begun to treat it as more than an administrative offence). Currently, a number of bodies deal with money laundering concerns: SBS, the Entity Banking Agencies, the revenue police, the FBiH Tax Authority and the RS money laundering division of the Finance Ministry - but the work of these bodies needs to be better co-ordinated.

In both Entities and Brcko District, laws now oblige bank and financial institution employees to report suspicious transactions; every transaction over KM30,000 (around €15,000) must be reported to the revenue police who check its legitimacy. A former favourite method of money laundering was through the establishment of **fictitious companies**. New registration procedures have made this more difficult, and the recent identification in the Official Gazette of unused accounts has also had a discouraging effect on launderers. While these are welcome developments, other businesses providing a money or value transfer service (e.g. gambling and casinos, foreign currency exchange, insurance, real estate, etc.) should arguably also be subject to licensing, registration and monitoring. These issues are addressed by an Action Plan against money laundering which all relevant agencies now need to implement.

3.6.4 *Preventing and combating crime, combating illegal trafficking and illicit drugs*

BiH should develop a framework for co-operation aimed at fighting and preventing criminal and illegal activities, notably organised crime. BiH should devote particular attention to issues

such as trafficking in human beings, illegal economic activities (i.a. corruption, illegal transactions, illicit arms trafficking and terrorism. BiH would also need to be able to cope with the health and social consequences of different forms of drug abuse, preventing the diversion of chemical precursors and introducing and / or reinforcing structures for combating illicit drug trafficking

BiH has begun to address crime in general and corruption in particular. Parliament passed a Law on Conflict of Interest within the institutions of government; the Civil Service Law details actions that could pose conflicts of interest and within the new Ministry of Security work has begun on drafting an anti-corruption strategy. The State Prosecutor's Office has begun work on a number of **high-level criminal cases**, bringing several to successful conviction. Also, the Special Panels in the State Court are about to begin work, including a trial of the biggest case in human trafficking BiH has yet seen.

The fight against crime will, however, be long because of a symbiotic relationship between crime, business and politics. **Corruption** has both seriously affected BiH's economic performance and brought its politics into disrepute. Recent examples include Hercegovacka Banka in FBiH which reportedly embezzled millions, and the electricity generating companies (Elektroprivreda) where audits revealed, particularly in RS, misappropriation, conflicts of interest and mismanagement on a grand scale.

Organised crime is a major problem. Smuggling of high-tariff goods such as cigarettes, alcohol, petroleum products is widespread. BiH figures put losses due to customs fraud and smuggling at €150 - €300 million per year, roughly equivalent to the annual state budget. Drug traffickers have exploited BiH's (now less) porous borders, divided legal jurisdictions and weak customs controls. They have used BiH mainly as a country of transit to western Europe. Drug smuggling persists. The smuggling of migrants through BiH has diminished thanks to the work of the SBS. However, sophisticated **people trafficking** networks, dealing also in women for sexual exploitation, continue to push victims both to and through the country. In this connection, the 2003 US "Trafficking Persons Report" bracketed BiH among the worst offenders. Nevertheless, BiH subsequently avoided sanctions because, the US noted, it had taken "quick action to address problems". Symptomatically, however, as follow-up to the November 2002 London conference on organised crime, BiH presented two separate and apparently uncoordinated records of achievement by two different State ministries. The Ministry of Security co-ordinated the drafting of an action plan to deal with organised crime; the latter was adopted in October 2003.

Within BiH, **terrorism** has mostly been targeted at returnees or politically undesired minorities in particular regions. Probably, attacks on individuals or families are the result of localised grievances rather than co-ordinated actions. Also, the number of localised attacks has been declining. In terms of "international terrorism", there is evidence that some "charities" operating in BiH have had connections with terrorist organisations, but when identified they have been closed down. To date no attacks on international interests in BiH have been registered. Following the events of 11 September 2001 an anti-terrorism co-ordination team was established. It worked efficiently, but was not immediately re-established under the current Council of Ministers. BiH, like others, is challenged to see that the rights of terrorist suspects are respected.

In all areas related to justice and rule of law BiH is challenged to **improve inter-agency and inter-Entity co-ordination and co-operation**. Within BiH there is still no common information system either for the police or the judicial and prosecutorial systems. Since SIPA is not yet operational there is no formal agency at State level to process criminal information;

intelligence sharing depends on the good will of the agencies involved. In issues of justice and home affairs, as in others, improved co-ordination within BiH is needed to act effectively and to make co-operation in a SAA context meaningful.

3.7 Co-operation Policies

A future SAA would mean the establishment of close co-operation in a wide range of areas. Co-operation would be designed to provide EU policy guidance and assistance and to promote economic and social development within BiH. It would not be limited to bilateral EU - BiH co-operation, but would also take place within a regional framework. Thus, special attention would be devoted to measures which foster co-operation between BiH and its neighbours and promote regional stability.

3.7.1 Economic, monetary and statistical co-operation

BiH should foster reform and economic integration into European structures by improving the formulation and application of market-based economic policies. It should improve its capacity to provide information on macroeconomic performance and forecasts, to formulate economic policy and to develop the instruments necessary for its application. It should also take appropriate account in its policy development of the EU's economic and monetary union. BiH should develop a statistical system, capable of providing the timely, reliable, objective and accurate data needed to plan and monitor transition and reform.

