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INTRODUCTION

The Stabilisation and Association process (SAP), which was confirmed at the Thessaloniki Summit in June 2003 as the European Union's policy framework for South Eastern Europe until accession to the EU, provides for the establishment of the Stabilisation and Association Agreements (SAA).

This report reviews the political, economic, legal and administrative requirements inherent in a Stabilisation and Association Agreement and analyses how Serbia and Montenegro has been addressing these requirements. The findings of this staff working paper constitute the basis of the Commission assessment on the preparedness of Serbia and Montenegro to negotiate a stabilisation and Association Agreement with the European Union (COM (2005) 476).

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 the European Convention 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 an SAA. The consolidation of international and regional peace and stability and the development of good neighbourly relations should be the shared objective of both the EU and Serbia and Montenegro in the context of an SAA. In its conclusions of 29-30 April 1997, the General Affairs Council also clearly underlined that full cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY) is an integral part of the EU's conditionality for the Western Balkans countries.

1.1. Democracy and the Rule of Law

Serbia and Montenegro enshrines the principles of democratic governance and rule of law in the constitutions at State Union and republican level.¹

In practice, the functioning of democratic institutions and respect for the rule of law have been affected by the lack of political consensus on the future of the State Union, conflicting interpretations of the State Union Constitutional Charter and the failure to adjust the republican Constitutions. This has led to **constitutional and legal uncertainty**. The powers attributed to the State Union have been questioned by the republics, in particular by Montenegro. The **functioning of the institutions** of the State Union, which has no own resources, has been weakened by disputes over republican budgetary contributions. As regards the **revision of the constitutions** of the two republics, while work is ongoing, there is not yet the necessary consensus within each republic to complete this key reform.

Recent clarifications concerning the trade and internal market competences have helped reduce the constitutional problems. Progress has also taken place with the establishment of the State Union Court. Moreover, as regards those competences that were transferred to the

¹ The State Union comprises two member states: the Republic of Serbia and the Republic of Montenegro. Throughout this report the terms republic(s) and republican refer to the Republic of Serbia and the Republic of Montenegro as member states of the State Union of Serbia and Montenegro.

republican level, inter-republican co-operation has been recently established in some areas related to justice and home affairs.

Since 2000, **elections** have taken place at all levels. Election rules and procedures are mostly in accordance with democratic standards, although improvements are still needed especially in updating the voters' registers. The turn-out requirements in Serbian legislation which led to repeated and failed presidential elections were eventually revised in February 2004 paving the way for the first democratically elected President in June 2004. Montenegro has also made similar changes.

In **Serbia** the rule of law remains weakened by the **legacy of the Milosevic regime**, i.e. the persistent links between organised crime, war crimes and political extremism, and their continued obstructive presence within parts of the current political, institutional, military and state security systems.

In **Montenegro**, the rule of law needs to be further strengthened. Links continue to exist between organised crime and segments of the political and institutional system.

International surveys indicate that **Serbia and Montenegro** suffers from a high level of corruption. The fight against organised crime and corruption therefore represent key challenges for Serbia and Montenegro.

1.1.1. Legislature

Serbia and Montenegro has three legislative bodies: the Parliament of the State Union and the Parliaments of the two republics.

State Union

The Parliament of the State Union is composed of delegated representatives of the two Republican Parliaments. Direct elections were foreseen by the Constitutional Charter after the first two years of the parliamentary mandate, i.e. in March 2005. The adoption of legislation on the direct election of the State Union Parliament is a republican competence. Serbia adopted the legislation. In Montenegro the legislation was not adopted as the ruling coalition argued that direct elections should be postponed until after a referendum on independence. A compromise was found in early April 2005 whereby the Constitutional Charter would be revised so that direct elections to the Parliament of Serbia and Montenegro would be held separately in the two republics whenever elections to the respective parliaments take place. The terms of office of the current deputies to the Parliament will be extended until such elections take place.

The State Union Parliament has limited legislative competences. These relate mostly to the establishment of other State Union institutions, State Union symbols, defence, ratification of international agreements and some elements of Serbia and Montenegro's internal market and to the field of justice and home affairs. Legislative activities related to these limited competences have been slow for political and procedural reasons. Since its establishment in March 2003, the Parliament adopted around 20 acts and ratified a number of international agreements and conventions.

The functioning of the Parliament saw some recent improvements. In May 2004 standing Rules of Procedure and a number of parliamentary committees were established.

Communication with, and control of, the Council of Ministers has become more regular. Public consultation is, however, still weak and inadequate. The Parliament lacks specialised staff, although some training initiatives are ongoing. A Committee for European Integration has been established, with the key function of reviewing the EU compatibility of laws, but this is still at an early stage of development. The draft Resolution on European Integration has been finalised, but has not yet been adopted.

Serbia

In the past four years the functioning of the Serbian Parliament has faced serious challenges due to political instability and a lack of respect for legal procedure. Nevertheless, the legislative activity has intensified significantly over the last year.

There is a developed system of parliamentary committees, many of which are now chaired by the opposition in accordance with party representation in the parliament. Their role in law-making is increasing but still needs to be reinforced. There is also a pro-active Committee for European Integration, which was the driving force behind the October 2004 adoption of the Resolution on European integration, a text calling on the Government to prepare a strategy for joining the EU and to report quarterly on the progress in the process of European integration. This Committee still has a limited role and capacity to check the EU compatibility of legislation. While more transparency in the legislative process has been introduced, procedures for consultation are not yet satisfactory. The Parliament lacks specialised staff.

Montenegro

The Montenegrin Parliament enjoys a stable majority. However, in September 2003 a major parliamentary crisis occurred, with the decision of the opposition parties to withdraw from all parliamentary activities. In autumn 2004, following international involvement, parts of the opposition returned first on a temporary basis, for the purpose of the debate of the bills on direct elections to the State Union, and then permanently. However, the opposition has not returned fully to the parliamentary committees.

The Montenegrin Parliament is currently drafting new Rules of Procedure strengthening the role of committees and improving the internal functioning of the Parliament. It has undertaken intensive legislative activity. However the knowledge of the Parliamentarians and administrative staff on EU Integration processes must be enhanced in order to allow the Parliament to carry out properly its function. There is an established procedure for public consultation in the legislative process, including with civil society.

There is a European Integration Committee, with powers to monitor and initiate harmonisation with the *acquis*, but with limited results to date. The adoption of a Resolution on European integration is underway.

1.1.2. Executive and presidency

State Union

At the State Union level, the Council of Ministers is composed of five members covering respectively foreign affairs, defence, human and minority rights, internal economic relations and international economic relations. The Chair of the Council is at the same time President of the State Union.

The work of the Council suffers from structural weaknesses in particular concerning coordination, which affects policy planning at the State Union level. The lack of constitutional clarity has affected the performance of individual ministries, in particular the Ministries of Internal and External Economic Relations. Although the Constitutional Charter provides for one Ministry of Foreign Affairs at the State Union level, Montenegro also maintains a Foreign Ministry. Furthermore, the State Union diplomatic service is based on the principle of proportional representation of the two Republics, while being paid exclusively by the Serbian budget. The Ministry for Human and Minority Rights has produced significant policy and legislative initiatives and has developed wide-ranging activities on the ground, albeit primarily in Serbia. It has been assigned new powers and managed to perform them in a satisfactory manner despite the lack of adequate resources. The Ministry of Defence, under the guidance of the Supreme Defence Council, has taken significant steps towards a comprehensive reform of the army, including civilian control and oversight, but this process requires further significant efforts. Both Ministers of Foreign Affairs and of Defence come from the same Republic in contravention of the provisions of the Constitutional Charter.

The President of the State Union has taken important initiatives towards regional reconciliation, including public apologies to Croatia and Bosnia and Herzegovina for crimes committed in the recent past. He has also taken a strong and positive position on Serbia and Montenegro's obligation to cooperate with International Criminal Tribunal for former Yugoslavia.

The high-level Serbia and Montenegro Council for European Integration, set up to give a political steer and strategic guidance to the country's EU aspirations, has recently been reactivated, after a long standstill.

Serbia

In Serbia, there is a lack of co-ordination within the government. A particular problem is posed by the high degree of politicisation of the public administration, with serious implications for institutional and policy continuity. Conflict of interest has been addressed through new legislation, but has only started to be implemented. The implementation of sectoral reforms varies significantly across ministries.

The current Government has followed a structured approach towards European Integration, continuing the work launched under the former administration. A comprehensive strategy for joining the EU is in preparation. A new mechanism, institutionalised in the government Rules of Procedure, stipulates that every proposed bill must be accompanied by a statement on compliance with the EU *acquis*.

The June 2004 election of the first democratic President of Serbia put an end to a protracted institutional vacuum. Although regulated by an obsolete constitution, making some of its powers inapplicable in practice (e.g. as those relating to the armed forces), the presidency has significant institutional and political leverage. This has been further strengthened by the initiative to establish an office to deal with individual citizens' petitions.

Montenegro

In Montenegro, the functioning of the executive reflects a rather stable governing coalition, which facilitates decision-making. There is, however, an environment conducive to corruption and nepotism. The overall legislative performance of the government has been noteworthy.

Implementation however is weak and requires further strengthening in terms of human, budgetary and other necessary resources - beyond just donor assistance. There is a well established practice of public consultation and using foreign expertise, although the latter needs improvement in terms of taking on board relevant international standards. Cooperation with civil society has been improving, notably on EU-related issues. In November 2004, the government amended its Rules of Procedure, introducing a mandatory statement on compatibility of draft bills with EU standards. The Ministry for International Economic Relations and European Integration saw its capacity and infrastructure enhanced.

1.1.3. Public Administration

State Union

The State Union administration saw a significant reduction in the number of civil servants following the adoption of the Constitutional Charter and the subsequent transfer of competences to the republican level. However, some State Union institutions are still burdened with a surplus of employees, while at the same time lacking competent staff. There are no genuine civil service laws at State Union level, apart from basic regulations governing the work of the Council of Ministers and the internal organisation of the ministries. This affects the accountability of State Union officials. Furthermore, no specific legislation regulating conflict of interest or the establishment of an Ombudsman are envisaged at State Union level.

Coordination on EU-related issues is not yet satisfactory. Despite its professional commitment, the position of the European Integration Office remains fragile due to a lack of resources. The Office continues with education projects, giving a growing number of civil servants advanced training in EU affairs.

Serbia

The Serbian administration has grown significantly, primarily due to the takeover of employees from the former federal level. Future rationalisation and the social impact of redundancies will be a major challenge and a possible motive for resistance to reform. Clear legal instruments are needed to tackle the problem of political interference in the work of the administration and the spill-over of party politics, affecting both institutional and policy continuity, inside the civil service.

In November 2004, a comprehensive strategy was approved by the government, envisaging a set of concrete measures and deadlines for the establishment of a professional, accountable, depoliticised and decentralised civil service but without clear budgetary projections apart from expected donor support. This raises the issue of long term sustainability. The Government has adopted new bills on the Government and on Public Administration. Regulations on civil servants and their salaries are still pending, as is a law creating an Ombudsman institution. Important laws on free access to public information and on the prevention of conflict of interests have entered into force. A Law on Local Government was adopted in February 2002, but its further review is envisaged as part of the implementation of a new strategy for public administration reform.

The institutional capacity for coordination on EU-related issues has seen significant improvement. There is a pro-active European Integration Office that has initiated a comprehensive restructuring of the Serbian administration intended to meet the requirements

of the SAP. The Deputy Prime Minister heads all EU-related activities, and there are European integration contact points in all line Ministries. Coordination has been established with the Serbian parliament. The Office has a statutory role in ensuring overall compatibility of draft legislation with that of the EU. It has developed a wide range of contacts with different social actors of the society, including media, NGOs, business associations and trade unions, and has associated them in key events concerning the EU integration process.

Montenegro

In Montenegro, progress has taken place since 2002 in establishing the legislative framework of public administration reform. In practice, weak implementation capacities, both in terms of funds and infrastructure, personnel and training, are coupled with the problems of poor accountability, political interference and patronage. There is an Office of the Republican Ombudsman, although to date there have been limited results, and a law on prevention of conflict of interests. Administrative and financial resources are limited. Montenegro adopted legislation on local government in July 2003.

Rationalisation of the public administration is an issue that need to be addressed. New recruitment and assessment procedures, compounded by new salary system, came into force at the start of 2005, but the budgetary situation is precarious. Inter-ministerial coordination on EU-related issues has become more structured, with the improved functioning of the Ministry for International Economic Relations and European Integration. However further improvements are needed in terms of more regular coordination with the line Ministries. More regular cooperation has been established with the Parliament, as well as institutionalised cooperation with civil society.

1.1.4. Army Reform

Defence is a **State Union** competence. Reform of the military has proven to be a difficult process facing significant resistance and obstruction from some political actors and elements within the Army itself. Furthermore, the reform has been affected by constitutional disputes over the scope of powers. Some important measures have already been taken, although they will need time to produce the desired results.

The Defence Strategy, a key document for military reform, was adopted in November 2004, thus creating the preconditions for the adoption of the military doctrine and subsequent changes to the laws on defence and on the army. The military security service, which in the past was often abused for political purposes, was transferred from the Army Chief of Staff to the Ministry of Defence. A State Union parliamentary committee for its civilian control was established in May 2004. Financial control is now entirely in the hands of civilian institutions.

Reform, however, remains constrained by scarce financial resources. The issue of the ownership and rationalisation of military assets is still unresolved as the republics cannot agree on the law on State Union property. A partial transitional solution was found with the creation of a Fund for military reform in June 2004, but the legal status of the fund is questioned and the decision-making on the disposal of assets is subject to cumbersome procedures.

Significant personnel changes have been made, including the retirement or dismissal of a number of high-ranking officers, some of whom had close ties with the former regime or were indicted by ICTY. While the Ministry instructed all soldiers to report any information on the

whereabouts of ICTY indictees, and to support their arrest in military locations, no progress in this key area has taken place. There is still resistance within the military system to the rule of law.

1.1.5. Relations with the international community

Serbia and Montenegro's relations with the international community have improved enormously since the fall of the Milosevic regime. The country joined the United Nations, the OSCE, the Council of Europe and the international financial institutions and has worked on developing its international relations. However, the legacy of Serbia and Montenegro's past still affects relations with the international community.