In the context of its over-arching policy objective of integrating into EU structures, BiH needs to formulate a **coherent medium- to long-term economic strategy**. Here, it has already taken some steps by identifying policy priorities. In co-operation with the World Bank, a Co-ordination Board for Economic Development and EU Integration, made up of the BiH Council of Ministers and Entity representatives, has overseen the formulation of a Poverty Reduction Strategy Paper (PRSP) which is based on wide consultation. This effort has, however, underlined BiH's need to develop further sound analytical capacities both within and outside government; BiH needs an improved ability to analyse and predict the implications of policy decisions both within and across sectors. This is arguably an area where BiH government could co-operate fruitfully both with its own academic community and with EU experts in the context of a SAA.

A number of difficulties will however constrain effective co-operation. First, the prevalence of the **grey economy** is a distorting factor. Admittedly, the grey economy has functioned as social safety net for the otherwise unprotected in a dysfunctional economy. Further, it demonstrates hidden economic vitality and growth potential. Nevertheless, the grey sector (estimated by some at about 40% of total BiH economic activity) renders effective policy formulation difficult and distorts regional and international economic co-operation by undermining a level playing field.

Secondly, the chronic and persistent **weakness of BiH statistics** cannot be ignored. In October 2002 the High Representative imposed a Law on Statistics, assigning greater authority to the State statistical office (BHAS) and obliging Entity statistical institutes to align their methodology, standards and practice with those of BHAS. The latter should produce State-level statistical indicators. However, progress has been worryingly slow. Currently poor (or non-existent) State-level statistics make both coherent policy-making within BiH and the proper conduct of trade relations impossible. Full implementation of this law would be essential for a SAA.

3.7.2 *Investment promotion and protection, industrial co-operation, small and medium-sized enterprises, tourism*

BiH should aim to create a favourable climate for private investment, both domestic and foreign, in order to promote economic and industrial revitalisation. In the fields of industrial co-operation, SMEs and tourism, BiH should develop policies aimed at promoting the modernisation and restructuring of industry, the reinforcement of the SME sector and the development of tourism.

Given its low levels of domestic investment and declining foreign assistance, BiH acutely needs **foreign direct investment** (FDI). Admittedly, legal impediments to FDI are few. However, to improve further the business environment and support industrial co-operation, disincentives and structural impediments need to be removed: lack of commitment to privatisation, complicated company registration procedures, high enterprise debt, labour rigidities, an unclear fiscal framework, poor corporate governance, the high cost of utility services, etc. Important progress was made with the OHR-led "Bulldozer Initiative" which dismantled barriers to enterprise through a bottom-up approach. The initiative, which is continuing under a BiH lead, should evolve into a form of business advocacy.

Obviously, modernisation of the BiH economy must focus not only on FDI and on restructuring large public enterprises, but also on freeing the growth potential of indigenous **small and medium-sized enterprises** (SMEs). BiH has committed itself to implement the European Charter for Small Enterprises. However, BiH still needs a common SME definition and harmonised registration procedures at the lowest possible level. Further, company taxation should arguably be such as to encourage start-ups. Business advocacy needs to be improved, giving SME stakeholders a voice on proposed legislation. The BiH financial sector, though much improved, needs to become more responsive to business needs by developing suitable financial instruments (e.g. guarantee schemes). Finally, the EU needs a central interlocutor with whom to discuss SME policy and possible future integration into relevant Community programmes.

Tourism has growth potential in BiH, but would require investment in advertising and infrastructure development. The definitive elimination of all land mines is essential. Know-how transfer and the study of possible joint operations could be developed under a SAA.

3.7.3 *Agriculture and agro-industrial sector*

BiH should aim to modernise and restructure its agriculture and agro-industrial sector. In particular, co-operation could include: (i) development of private farms and distribution channels, methods of storage and marketing, (ii) modernisation of rural infrastructure (transport, water supply, telecommunications), (iii) improvement of productivity and quality using appropriate methods and products; (iv) training and monitoring in the use of anti-pollution methods in connection with inputs, (v) development and modernisation of processing firms and their marketing methods, promotion of industrial co-operation in agriculture and the exchange of know-how, and (vi) development of co-operation on animal and plant health in the form of assistance for training and the organisation of controls with a view to gradual harmonisation with Community standards.

As indicated in section 3.3.2, **agriculture** contributes about 12% of BiH GDP. It employs around 18% of the total BiH population. Given its liberal trade regime, BiH is a significant importer of agricultural and agro-industrial products. This is because the agricultural sector suffers from an outdated and disconnected structure and is, moreover, constrained by

uncertainties over land ownership. Productivity is very low and little is produced for non-domestic consumption. Capacity utilisation is low; the proportion of unused land is high (reportedly, 50% of arable land in FBiH and around 30% in RS.) Livestock farming is reportedly also in decline. Laboratory cover and certification arrangements are patchy and below international standards. For BiH agriculture to realise its potential, reform is required. For example, a coherent and complete land registry system is a priority in order to eliminate doubts about ownership and thus improve the investment climate.