Cooperation with the **International Criminal Tribunal for former Yugoslavia (ICTY)** is an international obligation for Serbia and Montenegro as a UN Member State and as a signatory of the Dayton / Paris Agreements. It is also an obligation under the Council of Europe post-accession commitments and an integral part of the EU's political conditionality under the Stabilisation and Association process. ICTY co-operation is an international obligation for Serbia and Montenegro as a whole and concerns therefore also the Republic of Montenegro.

In the report submitted to the UN Security Council in November 2004, the ICTY Prosecutor noted that, while progress had taken place as regards granting waivers to witness and access to documents, the authorities did not show any concrete willingness to co-operate concerning the transfer of indictees.

Since then the National Council for Cooperation with ICTY chaired by the State Minister for Human and Minority Rights has continued to take important decisions concerning waivers for witnesses and access to documents, clearing the backlog of ICTY requests. However, the implementation of the Council's decisions is sometimes obstructed by those in the administration and the army in possession of documents but unwilling to cooperate with ICTY.

Concerning indictees, a significant number of indictees has voluntarily surrendered and been transferred to The Hague in the recent months. However, there is still a number of indictees at large, in particular Ratko Mladic and Radovan Karadzic, who need to be brought to justice. The authorities are expected to take action in this respect.

The State Union Council of Minister has adopted in March 2005 a draft law on the freeze of the assets of ICTY indictees. In the meantime, Serbian Courts have issued an order freezing these assets.

Domestic courts have a cooperative attitude and are carrying out good work in trying some low-profile cases, notably Ovcara. Steps have also been taken to improve their organisational and infrastructure capacities. Legal amendments are made to address the issue of command responsibility. However, the overall political climate is such that there is no guarantee that any high profile war crimes trials could be conducted in a fair and transparent manner.

Serbia and Montenegro takes a positive attitude towards the **International Criminal Court (ICC)**. It is one of the founding members of the ICC and ratified the Rome Statute in 2002. Specific legislation for cooperation with the ICC is being drafted both at the State Union level and in Montenegro, although this is a State Union responsibility. Serbia and Montenegro has

consistently refused to sign bilateral agreements giving exemptions from ICC jurisdiction. It should continue to do so.

There are no major problems in Serbia and Montenegro's compliance with the **Dayton agreement**, apart from those relating to cooperation with ICTY.

Full respect of **United Nations Security Council Resolution 1244**, governing the current status of Kosovo, is an obligation for Serbia and Montenegro as a UN member and a key requirement for regional stability.

The situation deteriorated following the violent incidents against minorities in Kosovo in March 2004. These events blocked Belgrade-Pristina dialogue launched in October 2003 and deadlocked relations. In spite of President Tadic's call for conditional participation in Kosovo elections, Kosovo Serbs massively followed the Government policy of boycotting them.

Of particular concern is the difficulties experienced for entry to Serbia by Provisional Institutions of Self-Government (PISG) representatives taking part in regional initiatives and conferences, despite the efforts by the European Commission and the State Union Ministry of Foreign Affairs. Technical cooperation has been established between the Serbian Ministry of Justice and United Nations Mission of Interim Administration (UNMIK), including on the key issue of enforcement of Council of Europe conventions.

Under the good offices of the Special Representative of the Secretary General, relations with Belgrade are progressively normalising, as demonstrated by the positive re-launching of the dialogue on missing persons chaired by the International Committee of the Red Cross in March 2005.

With the establishment of a new Government in March 2005, the conditions have been restored for an increase dialogue and mutual cooperation with Pristina. The participation of Kosovo Serbs in the institutions to address its legitimate concerns in the implementation of the UN-led Kosovo standards is now crucial and should be encouraged by Belgrade.

In line with UNSCR 1244, Belgrade should have a constructive attitude with a view to promoting the development of a democratic, multi-ethnic society in Kosovo in the interest of all Kosovo communities. Furthermore, Belgrade's constructive engagement on the Kosovo issue will help to advance Serbia and Montenegro's European perspective, while obstruction could turn into an obstacle.

Serbia and Montenegro's accession to the **Council of Europe** in April 2003 was a key foreign policy achievement. Membership now serves as an important framework for the protection of human rights and the rule of law in general for Serbia and Montenegro, in particular after the April 2004 entry into force, of the European Convention of Human Rights and the European Convention on Prevention of Torture. The uniform implementation of these international obligations throughout Serbia and Montenegro is however hampered by the unclear interpretations of the State Union Court's role in the enforcement of the Conventions and by constitutional disputes.

The country has applied for membership of the **NATO's** Partnership for Peace, which is however contingent upon cooperation with ICTY. In December 2004, the International Court of Justice declared that the lawsuit filed by Serbia and Montenegro against NATO in relation

to the 1999 conflict was not receivable as the then Federal Republic of Yugoslavia was not member of the UN.

Based on the **WTO's** statutory provisions allowing for membership of independent customs territories such exist in Serbia and Montenegro, the previous 2001 application of FRY was withdrawn and two separate applications for WTO membership by both Serbia and Montenegro were submitted in February 2005 and accepted by the WTO's General Council.

1.2. Human Rights and the protection of minorities

Basic human and minority rights are enshrined in the **Charter on Human and Minority Rights**, adopted in the context of the constitutional revision of 2003. This has the force of a constitutional act. Republican Constitutions also contain extensive lists of fundamental rights and freedoms. However, the 2002 Law of the then Federal Republic of Yugoslavia on the protection of minority rights *de facto* applies only in Serbia, as Montenegro is preparing its own act. In spite of improving contacts between the State Union and Republican bodies, the complex division of powers continues to create difficulties in coordination, notably with the Montenegrin administration, and affects the full implementation of Serbia and Montenegro's international obligations. Finally, an agreement on a Serbia and Montenegro judge in the European Court of Human Rights was achieved and the State Union Council of Minister adopted the decree on the appointment of a state agent. In the meantime, more than 400 cases against Serbia and Montenegro are pending before the European Court of Human Rights. Internally, the right to constitutional appeal is guaranteed in the Constitutional Charter and in the Montenegrin Constitution. The Serbian Constitution does not provide for constitutional appeal. The human rights situation on the ground has significantly improved. Further improvements are however needed, notably in ensuring full protection of minorities. The ratification of other Council of European conventions, such as the European Charter on Regional and Minority Languages, should also take place shortly.

1.2.1. Civil, social, economic and political rights

Over the recent years there has been a significant overall improvement in human rights protection. Legislative reforms were undertaken, the death penalty was abolished and human rights practice in general has improved.

However, there has been little progress in relation to police investigations and legal proceedings regarding **mass graves** identified in **Serbia**.

Serbia still has to investigate fully all allegations of human rights violations during the state of emergency in March / April 2003. This is also required under the decision of the Serbian Constitutional Court concerning the constitutionality of the state of emergency.

There have been various efforts to bring the respective legal and practical standards in line with the provisions of the European Convention for the Prevention of **Torture**, including through educating relevant parts of the state and republican administrations. The authorities, however, need to react adequately to the cases brought by the UN Committee Against Torture. In **Serbia**, the situation seems to be generally improving with the establishment and restructuring of the Office of Inspector General in the Serbian Ministry of Interior. In **Montenegro**, human rights NGOs claim that police torture during detention is a problem, but that action is often obstructed by the police itself. In both Republics, slow and inefficient judicial proceedings impede adequate legal action.

The **Serbian** Law on the Accountability for Human Rights Violations (the “**Lustration Law**”), was an important step in dealing with the past, as it provides a basis for the screening of candidates for top positions in all branches of the administration and judiciary regarding potential human rights violations committed from 1976. However, it has not been enforced. The deadlock, allegedly for procedural reasons, in fact reflects a lack of political consensus on lustration.

While the media in Serbia and Montenegro generally operate in an open and pluralistic environment, a complete reversal of long-standing problems in the field of **freedom of expression and media** has not yet materialised. Freedom of expression in **Serbia** is still partly limited by existing Criminal Code provisions stipulating prison sentences for slander/libel. In Montenegro this was abolished in December 2003. The new Serbian Law on Public Information, rushed through Parliament during the state of emergency, contains restrictive provisions concerning ban of media outlets. The protracted illegality of the appointment of members of the Broadcasting Council, the licensing and supervisory body for electronic media, was addressed through legal amendments in August 2004, but the appointment of a Council has not been fully completed yet. The independent functioning of local media is also problematic in some areas.

Serbia adopted an important Law on Free Access to Public Information in November 2004, but this is not yet fully implemented. In **Montenegro** similar legislation is still pending.

Regarding **freedom of association**, new legislation is being prepared in **Serbia**, to regulate separately the status of political associations and the status of NGOs, trade unions and other as civil society in particular is facing continuing difficulties due to the lack of a proper legal framework. The new Law on Financing Political Parties was adopted. While no legal restrictions exist concerning trade unions, they show little practical autonomy. **Montenegro** has a satisfactory law concerning NGOs, but amendments should address financial aspects and tax exemptions. New laws on political parties and their financing were adopted in 2004.

The establishment of an **Ombudsman** is still at an early stage. No Ombudsman institution is envisaged at the State Union level. In **Serbia** the relevant law has not yet been adopted. The Cabinet of the Serbian President set up an office to deal with individual petitions and assist citizens in resolving human rights related problems, but it has a limited mandate and relies on action by the relevant governmental services. There is a Provincial Ombudsman in Vojvodina. **Montenegro** has an office but this is still at an embryonic level. In addition to insufficient infrastructure and resources, there is a serious lack of understanding of the real mandate and role of this important institute.

As regards **labour rights**, a legislative framework exists in **Montenegro** and in **Serbia** it saw significant amendments in early 2005. Enforcement is however rather weak and violations persist in practice, despite efforts to improve the functioning of labour inspectorates. Social dialogue needs to be strengthened. Legislation exists paving the way for tri-partite dialogue.

Concerning **women’s rights**, Serbia and Montenegro is a signatory to the UN Convention of Elimination of all Forms of Discrimination against Women (CEDAW) and its accompanying Protocol. The national legislation is also mostly in accordance with international standards, but the adoption of a comprehensive Anti-Discrimination Act is necessary as a further guarantee and protection mechanism.

In spite of the fact that there are no legal restrictions, the representation of women in public life remains poor, as is their practical access to job opportunities. Domestic violence is a concern in both Republics. Efforts have been made to address this issue in family law and in the criminal legislation, together with human trafficking which is stipulated as a specific offence.

Further efforts need also be made respect the **rights of the child** and take action to eliminate discrimination against minority and disabled children.

There are some outstanding issues in relation to **property rights**, both individual and communal, in **Serbia**. A new draft law is in preparation, in cooperation with the Council of Europe. **Montenegro** adopted its law in March 2004; however, there is no visible progress as regards implementation.

The authorities are confronted with an increasing number of **return** claims. The current lack of legal certainty may also affect the process of economic reform and must therefore be tackled more rapidly.

1.2.2. Minority rights and refugees

International agreements have been signed by Serbia and Montenegro with countries in the region (Hungary, Romania, former Yugoslav Republic of Macedonia and Croatia), and a further agreement is pending with Albania.

There has been steady progress in the protection of minority rights in Serbia and Montenegro, although recently overshadowed by ethnically motivated incidents against minorities in Vojvodina. The key national document is the **Charter on Human and Minority Rights**, adopted as a complement to the Constitutional Charter, which provides comprehensive guarantees and mechanisms for protection, in conjunction with the provisions in the Republican Constitutions. A law was adopted at the State Union level in 2002, but is effectively only applicable to Serbia, as Montenegro is in process of preparing its own act, which is now significantly delayed. However, despite improvements, ethnically motivated incidents still occur, reflecting the legacy of the past decade and systemic issues in the implementation of existing standards. In 2003-2004, the situation significantly deteriorated in Vojvodina, with an increasing number of violent incidents, particularly against notably ethnic Hungarians. The reaction of the authorities was belated and insufficient. Although important steps have been taken to address the issue, including the October 2004 establishment of a high-profile Council for National Minorities, chaired by the Serbian Prime Minister, further efforts need to be made.

Similarly, political instability at Republican level led in 2004 to complete standstill in implementation of the 2001 governmental programme for Southern Serbia. The protracted deadlock concerning government funding in the region, adversely affecting the internationally sponsored projects has eventually been resolved. In March 2005, the Co-ordinating Body was restructured and re-activated.

The establishment of **National Councils** for minority groups under the 2002 Minorities Act has continued, although in **Serbia** only and with occasional difficulties. In spite of efforts by the Serbian authorities to secure funding in 2004 and 2005, their financial situation remains precarious. Progress has been recorded concerning the use of minority languages, including in southern Serbia with the official use of Albanian. Work has continued on the integration of

Roma, including measures in the education system, but the precarious situation of the Roma community persists.

Montenegro has been preparing its own legislation, although this is seriously delayed due to the lack of political consensus notably concerning the modalities for political representation of minorities. Steps have been taken to improve the situation of the Albanian community, including the launch of Albanian-language teacher training.

The high number of **refugees and IDPs** continued to aggravate difficult socio-economic conditions in both Republics. Furthermore, the precarious situation of this vulnerable part of population has significant impact upon the overall political situation and the ongoing trends of radicalisation in the country. According to UNHCR data, there are currently 289,680 refugees and 244,833 registered IDPs. In January a comprehensive refugee re-registration exercise was undertaken by UNHCR. While the figures remain to be finalised, provisional results indicate that the number of registered refugees has been almost halved to around 140 000. In **Serbia** the authorities continue their efforts on both repatriation and local integration, based on the 2002 National Strategy and in cooperation with partners in the region. The implementation of new legal provisions allowing dual citizenship resulted in a fall in the number of refugees, as some of them lost refugee status by acquiring Serbia and Montenegro citizenship. The implementation of the agreement on the return of refugees with Bosnia and Herzegovina (signed in October 2003) has already produced results, facilitated safe returns, thus also contributing to the overall drop on number of refugees. Cooperation with UNMIK in the return of IDPs to Kosovo has stalled, following the violent events of March 2004. Serbia and Montenegro is also participating in the regional initiative on refugees return with Bosnia and Herzegovina and Croatia.

Montenegro has prepared its own National Strategy, to allow either repatriation (or removal to a third country) or local integration. The current Montenegrin legislation has serious deficiencies in areas such as access to employment and related rights (health care and pension funds), coupled with voting restrictions for IDPs.