Unfortunately, the agricultural sector provides a good example of the pernicious effect of BiH's poor statistical base: inadequate and un-coordinated data collection hamper analysis and thus the formulation of policy options. It is, for example, not clear that existing Entity agricultural policies in favour of subsidies designed to achieve self-sufficiency in agriculture and food production are justified in the long term. Under a SAA, BiH would need to maintain a policy dialogue on these issues. Especially, in the light of the EU's 2003 decisions to begin decoupling agricultural subsidies from production, the BiH Entities would need to present policy positions based on a more transparent analysis and a clear economic rationale.

3.7.4 *Customs and taxation*

3.7.4.1 Customs

BiH needs to ensure that it has a customs service able to meet the demands resulting from the liberalised, preferential trade implied by a SAA. In particular, BiH would need a unified customs service with efficient management and investigation methods. It would need to establish relevant cross-border infrastructure, develop interconnections with the transit systems of the Community, ensure proper revenue collection, simplify inspections and formalities in respect of the carriage of goods, and introduce modern customs information systems.

The BiH constitution identifies **customs policy** as a state responsibility (art. III.1.c). In practice, however, administrative authority and revenue collection were with the Entities. BiH thus developed several occasionally competing customs services. With assistance from CAFAO, separate but co-operative Entity customs services were established. Identical tariff rates were established, enforcement capabilities developed, compatible communications and computer systems introduced and detection and collection rates improved. Over time this resulted in improved revenue collection, despite the gradual introduction of free trading agreements.

Despite these achievements, political interference and a lack of management will to enforce the law allowed fraud and customs evasion to persist, undermining the putative BiH single market and BiH's ability to police effectively a preferential trading regime. In response to these weaknesses and to international pressure, an Indirect Tax Policy Commission developed a draft law on an indirect tax system covering customs revenue and VAT. The law, when implemented will mean the collection of indirect taxes at State level through an **Indirect Tax Authority** (ITA). Agreement was found among State and Entity representatives even on contentious issues such as the location of ITA headquarters (Banja Luka), the ITA regional structure, etc. The law has been approved by the Council of Ministers, but awaits parliamentary adoption. The implication of the legislation is groundbreaking insofar as BiH public finances would no longer depend exclusively on Entity transfers and the BiH Ministry of Finance would have a role in policy formulation. The law would thus constitute a major advance towards EU practice; it would improve fiscal sustainability, help combat fraud,

support the internal BiH market and significantly upgrade BiH's ability to sustain a future SAA with the EU.

3.7.4.2 Taxation

Co-operation with the EU should facilitate reform of the BiH fiscal system and help develop the tax administration in order to ensure effective tax collection. The fight against fiscal fraud in BiH should remain a priority.

Taxation too has been an Entity competence. Like customs duties, taxes have been variably collected and widely avoided. At present, the tax base throughout BiH is narrow, meaning high rates for those who pay (often driving legitimate business into the grey sector). Revenue, however, is weak and based on consumption and imports. There is only limited use of direct or property tax. Further, the division of responsibility for taxation among the Entities led to the setting of different taxes and different rates (corporate tax at 30% in FBiH and 10% in RS; sales tax varying between 20% and 8% depending on location and type of good or service). While tax differences may be justified by competition, the existence of Entity jurisdictions has often led to double reporting requirements and some double tax imposition.

The fiscal system thus has **a number of weaknesses**: it has provided disincentives to investors, facilitated evasion and undermined the single market. It has also meant that there is no overview of the fiscal stance, there is no consolidated government account and only partial accounting. Revenue has been too weak to ensure the smooth functioning of public services or to allow capital investment.

In part, to address these weaknesses, the introduction of **value-added tax (VAT)** has been proposed and adopted as government policy. VAT will be introduced at State level to minimise evasion, maximise revenue and meet EU acquis. The plan is for VAT receipts, like customs revenue, to be paid into one account from which disbursement will go first to the State and subsequently to the Entities. This would reverse the current order of call and should guarantee adequate revenue for the State. The aim is to introduce VAT in 2005. Final approval of the law on the ITA needs to be given quickly by parliament and planning needs to advance to meet the 2005 deadline.

3.7.5. *Employment, social policy, education and training, research and technological development (RTD)*

3.7.5.1 Employment and social policy

Co-operation in this area should aim at supporting BiH in reform of employment policy, labour law and social security. The focus would be on upgrading job-finding and career advice and promoting local development. Back-up measures would be provided to encourage a functioning social dialogue at all levels. Labour law should facilitate industrial restructuring and improve the level of health and safety protection for workers. Regarding social security, BiH would need to adapt its social security systems to the evolving economic situation and new social requirements.

Based on the number of people registered at employment offices, the unemployment rate in BiH is around 40%. However, data from a Living Standards Survey indicate much lower levels of **unemployment** and suggest that it is highest among young people. The reason for this discrepancy in figures probably lies in the large number of people who are active in the "grey", i.e. unregistered sector. Entity level legislation governs working conditions, but the effect of

existing norms is limited by economic debility and the prevalence of activity in the informal and thus unregulated sector. In practice, BiH employment standards thus diverge significantly from those of the EU. Social policy and social assistance are also fragmented and in both Entities constrained by limited resources.