2. ECONOMIC CRITERIA

Respect for market economy principles should form the basis for domestic and external policies of a country that wishes to enter a Stabilisation and Association Agreement with the EU. This entails a stable macroeconomic environment supported by a stable institutional framework, a comprehensive liberalisation of prices, trade and current account transactions, the creation of a strong private sector through de-monopolisation and privatisation and the establishment of a prudently managed financial sector. These policies should be supported by a stable and transparent legal and regulatory framework.

2.1. Economic situation and stability

2.1.1. Economic situation

Economic policies in the 90s left the country with weak economic starting conditions, and broad-based economic reform and transition started only a few years ago. Following the 2000 political changes in Serbia, the new authorities started economic reform and stabilisation. In Montenegro reforms started in 1998/1999. From 2000 to 2003, market-oriented stabilisation policies led to a recovery of real GDP by cumulative 19% and a substantial reduction of

inflation from well above 100% to single-digit levels at the end of 2003, though annual inflation for 2004 has accelerated again and reached 13.8% in December. 2004 GDP growth is estimated to 7.2 %, reflecting a recovery in industrial output and a rebound in agricultural production.

Economic stability has increased significantly. Following the resumption of IMF membership in December 2000, the authorities embarked upon some initial economic stabilisation and reform measures under a short-term IMF programme. From 2001 to 2003, more comprehensive economic reform and stabilisation laid the foundation for sustained macroeconomic stability. It was supported by successive IMF programmes, a stand-by arrangement and the current three-year extended arrangement, that runs until May 2005. A crucial step was the imposition of hard budget constraints on fiscal authorities and of the end of government deficits financing through money creation. This was supported by tight programme ceilings for granting of credits by the National Bank of Yugoslavia. The use of the exchange rate as a nominal anchor helped stabilise inflation expectations, and led to increased stability and, thus, economic activity.

Serbia

In Serbia, real GDP grew on average by around 4.5% from 2000 to 2003 annually, following a drop by 16% in 1999 due to the Kosovo crisis. Growth in that period was driven by services, construction and trade, while industrial production performed poorly. Agricultural production was negatively affected by severe droughts in 2000 and 2003 and agriculture's share in GDP has shrunk continuously over the past several years. Growth for 2004 is estimated to have accelerated to around 6 %, fuelled by a strong growth in agricultural production of around 20% and a rise in manufacturing production of nearly 10%.

The **reform progress** slowed in the difficult political situation, following the assassination of Prime Minister Djindjic in March 2003. However, reform momentum was regained after the creation of a new government in Serbia in March 2004. In particular, a large number of laws in the economic and financial sphere have since been adopted by the Serbian Parliament.

Nevertheless, **employment** remains low and unemployment high. This reflects the fallout of 1990 conflicts and sanctions together with inflexible labour laws. In 2003, the economic activity rate for persons above 15 years was at 47.5%. In Serbia, official figures for end-2004 show an unemployment rate of 32.4%, as compared to around 27% three years earlier. However, this figure would be significantly lower if adjusted for those who are registered as unemployed and receiving benefits but not really seeking work. This not only put strains social expenditure but also injures republican fiscal policy.

Until early 2004, **inflation** in Serbia had continuously fallen. Consumer price inflation fell from 113% at the end of 2000 to below 8% at the end of 2003, despite adjustments in administered prices, for food and electricity etc. (see below). However, annual inflation (end-of-period) accelerated again in 2004 and reached 13.8% in December, spurred by strong domestic demand, the rising cost of fuel imports and increases in administered prices. Strong wage growth, via its impact on domestic demand and on administered prices, continues to be a major liability to further disinflation. Average real gross earnings rose between December 2003 and December 2004 by 21%, after a corresponding rise of even 26% in 2003. These rises have well exceeded the rise in labour productivity over the same period, also when taking into account the drop of real wages in the second half of the nineties.

Exchange rate stability in Serbia has increased. The exchange rate of the dinar to the euro remained roughly stable in nominal terms from early 2001 to end of 2002. This implied a real appreciation of around 50%, given the higher inflation in Serbia during that period. Since early 2003, the authorities have become increasingly concerned about safeguarding external competitiveness and adopted a more flexible approach of the “managed float” policy. As a result, the dinar depreciated by 11% vis-à-vis the euro in 2003 and by 9% in the first nine months of 2004. In real terms, the exchange rate remained broadly stable in 2003 and during the first ten months of 2004, in line with announced policy objectives under the IMF programme.

Furthermore, Serbia’s **current account deficits** have risen. On the external side, the situation in the past three years has been characterised by current account deficits of around 9% of GDP (after grants) in 2002 and 2003, rising to almost 11% in 2004. This reflects continued high imports for consumption and investment purposes, but also continued structural weakness in exports. Exports have, in real terms, barely risen over the past few years, translating into continued losses of market shares of Serbian exporters. With an export that only covers 1/3 of the imports, external sustainability remains a major challenge, in particular as an increasing share of the current account deficit is debt financed. The level of total external debt remains high at around 56% of GDP or 2.6 times projected exports of goods and services for the whole of 2004. Moreover, rising debt service obligations over the medium term, as well as important financing needs for restructuring and investment, will continue to put a heavy strain on the country’s balance of payments. Improving the business climate to attract FDI and the competitiveness of Serbian enterprises are key to reversing this trend.

Montenegro

In Montenegro **macroeconomic stability** has improved but growth remains modest. Economic reforms and stabilisation started in 1998/1999 with substantial financial support from international donors. The republic moved to de-facto autonomy in trade and customs and a separate monetary regime, with first the German mark and later the unilateral adoption of the euro to perform the function of sole legal tender. Following relatively high real GDP growth in 2000 at 12.5%, average annual growth during 2001 - 2003 reached only 1 to 2%. This modest growth was driven by services and construction, while industrial production stagnated. GDP growth accelerated in 2004 to 3-4%, supported by increasing activity in tourism and agriculture.

Official figures show **unemployment** at above 30% (estimates based on surveys show a rate of about 20%). High taxes on wage income remain a major deterrent to new job creation by the private sector. The situation has somewhat improved since spring 2003 when the government introduced a temporary reduced rate for new jobs with the objective of moving jobs from the grey to the formal sector.

Inflation has fallen in Montenegro. Annual inflation in that republic came down from 25% at end-2000 to 6.6% at end-2003. For 2004, consumer prices grew by 3.4%. This implies a continuous real appreciation in the ‘euro-ised’ economy.

Montenegro’s **external deficits** remain high, although the trade deficit continued to decline. The external situation is characterised by persistent balance-of-payments deficits, as net capital and financial inflows cover only part of the current account deficits. This has led to continued tight monetary conditions.

2.1.2. Fiscal policy

Fiscal policy in Serbia and Montenegro before 2000 was characterised by a considerable lack of transparency and unsustainable deficits. Since then the situation has improved considerably, and major progress has been achieved in fiscal consolidation. In 2003, the consolidated general government deficit of Serbia and Montenegro reached 4.2% of GDP. Revenues increased to 42.6% of GDP, due to improved tax collection, and expenditures rose to 46.8% as fiscal policy turned expansionary in the run up to the general elections in December 2003. Fiscal consolidation was supported by a comprehensive reform of public finance in Serbia and in Montenegro. Expenditure control was enhanced through the introduction of Treasury systems in both republics, although further progress is needed to establish a fully-fledged system of commitment control.