EU - BiH co-operation in this area would aim to improve the level of health and safety protection for BiH workers, using as a reference the level of protection existing within the EU. A further important reference tool will be BiH's Poverty Reduction Strategy Paper. While a number of actions have been undertaken, future co-operation could concentrate on creating the conditions which would encourage the incorporation of currently unregulated activity into the formal and registered sector. Gradual **regularisation of employment** would allow the collection of taxes (providing funds for social programmes) and the enforcement of minimal social norms. It would also provide a coherent overview of BiH employment situation and would allow BiH's (still rudimentary) job-finding and careers services to concentrate limited resources on the most important issues.

3.7.5.2 Education and training, RTD

In education, training and RTD, co-operation could aim to help BiH raise the level of general education, higher education and vocational training. It would aim to promote youth co-operation. It could also encourage the development of an environment conducive to research, notably through joint RTD ventures and the transfer of technology and know-how.

In 2000 / 2001 97% of BiH primary school age children were enrolled in school, but only 56% in secondary education. The overall **quality of education** was negatively affected by the war through the destruction of infrastructure and the collapse of the economy. World Bank estimates suggest that spending on primary education is around 2.7% and on secondary education around 1.4% of GDP. BiH figures suggest that almost 90% of the FBiH education budget goes on teacher salaries, leaving almost nothing for investment in infrastructure, training, etc. Unsatisfactory funding means low social status for teachers and general dissatisfaction in the education sector. This has been compounded by ethnic divisions (some schools have provided segregated teaching under one roof), by outdated teaching methods and by text books containing ethnically offensive language. **Vocational training** is also known to be inadequately tailored to labour market needs. Because of the war and economic weakness, **RTD** capacity is extremely limited in BiH. Researchers and academics have left in large numbers. Nevertheless, BiH has been active in the field of international scientific co-operation, including co-operation with the EU. In 2003 BiH submitted a number of proposals under the 6th Framework Programme for RTD.

Reform of the education sector has been complicated by the absence of a co-ordinating State-level ministry of education. Nevertheless, important reform, including the de-politicisation of education, has begun. In November 2002 education authorities at Entity level agreed five pledges on "Education Reform" with the PIC. An important element of this agenda was the adoption in June 2003 by the BiH parliament of a **Framework Law on Primary and Secondary Education**. The law creates a single system of certificates and diplomas and allows the transfer of pupils throughout BiH. It established a common core curriculum for all schools and introduced it for the 2003 – 2004 academic year. In September 2003 BiH signed the **Bologna Declaration**. This is an important development since participation requires structural reform of university governance, management and finance. The **TEMPUS programme** assists BiH higher education in the process of reform through co-operation with higher education institutions in EU Member States.

3.7.6 Culture, audio-visual, telecommunications and postal services, information society

3.7.6.1 Culture and audio-visual

An SAA could promote cultural co-operation, notably with EU Member States and with neighbouring countries, with the overall objective of increasing mutual understanding. In the field of audio-visual, BiH should take steps to promote the European audio-visual industry and encourage co-production in the fields of cinema and television. It would also need gradually to align its policies and legislation with those of the EC, including on matters of cross-border broadcasting and the acquisition of intellectual property rights for programmes and broadcasts by satellite or cable.

BiH has not yet ratified the Council of Europe **Convention on Trans-frontier Television**, but, reportedly, adheres to its provisions. BiH has also accepted the need to align with the EU's **Television without Frontiers** directive. In terms of regulatory bodies, BiH is comparatively advanced in that it has an independent Communications Regulatory Agency (CRA) responsible for issuing licences to the electronic media and overseeing respect for rules and standards in broadcasting. The CRA is financially and organisationally distinct from the Ministry of Communications, but BiH needs to ensure that the independence of the CRA is maintained.

Proper co-operation in this area will also depend on a number of further reforms. Intellectual rights are governed by a BiH Law on Copyrights and Related Rights, legislation which was drafted in line with European practice. However, enforcement is poor. The **Public Broadcasting System** (PBS) largely respects the provisions of the law, but the same cannot be said of all commercial broadcasters. A further concern relates to the realisation of public broadcasting itself. Although this was a Road Map requirement, the viability of PBS remains under acute threat from financial weakness and an inadequate legislative basis. BiH must urgently accompany legislative change with significant PBS restructuring if it is to ensure the survival of the public broadcasting system.

3.7.6.2 Telecommunications, information society, postal services

Co-operation under an SAA could be used to expand and strengthen co-operation in telecommunications and postal services and gradual alignment with the acquis. This would involve, in particular: (i) the development of legal and regulatory aspects of telecommunications and postal services, (ii) if necessary, the progressive liberalisation of the sector, (iii) the promotion of an investor-friendly environment for the modernisation of the telecommunications network and integration into European and world networks, (iv) institutional reforms suitable for a liberalised environment and (v) the promotion of European standards and regulatory approaches. BiH should also aim at the progressive development of the information society, including co-operation in the area of electronic communications infrastructure.

The current legal framework for **telecommunications** is set by a Communications Law of September 2003. The law is reportedly compatible with European standards. An independent regulatory body exists, and a new State ministry dealing with communications (and transport) was established in 2003. There are three Entity-based telecom service providers (Telecom RS, Telecom BiH and HPT Mostar) which have de facto monopolies of fixed network operations on their own territory. Recent audits of the three companies revealed alarming patterns of mismanagement and incompetence, leading to great financial losses. In RS there are 20 fixed line and 19 mobile telephones per 100 inhabitants. In FBiH the corresponding figures are 26 for the fixed network and 20 for mobiles. There is some competition within the mobile sector

(where each operator is required to provide state-wide coverage within three years), and this provides some competition to the fixed network monopolies. Although pricing remains under Entity government control, there are no formal restrictions on foreign investment or ownership. While the process of liberalisation has thus begun, the Council of Ministers has stressed the need for further measures leading to more competitive service provision. Further liberalisation would help BiH accelerate the availability of good quality communication services and the take-up of information and communication technologies. A SAA would imply alignment with the European approach to regulation of the sector and promotion of its use. Compliance with this part of a SAA should not impose insuperable problems, but would require a readiness to address identified weaknesses and a willingness to participate (perhaps as observer) in the EU's existing mechanisms for this sector.

E-business still plays a minimal role in BiH. The country urgently needs a common e-signature law to facilitate such business. Internet access has grown from a low base. Estimates suggest that few citizens have direct, but increasing numbers have indirect access. Access by government bodies remains low.

Postal services in BiH are currently delivered by three operators which are restricted to their respective geographical areas. Legislation on a BiH Post Office has been drafted, but not yet approved. Privatisation of the RS Post Office has begun.

3.7.7 *Transport*

In transport, co-operation should contribute to the restructuring and modernisation of the BiH transport system and improving related infrastructures, improving the free movement of passengers and goods, achieving standards comparable to those prevailing in the Community, aligning BiH transport legislation with that of the EC, and allowing progressive mutual access to the EU and BiH transport markets and facilities.

Much of BiH's **transport infrastructure** has been repaired since the war. However, if BiH is eventually to reach operating standards comparable to those in the EU and to survive in an increasingly competitive environment, further substantial upgrading is required. Structural improvements are needed in roads, railways, river transport, and aviation. An example: due to administrative complications a rail journey across BiH still requires railway engines to be changed. Improvements will require both co-ordination of the various actors involved through a long-term transport strategy (currently lacking) and investment (at a time when international donor funds are declining).

BiH has begun to address some of the challenges, including those associated with a SAA. Road transport services prices are set freely and there is market competition. As regards air transport, a Civil Aviation Law has been passed. BiH is now a member of the International Civil Aviation Organisation (ICAO) and a Directorate-General for Civil Aviation exists at State level. (A Director-General was appointed in October 2003 after lengthy delays.) To minimise safety risks in the sector, clear and simple administrative structures are required. Further, BiH has begun to upgrade its border crossing infrastructure and related roads in order to promote access to European transport networks. The concern for transport integration is further reflected in a current project to construct within BiH a motorway linking BiH to Corridor Vc (Budapest–Osijek–Sarajevo–Ploce) and other strategic routes. It is essential that in this major project BiH already now reflect best European standards in terms of public procurement, environmental impact assessment and transparent decision-making. Furthermore, in October 2003 BiH formally undertook to sign a Memorandum of Understanding on developing a regional core transport infrastructure network.

3.7.8 Energy

Co-operation between the EU and BiH in the field of energy would need to take into account the principles of the market economy and the European Energy Charter. BiH energy policy should be developed with a view to gradual integration with EU policies and networks. Co-operation could focus in particular on the formulation and planning of energy policy, modernisation of infrastructure, improvement and diversification of supply, development of energy resources and renewable energy, and promotion of energy saving and energy efficiency.

BiH has significant energy reserves, particularly hydro-electrical potential. In part because of industrial collapse, electricity generation is greater than domestic demand and BiH thus exports energy (although oil and gas are imported). BiH has ratified the European Energy Charter and signed the Athens Memorandum of Understanding on Regional Electricity Markets in South East Europe. BiH's limited electricity surplus and export capacity cannot however disguise the need for substantial modernisation and reform within this sector. Recent audits of electricity generating companies revealed widespread mismanagement and fraud. Prices remain administratively fixed and there is no internal **energy market**. Moreover, while medium-term energy sector requirements are currently under review in the context of the BiH Development Strategy / Poverty Reduction Strategy Paper, BiH still lacks a coherent energy development strategy taking account of diverse issues such as energy efficiency, diversification, security of supply, environment and international commitments.

With international assistance but against significant resistance from vested interests, reform of the important, but poorly managed, electricity sector has slowly begun. The strategic POWER III project aims to improve efficiency by dismantling the three existing vertical electricity monopolies and creating a unified energy system throughout BiH. "Unbundling" of generation, transmission and distribution, when implemented, would allow the creation of new distribution and generating companies (which could eventually be privatised given favourable market conditions, investor interest and political support). Action Plans to address restructuring have been agreed by both Entity governments. Not least because SAA co-operation in this sphere will reflect the principles of the market economy and because this project is key for **regional co-operation in the energy market** (cf. the Athens Process), it is essential that BiH take this reform forward decisively. The commitments taken by BiH at the June 2003 PIC ("adopt laws on the transmission company and independent system operator, appoint regulators at state and entity levels and adopt a harmonised action plan for energy sector reform") must be fully realised. Legislation should be in line with Community acquis.

3.7.9 Environment

In the framework of a SAA, BiH could strengthen co-operation with the EU in combating environmental degradation, in particular as regards air and water quality, pollution monitoring, promotion of energy efficiency and safety at industrial plants, classification and safe handling of chemicals, urban planning, waste management and protection of forest, flora and fauna.