Serbia

According to national accounting standards, the Serbian **government deficit** for 2004 fell to 1.7% of GDP as almost all major revenue categories substantially exceeded expectations, reflecting strong domestic demand and improved tax enforcement. Nevertheless, despite this progress, fiscal sustainability remains a considerable challenge and further budget deficit cuts are projected for 2005 and following years. Further fiscal adjustment seems inevitable, in particular with respect to current spending, to allow for a more growth-conducive structure of public spending, including capital spending or new expenditure priorities related to restructuring costs. Furthermore, debt service payments are projected to increase substantially over the medium term. Also, fiscal policy has a major role in strengthening macroeconomic stability in the country, against the backdrop of an again accelerating inflation and high current account deficits.

Montenegro

In Montenegro, the **consolidated fiscal deficit**, which stood at around 8% of GDP in 2000, was gradually reduced to around 6% of GDP in 2003. For 2004, the consolidated deficit is expected to remain below 3% of GDP, slightly below initial budget plans. As this level of deficit still remains relatively high, also in the light of the currency regime of Montenegro, there is need for further fiscal consolidation and prioritisation of public spending.

2.2. Price and trade liberalisation

Contrary to other countries with which SAAs have been concluded or are under negotiation, Serbia and Montenegro have not yet become members of the World Trade Organisation (WTO) and, consequently, have not undergone the deep reform and trade liberalisation which membership in this organisation implies.

In **Serbia**, first steps towards price liberalisation were taken in autumn 2000 when price controls on most goods were abolished, except for some food items, medicines, electricity and public services. These price categories were adjusted gradually and some remain controlled. Electricity prices have been increased gradually from a very low average level of 0.9 euro cents per kWh in October 2000 to almost 3.6 euro cent in mid-2004, this being close to variable cost recovery. A new price law envisages free commodity and services prices with a few exceptions for energy supply and utilities.

In **Montenegro**, prices were almost completely liberalised at end 2000. Price controls on milk and bread remained in place for a transitional period and were gradually removed during 2001. Average electricity prices rose to 4.6 euro cent in the period 2001-2003 per kWh, but further tariff increases will be required.

Serbia and Montenegro assumed the obligations under Art. VIII, sections 2, 3 and 4 of the IMF Articles of Agreement in May 2002 and has thereby established **current account convertibility** of its foreign exchange regime.

2.3. Privatisation, private sector development and financial reform

2.3.1. Privatisation and private sector development

Serbia

Privatisation in Serbia started in 2001, but has recently been slower than foreseen. In mid-2001, the *Serbian* authorities adopted a new legal and institutional framework for the transparent privatisation of 4000 - 4500 socially and state-owned enterprise by mid 2005. By the end of 2004, the number of privatised enterprises stood at 1,350. As for tender privatisation, 74 companies had been offered for sale and some 1231 SMEs had been offered through auctions by end-September 2004.

The process of **restructuring some 60 large insolvent socially-owned companies** that were identified in 2002 by the Privatisation Agency has progressed only slowly. Liquidation proceedings are expected to start in 2005 and for some of these companies, restructuring plans have already been adopted, but it appears that creditors, including the government, have not been willing to restructure the outstanding liabilities of these companies. Little progress has so far been made in reform of publicly owned utilities, although for some of these restructuring plans have been developed and adopted by government.

The **restructuring of network industries**, such as the energy, telecommunications or transport sector, is still in its infancy. Some progress has been made in creating the necessary regulatory framework and setting up well-equipped regulatory agencies in these sectors. The actual restructuring of the sectors, the unbundling of activities or the opening to competition remain an important future task.

The country has still a relatively large share of agriculture. In terms of value added it amounted to around 16.6% in 2002, and is estimated to have fallen to somewhat below 16% in 2004. Also the share of the industry, with more than 30% is relatively high.

Montenegro

In Montenegro, a new **privatisation** framework was adopted in 1998/1999. This framework provided for a variety of methods, including mass voucher privatisations, through which some 200 medium-sized companies were sold by end-2001. The restructuring and privatisation of 16 large industrial enterprises which account for 45% of industrial assets, including KAP, the big aluminium plant, is only slowly approaching conclusion. Concerns have been raised in relation to irregularities and the transparency in the ongoing privatisation process.

2.3.2 Financial sector reform

Since the start of reforms in late 2000, substantial progress has been achieved in sanitising and restructuring a banking system that earlier suffered from bad loans, illiquidity and a low level of financial intermediation. Effective banking supervision institutions are gradually being established (see also 3.4.3).

Serbia

In Serbia, in-depth inspections and classifications have been undertaken for all operating banks. In early 2002, all insolvent banks were liquidated or put under bankruptcy procedures in 2002. This included the four largest banks. As a result, the total number of banks fell from more than 80 in 2000 to 42 in January 2005. Of these eight are newly licensed foreign banks. The privatisation of major publicly-owned banks also continues. Three banks were offered for tender sale in 2004 and more are expected in 2005. The closure and strict control of troubled banks and the entry of foreign banks has raised public confidence in the banking system and supported the process of re-monetisation. Total deposits have increased from 17.7% in 2001 to 24.2 % of GDP in 2003.

In July 2004, responsibility of the supervision of the insurance sector was transferred to the National Bank of Serbia (NBS). Since then, the NBS has revoked the licenses of 15 insurance companies and ordered their liquidation, while 3 others have voluntarily agreed to cease operating. The two largest insurance companies, Dunav and DDOR, are both majority state-owned and between them account for about two thirds of the insurance market. There currently do not appear to be any specific privatisation plans.

Montenegro

In Montenegro, new banking legislation was adopted at end-2000 and later harmonised with international standards, laying the basis for bank privatisation. Some banks, including off-shore banks registered in the republic, have been closed, and ten out of 11 banks operating in the republic are controlled by private investors, including the largest, Montenegro Banka. Three banks are majority-owned by foreign investors. Immediate challenges include the privatisation of the remaining state-owned bank as well as the setting up of an institutional framework for the management of carved out assets and liabilities of restructured banks.

3. ABILITY TO ASSUME THE OBLIGATIONS RESULTING FROM AN SAA

In this section of the report the main elements of a future SAA are presented (*in italics*) and Serbia and Montenegro's capacity to take on these obligations is assessed. Clarity on the division of powers between the State Union and the two Republics is crucial not only for Serbia and Montenegro's ability to negotiate and conclude negotiations but also to implement and enforce the obligations resulting from an SAA. The Constitutional Charter contains rules on the **division of competences** between the State Union and the two constituent republics. Based on the information provided by the authorities on the current situation, the Commission understands that these competences are articulated as follows. The State Union itself holds powers relevant for an SAA in the fields of international political cooperation, non-economic international obligations (such as cooperation with ICTY), human and minority rights and regional cooperation. In addition, the State Union is competent for defence – a matter which is linked to the respect of the SAP political criteria. Other policies, in particular trade, customs,

economic and fiscal matters as well as sectoral policies such as agriculture, energy and transport, the environment, electronic communications and audio-visual, the police and judiciary, lie within the respective remits of the two republics. Nevertheless, certain legislative powers and administrative structures remain on the State Union level. The Constitutional Charter's implementation law explicitly mentions a number of bodies and organisations at State Union level in this respect, including the Bureau for Standardisation, the Accreditation body, the Bureau for Intellectual Property, the Bureau for Measurements and Precious Metals and the Bureau for Statistics. Moreover, in the field of Justice and Home affairs the State Union has a legislative competence but implementation takes place at the level of the republics.