In BiH the state of the environment is poor, but (with the exception of specific conflict-related problems such as unexploded ordinance) probably no worse than in some central European candidate countries at a similar stage of their development. A gap may be developing between the two Entities, with FBiH slightly more advanced but with both Entities in considerable environmental distress. Implementation and enforcement of existing law is poor and public environmental awareness low. Whilst there is some monitoring of environmental data, it is

unclear how such data are used. No mechanisms are yet in place to ensure that **environmental protection** is consistently integrated into the formulation of other policies.

A SAA would require the parties to develop co-operation in combating environmental degradation. In the case of BiH, co-operation may have to overcome a number of important, not least **institutional hurdles**. International assistance has helped develop a framework of environmental law, but the framework remains incomplete. There is no national strategy for the environment and no agency to monitor, implement or enforce policy. Responsibility for environmental issues is set at Entity level, but even with an Inter-Entity Environment Co-ordinating Committee set up in 1998, co-ordination between the players remains sub-optimal. In fact, BiH is party to a number of international conventions and protocols, but their implementation, monitoring and enforcement at Entity level is not secured. In at least one case, a bilateral agreement involving substantial assistance is apparently under threat because inadequate structures and poor human and financial resources make adequate implementation impossible. A future SAA could concentrate first on addressing these weaknesses.

3.8 Financial Co-operation

A SAA with BiH would foresee the continuation of EC financial support in order to help BiH achieve the objectives of the Agreement. Financial co-operation could support democratic, economic and institutional reforms in line with the Stabilisation and Association Process. Such assistance could focus on different areas of approximation of legislation and co-operation policies covered by the SAA. BiH should develop the capacity to co-ordinate comprehensively the funds from the EU and other donors in order to ensure optimal use.

Under a variety of EC programmes, BiH has benefited from **assistance totalling over €2 billion since 1991**. Currently, the main EC aid instruments are CARDS and budget support through macro-financial assistance. Other programmes such as TEMPUS are also operational. In addition to EC assistance, considerable bilateral support has been given by partner countries and the international financial institutions. Four separate institutions are currently responsible for handling this aid on the BiH side: Treasury, MOFTER, Ministry of Foreign Affairs and the DEI. In addition, the Entities have assistance management institutions. Worryingly, there is not yet an established mechanism to co-ordinate these different ministries and not even all assistance is yet recorded in a consolidated national account.

As CARDS assistance continues under a SAA, the need for adequate **co-ordination capacity within the DEI** will become ever more evident. DEI already contributes to annual CARDS programming exercises, but this role needs to be significantly upgraded. The aim must be for BiH to take progressively more responsibility for the management of EC aid. With its Rule Book now in place, DEI must proceed to establish a full Aid Co-ordination Section. The planned formation of a Co-ordination Committee within the DEI to monitor overall aid would, if realised, facilitate analysis, the determination of priorities and thus overall implementation.

3.9 General Evaluation

Although BiH has reiterated its desire to proceed to a SAA and has articulated its belief that it could handle the challenges involved, there can be no doubt that **SAA implementation would be a major challenge**. This section, dealing with the technical challenges implied by a SAA has indicated a pattern of intermittent progress, interspersed with areas where crucial reform has not been completed, or in some cases even begun.

Section 1 of this report identified the political challenges BiH faces. Section 2 concentrated on (macro-) economic perspectives and this third section highlighted sectoral issues. In effect, however, no issue can be addressed in isolation. For example, weaknesses in the formulation and implementation of trade policy require not only technical adjustment, but resources to address them. This, in turn, demands political will to ensure that resources are not wasted or misappropriated elsewhere. In short, preparation for and implementation of a SAA is **a holistic exercise** involving all elements of the BiH body politic. If BiH brings political determination and marshals its resources effectively, it could address the sectoral challenges of a SAA within a reasonable time frame.

C. CONCLUSION

The goal of integration into EU structures, and eventual EU membership, enjoys widespread support in BiH. To achieve this goal, however, the country will first need to demonstrate that it shares certain fundamental EU values and that it has the capacity to meet the obligations of a Stabilisation and Association Agreement (SAA).

This Feasibility Study, which has been prepared taking account of BiH responses to a detailed questionnaire, assesses whether BiH has made sufficient progress to permit the opening of negotiations for a SAA. Accordingly, its conclusions focus especially on key priorities which are of particular relevance to the start of such negotiations. As in all similar studies, this Feasibility Study focuses on the particular merits and specific conditions of the country itself. The pace at which a country draws closer to the EU depends essentially on the pace at which it adopts and implements the necessary reforms.

The new European Partnership, which the Commission will propose in 2004, will present in greater detail the short and medium term priorities which the country will need to meet as it advances towards closer integration with the EU.

This study confirms that BiH has made considerable progress in stabilisation since the conflicts of the 1990's were brought to an end. The country is a member of the Council of Europe and has established normal relations with its neighbours. It is a strong supporter of regional co-operation.

Many refugees have returned, and most property claims have been settled. Dialogue among the communities has been resumed and a measure of confidence re-established. Democratic elections have been held, political succession has occurred peacefully, and new laws have been adopted. Steps have been taken to strengthen the independence of the judiciary. On the whole, the State Border Service works well.