3.1. Political dialogue

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

Reinforced political dialogue should not present major difficulties for the Serbia and Montenegro, as the EU's and Serbia and Montenegro's positions on many foreign policy subjects are comparable. Political dialogue would help the parties to further co-ordinate their efforts to meet the objective of enhancing Serbia and Montenegro's gradual rapprochement with the European Union and would also contribute to promoting regional co-operation. As proposed at the Thessaloniki Summit, two meetings of the political dialogue have been held so far.

To make this dialogue fruitful, it is vital that Serbia and Montenegro take a co-ordinated single stance. In the past, diverging views have emerged occasionally between the two republics on some issues (e.g. Iraq), while on others (e.g. ICC) policy has been more consistent.

3.2. Regional co-operation

Under the SAA Serbia and Montenegro 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 Regional Conventions with provisions on free trade, political dialogue, mutual concessions on the movement of workers and supply of services, and co-operation in justice and home affairs.

Serbia and Montenegro has pursued a policy aiming at improving relations with all its neighbours. This largely successful policy constitutes an important contribution to regional stability.

Serbia and Montenegro takes part in a number of regional initiatives, including SEECI, CEI, Adriatic-Ionian Initiative, and the International Commission for the Protection of the Danube River and Black Sea Economic Cooperation Council. Particularly intensive **multi-lateral cooperation** takes place in the South East Europe Cooperation Process (SEECPP), which Serbia and Montenegro chaired in 2002-2003. This process facilitates a variety of initiatives such as justice and home affairs cooperation, visa liberalisation and inter-parliamentary contacts. Serbia and Montenegro also participates actively in the Stability Pact for South Eastern Europe. Under the auspices of the Stability Pact, Serbia and Montenegro was one of the signatories of the Memorandum of Understanding on Trade Liberalisation and Facilitation

of June 2001 and thus committed to conclude **Free Trade Agreements** (FTAs) with other participants by end-2002. Serbia and Montenegro eventually succeeded to conclude the full network of bilateral FTAs with all the Western Balkan countries and with Bulgaria, Romania and Moldova by end 2003. By September 2004, these FTAs were ratified and in force. It is now critical that these international commitments are also fully implemented, without the politicisation which accompanied their negotiation.

Bilateral relations with all countries, both in the political and commercial sphere, have improved steadily, though more rapidly with some than others. Key events were the exchange of apologies between the Serbia and Montenegro and Croatian Presidents for crimes committed in the recent past, and the Serbia and Montenegro apology to the Bosnian people. Regular political dialogue has been established with all partners in the region and has recently resulted in the conclusion of a significant number of sectoral agreements (concerning refugee return, visa suspension, fight against organised crime and terrorism) facilitating the redevelopment of regional ties in all fields.

Some main issues are still outstanding, notably border demarcation with Croatia and BiH and the pending suits against Serbia and Montenegro before the International Court of Justice, which both these countries have filed.

As to specific bilateral relations, contacts with **Albania** are generally good. Occasional issues relating to the status of Kosovo have occurred, but political dialogue continues to develop constructively. There is increasing cross-border cooperation.

Political relations with **Bosnia and Herzegovina** have developed, leading inter alia to an apology by Serbia and Montenegro's President to the people of Bosnia and Herzegovina for crimes committed by Serbia and Montenegro citizens. A "special relationship" between Serbia and the Republika Srpska continues. Overall, inter-state relations are good and an example of the positive paradigm shift that Serbia and Montenegro's regional foreign policy has undergone in recent years. A variety of sectoral agreements are in place, including an FTA, an agreement on dual citizenship and a treaty on the return of refugees. There is also agreement to facilitate travel by allowing each other's citizens to enter respective territories with ID cards only. An Inter-State Cooperation Council serves as the highest bilateral body providing the necessary political impetus to further deepen these relations. Issues of illicit cross-border trade persist.

Border demarcation is an outstanding issue in Serbia and Montenegro relations with Bosnia and Herzegovina. More fundamentally, a Bosnia and Herzegovina lawsuit is pending against Serbia and Montenegro for genocide before the International Court of Justice.

Relations with **Croatia** have improved substantially, as reflected by the exchange of apologies between the two Heads of State for crimes their citizens committed against each other. During the November 2004 visit of the Croatian PM, the two countries agreed on further cooperation and mutual support in their respective efforts towards EU integration. Croatia's decision to suspend provisionally the visa regime for Serbia and Montenegro citizens was a further confidence building measure. Some progress has been made concerning the return by Serbia and Montenegro of family registers and cadastral records taken from Croatia during the war. Croatia undertook to facilitate the safe return of refugees, including by reconsidering arrest warrants, a long-standing obstacle.

There are currently numerous bilateral agreements, including on readmission and the fight against organised crime. An important agreement on protection of minorities was signed in November 2004 and is currently pending ratification. Regular cooperation on missing persons is ongoing. An FTA is in force, which is expected to strengthen the commercial ties between the countries. Montenegro has also developed its own bilateral co-operation on specific points, such as implementation of the Protocol on the interim border regime on Prevlaka.

The main outstanding issues between Serbia and Montenegro and Croatia continue to be the full border demarcation on the Danube, refugee return and the Croatian lawsuit against Serbia and Montenegro before the International Court of Justice.

Relations with the **Former Yugoslav Republic of Macedonia** have also improved since October 2000. There are no major outstanding issues. An agreement on border delimitation and demarcation is in force. An FTA, which has applied since 1996, is currently under revision.

In **conclusion**, Serbia and Montenegro has made major contributions to regional peace and stability and to the development of good neighbourly relations over the last few years. This is particularly significant given the country's earlier role as an instigator of instability. Consequently, the requirement of regional cooperation under a future SAA would not pose major problems for Serbia and Montenegro.

3.3. Free Movement of Goods

Ensuring free movement of goods is one of the main objectives of any association agreement with the EU. In the framework of a future SAA, both Serbia and Montenegro, which are autonomous in the conduct of their respective trade policies, would need to gradually establish bilateral free trade areas with the Community, within a transitional period to be determined during the negotiations. These free trade areas would have to be in conformity with relevant WTO provisions. In particular, both Serbia and Montenegro would need to abolish all quantitative restrictions or measures having an equivalent effect and progressively dismantle their respective customs duties and equivalent measures on essentially all trade with the EU. The customs authorities in both Serbia and Montenegro would need to be able to enforce and safeguard these demanding trade regimes.

Both Serbia and Montenegro, in accordance with their respective powers, would forego the introduction of new duties, restrictions or measures with equivalent effect in trade with the Community and abolish any domestic tax measures or practices discriminating directly or indirectly against EU producers. The EC autonomous trade measures already contain a standstill clause making them conditional on the beneficiary countries' not introducing new import duties and measures having equivalent effect in trade with the Community. This would become a contractual obligation under an SAA.