The country's infrastructure has been largely restored, the currency is stable, inflation is low and fiscal discipline introduced. Customs and taxation reform has been initiated. Agreement within the Indirect Tax Policy Commission and approval by the Council of Ministers of related draft legislation demonstrates growing consensus on key policies. Initiatives promoting an economic climate favourable to business are underway and have resulted in a recent increase in FDI.

Nonetheless, any assessment needs to recall that the country is still in the process of establishing a self-sustaining state, and that many fundamental reforms still need to be undertaken, including further progress towards the creation of a fully functioning single economic space, as provided in article I.4 of the BiH Constitution and in the Road Map recommendations.

BiH has not yet assumed full responsibility for government. It still needs to show through its own efforts that the High Representative's "Bonn Powers" are no longer needed, particularly in areas to be covered by a SAA. The powers, functionality and co-ordinating capacity of central government must be strengthened. An appropriate balance of responsibility between Entities and State needs to be found. Moreover, BiH's administrative base remains weak. It still needs to develop a professional, merit-based core of politically independent public servants. Some of BiH's governmental institutions, notably in Republika Srpska, have not yet demonstrated full co-operation with ICTY.

BiH's economy remains weak. The persistent lack of self-sustaining domestic growth raises concerns, especially given the high current account deficits and declining foreign assistance. The country remains dependent on foreign aid and, with 50% of the populations at or near the poverty line, is still vulnerable to systemic shocks. Despite the recent increase in FDI, more needs to be done to ensure a predictable flow of foreign capital. The financial basis of the State still needs to be reinforced. The funding mechanism provided by the Indirect Tax Authority needs to be consolidated, while, on the expenditure side, BiH has yet to ensure the optimal use of its limited resources.

Finally, BiH's technical ability to implement a future SAA remains under-developed. Core sectors such as trade do not yet function properly. Weaknesses in areas such as free zones, certification, competition, copyright, and statistics need to be effectively addressed. As noted in the 2003 SAP Report, BiH's core challenge of building a self-sustaining state able to integrate into EU structures remains.

Work will need to continue – indeed be stepped up – to meet all these challenges.

The European Commission has identified the following priorities for action in the course of 2004:

- *Comply with existing conditionality and international obligations* – Fully co-operate with ICTY, particularly on the part of RS, notably in bringing indicted war criminals to justice before the international tribunal. (The April 1997 EU General Affairs Council identified this as a specific condition for proceeding to contractual relations.) Complete outstanding Road Map steps. Comply with the Dayton-Paris Peace Accords. Take steps to implement BiH's Council of Europe post-accession criteria, especially in areas of democracy and human rights.
- *More effective governance* – Implement the Law on the Council of Ministers and the Law on Ministries. Convene meetings of the Council of Ministers and of Parliament with sufficient regularity to tackle government business expeditiously. Ensure that new State ministries and institutions created by the 2002 Law on the Council of Ministers become properly operational. Implement fully the 2003 – 2004 "Action Plan for Priority Reforms" and establish for 2004 (and following years) a consolidated State-level government work plan matching policy priorities with budgetary resources.
- *More effective public administration* – Make further effort towards creating an effective public administration, including developing a comprehensive and cost-estimated Action Plan for public administration reform with a clear distribution of competences (for example in the areas of police and health). Fund and co-operate with the Civil Service Agencies at State and Entity levels.

- *European integration* – Ensure the proper and full functioning of the Directorate for European Integration, including its aid co-ordination capacities.
- *Effective human rights provisions* – Adopt and bring into force outstanding legislation supporting refugee returns. In particular, introduce, adopt and implement legislation on the BiH Refugee Return Fund. Complete the transfer of the human rights bodies to BiH control. Ensure that unresolved cases of the Human Rights Chamber are dealt with and that the Chamber’s responsibilities are transferred to the Constitutional Court. Provide adequate funding for the Court. Assume full national responsibility for the State Ombudsman and make progress on the merger of the State and Entity Ombudsmen.
- *Effective judiciary* – Adopt legislation establishing a single High Judicial and Prosecutorial Council for BiH with the aim of consolidating appointment authority over the Entity judiciaries and strengthening the independence of the judiciary throughout BiH. Provide appropriate staff and funding for the State Court.
- *Tackling crime, especially organised crime* – Build up a State-level law enforcement capacity by allocating the necessary resources and facilities to ensure the full functioning of the State Information and Protection Agency and the BiH Ministry of Security. Proceed with structural police reform with a view to rationalising police services.
- *Managing asylum and migration* - Ensure the establishment and operation of proper structures dealing with asylum and migration
- *Customs and taxation reform* – Proceed with implementation of the recommendations of the Indirect Tax Policy Commission. Ensure parliamentary adoption of the Law on the Indirect Tax Authority, including the adoption of the related enabling legislation. Ensure implementation, including the appointment of a Director for the Indirect Tax Authority and the functioning of the new customs authority. Demonstrate progress in preparing the introduction of VAT with a view to beginning on schedule.
- *Budget legislation* – Adopt and start to implement a budget law covering multi-annual budget planning and forecasting and start to elaborate a consolidated government account.
- *Budget practice* – Take steps to record all income accruing to public authorities at different levels of government, including grants and other forms of international assistance.
- *Reliable statistics* – Implement the Law on Statistics, aiming at the creation of a functioning system of statistics with clear lines of responsibility and co-ordination mechanisms.
- *Consistent trade policy* – Establish a coherent and comprehensive trade policy and revise existing legislation to ensure a consistent policy on free zones. Establish at State-level certification and other procedures for the export of animal products and a phyto-sanitary office that are EC-compatible, with a view to promoting exports, but also enhancing standards and the single economic space.
- *Integrated energy market* – Implement Entity Action Plans for the restructuring of the electricity market.

- *Develop the BiH single economic space* - Establish the Competition Council. Introduce provisions on the mutual recognition of products in the legal order of BiH and implement a consistent and effective public procurement regime throughout the country. Remove all duplicate licences, permits and similar authorisation requirements to allow service providers (including financial institutions) to operate throughout BiH without having to fulfil unnecessary administrative requirements. Create a single business registration system that is recognised throughout BiH.
- *Public broadcasting* – adopt legislation in line with European standards and the Dayton – Paris Peace Accords and take steps to ensure the long-term viability of a financially and editorially independent single state-wide public broadcasting system for Bosnia and Herzegovina, whose constituent broadcasters share a common infrastructure.

Recommendations

The European Commission considers that BiH should be able to address these priorities in the course of 2004, provided that further sustained efforts are made. The European Commission will decide on a recommendation for a Council decision to open negotiations for a SAA with BiH as soon as it ascertains that significant progress has been made in meeting the priorities set out above. The Commission hopes that this will be possible in the latter part of 2004, but this will depend on BiH's own efforts and progress achieved. If progress is insufficient, the Commission will not be in a position to recommend proceeding with negotiations on a SAA.

While the pace of progress towards a SAA is largely in BiH hands and will be determined by BiH success in addressing the priorities identified in this Study, the European Commission will continue to support BiH reform efforts. The Commission proposes to intensify policy dialogue with BiH, in particular through reinforced meetings of the Consultative Task Force. In addition, Annual Reports, accompanied by the European Partnership, will indicate progress and identify overall priorities for action. Other new instruments identified at the Thessalonica European Council will be employed. The CARDS programme will continue to provide targeted support. In addition, BiH will continue to be considered for financing under other Community instruments such as loans from the EIB and, on an exceptional basis, macro-financial assistance.

BiH is also engaged in a number of other crucial reforms essential to the stabilisation of peace under the Dayton – Paris Peace Accords. These lie outside the immediate scope of this study and include areas such as defence, the intelligence services and reform of the Mostar city administration. All these have a fundamental bearing on BiH's ability to function as a modern democratic state and as a potential candidate for membership of the European Union. The European Commission strongly supports these efforts as evidence of BiH's willingness to make the reform needed to integrate into European structures, and will expect the BiH authorities to implement them on schedule during the course of 2004. Similarly, as a member of the PIC Steering Board, the European Commission strongly supports the reform agenda being pursued by the High Representative / EU Special Representative, and will expect the BiH authorities to co-operate fully in this process in the coming year so as to provide further evidence of their commitment to the reforms required for BiH to make progress on the road to Europe. These aspects will also be taken into account in the Commission's assessment of whether the necessary conditions are in place for the launch of the SAA.

List of Abbreviations

ATM	Autonomous Trade Measure
BHAS	BiH Statistical Office
BiH	Bosnia and Herzegovina
CAFAO	Customs and Fiscal Assistance Office
CARDS	(programme of) Community Assistance for Reconstruction, Development and Stabilisation
CEI	Central European Initiative
CFSP	Common Foreign and Security Policy
CRA	Communications Regulatory Authority
CRPC	Commission for Real Property Claims
CTF	Consultative Task Force
DEI	Directorate for European Integration
EC	European Community
EEA	European Economic Area
EU	European Union
EUPM	European Union Police Mission
FATF	Financial Action Task Force
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign direct investment
FTA	Free trade agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GFAP	General Framework Agreement on Peace (Dayton Agreement)
HJPC	High Judicial and Prosecutorial Council
HRC	Human Rights Chamber
ICAO	International Civil Aviation Organisation

ICC	International Criminal Court
ICTY	International Criminal Tribunal on former Yugoslavia
IFOR	Implementation Force
IMF	International Monetary Fund
IPTF	International Police Task Force
ITA	Indirect Tax Authority
JHA	Justice and home affairs
MFN	Most Favoured Nation
MOFTER	Ministry of Foreign Trade and Economic Relations
NATO	North Atlantic Treaty Organisation
NGO	Non governmental organisation
OHR	Office of the High Representative
OSCE	Organisation for Security and Cooperation in Europe
PBS	Public Broadcasting System
PIC	Peace Implementation Council
PRSP	Poverty Reduction Strategy Paper
RS	Republika Srpska
RTD	Research, Technology and Development
SAA	Stabilisation and Association Agreement
SAI	Supreme Audit Institution
SAP	Stabilisation and Association Process
SBS	State Border Service
SECI	Southeast Europe Co-operation Initiative
SEECF	South East Europe Co-operation Process
SFOR	Stabilisation Force
SIPA	State Information and Protection Agency
SME	Small or medium-sized enterprise

TAIEX	Technical Assistance Information Exchange Office
TIR	Transport International Rapide
UN	United Nations
UNHCR	United Nations High Commissioner for Refugees
VAT	Value Added Tax
WTO	World Trade Organisation