3.3.1. Implications of the twin-track approach

The two **Republics of Serbia and Montenegro** pursue **distinct trade and trade-related policies** and feature **distinct trade laws, customs administrations and customs codes**. Both in law and practice, they act autonomously in the conduct of their respective external trade regimes. Given their different economic interests, they apply different tariffs and systems of import levies and charges, notably on agricultural and some industrial products.

Consequently, in line with the twin track approach, the trade and trade-related elements of the SAA will be the subject of distinct negotiations with the two Republics. These will also be responsible for the subsequent implementation of the various relevant commitments resulting from the negotiations.

Trade liberalisation under an SAA and an interim agreement (which would apply pending the SAA's ratification) necessitates functioning trade policies in both Serbia and Montenegro to negotiate, conclude and implement substantive commitments towards the EU. The republics will also need to ensure that the objective of trade liberalisation is understood and shared by the domestic economic stakeholders which presently does not always seem to be the case.

Distinct negotiations will probably result in different trade concessions by each republic in import trade with the EU, possibly even after the end of the SAA transitional periods. Temporary and effective controls along the administrative boundary line would continue to be necessary for goods subject to significantly different import arrangements. However, Serbia and Montenegro will be requested to ensure that goods which both republics import duty-free or which are subject to the same tariffs can circulate freely within the territory of the State Union.

At the end of SAA transitional periods, liberalisation of substantially all trade between the EU and Serbia and Montenegro will be achieved.

The twin-track approach is not a pretext to dismantle the State Union-level institutions foreseen in the Constitutional Charter. Moreover, the achievements of the Action Plan for Trade and Internal Market should as far as possible be maintained as to assure free movement of goods in the State Union. Since a dismantling of already harmonised systems makes little economic sense and would contradict to the objectives of the SAP, any shift from the original Internal Market/Trade Action Plan will need to be kept to strict minimum.

3.3.2. Serbia and Montenegro's trade relations

Common features

Serbia and Montenegro are not yet members of the World Trade Organisation. The accession process to this organisation is ongoing. Serbia and Montenegro is also party to bilateral Free Trade Agreements with all the countries signatories of the Stability Pact's Memorandum of Understanding on trade.

The EU is by far Serbia and Montenegro's first trading partner, accounting for nearly half of the trade of each Republic.

Both Republics benefit from the Community's **autonomous trade measures** (ATMs)², which were extended to Serbia and Montenegro in November 2000³. These measures allow basically all imports originating in Serbia and Montenegro to enter the EC without quantitative restrictions and exempt from customs duties. The only exceptions are beef, wine

² Council Regulation, (EC) No 2007/2000 of 18 September 2000.

³ Council Regulation (EC) No 2563/2000 of 20 November 2000, amending 2007/2000 (OJ L 295/1, 23.11.2000)

and certain fishery products, to which tariff quotas apply. The EU will introduce tariff quotas on imports of sugar by mid-2005⁴.

These ATM are important for Serbia's and Montenegro's economic recovery. Serbia and Montenegro is the country for which the ATMs have created the largest margin of preference over competitive suppliers, in particular regarding fruits, vegetables, sugar, leather and chemical and steel products. However, the overall opportunities offered by the preferences are far from being fully exploited yet. Neither republic has been able to fully realise the export potential brought about by economic growth in the country and in the EU.

Significant proportion of both Serbia and Montenegro's exports are raw materials or goods with a low level of processing and relatively low value-added. Iron and steel, fruit, vegetables and sugar constitute the largest components in **Serbia**. Exports of agricultural goods have returned to earlier, levels. In **Montenegro** aluminium dominates exports. By contrast, imports are generally of a higher processing stage. While there is a positive trend of increasing imports of capital goods, (pointing to higher investment in the country underpinning structural reforms) the growth of consumer goods imports remains significant.

Serbia

Total Serbian **exports** grew from a relatively low base of around € 2 billion in 2000 and 2001 to € 3.7 billion in 2004. The volume of merchandise **imports** has more than doubled, from around € 3.7 billion in 2000 to € 11.1 billion in 2004, As a result, the trade deficit has risen continuously from around €1.5 billion (USD 1.8 billion) in 2000 to almost (€6 billion (USD 7.5 billion)) or 6% of GDP in 2004⁵.

Serbia's main foreign trade partners are the EU (Germany and Italy) and Russia. On an aggregate level, the European Union accounts for nearly half of Serbia's trade. The EU also stands for the largest part of the republic's trade deficit. Yet, Serbia's exports to the EU grew from 763 million in 2000 to € 1.5 billion in 2004 or 52 % of the republic's total exports.

Serbia's individual bilateral trade relations are marked by deficits, with the exception of trade with Bosnia and Herzegovina (Serbia's prime export destination) and the former Yugoslav Republic of Macedonia. Since the conclusion of the bilateral FTA, Serbian exports to Croatia have increased markedly.

On 31 March 2004, the EU and the Republic of Serbia signed a bilateral agreement on trade in textiles, under which the European Communities will remove current import quotas on textile products in exchange for tariff dismantling on EU imports into Serbia. It is expected that this agreement will enter in force in the first half of 2005.

Montenegro

Montenegro also faces a substantial trade deficit. In 2004, Montenegro exports totalled € 0.31 billion while the merchandise imports stood at € 0.74 billion. The deficit was equivalent to

⁴ Council Regulation (EC) No 374/2005 of 28 February 2005, amending 2007/2000 (OJ L 59/1, 5.3.2005)

⁵ The suspension of import preferences for Serbia and Montenegro sugar from May 2003 until August 2004 led to a de facto freeze of exports of this important commodity due to the high non-preferential EC tariffs. Sugar had accounted for nearly 10% of Serbia and Montenegro's export value in 2002.

almost 30% of the GDP but was somewhat compensated by an inflow of revenues from tourism and transfers. Montenegro's largest trading partners in 2004 were the EU (Italy, Greece and Slovenia), Bosnia and Herzegovina, and Switzerland (the latter as the main destination for aluminium exports). The EU share in **Montenegrin** exports stood at 45% in 2004.

3.3.3. Trade regimes

Common features

Although some level of autonomous **trade liberalisation** was achieved in the course of the last years, border protection in both republics remains complex, lacks transparency and is subject to frequent changes, in particular through unilateral increases in import charges. The situation is rendered more difficult by the fact that, currently, neither Serbia nor Montenegro are bound by multilateral obligations under the WTO. Before any SAA negotiations can initiate, Serbia and Montenegro will have to provide a full description of all aspects of their trade regimes and undertake not to modify them pending the conclusion of the negotiations.

A new import licensing system applying to some iron and steel products, introduced by both Serbia and Montenegro in the context of the Internal Market / Trade Action Plan (after licenses had already been abolished in 2001), needs to be reviewed.

Recurrent increases in charges have taken place in both Republics in contradiction to the standstill clause enshrined in the autonomous trade measures⁶ which bans increases in existing duties, charges or any other restriction as well as the introduction of any new tariff or non-tariff barrier.

On substance, these increases in protection reflect the structural weakness of the country's economy and export capacity, an element which will need to be taken into account when assessing Serbia and Montenegro's capacity to withstand competitive pressure and liberalisation under an SAA.

Finally, both Republics have different systems of **export subsidies** for their respective products, which would also need to be addressed under an SAA.

Serbia

In Serbia, although protection still remains relatively high on agricultural and processed products and on basic industrial items, tariffs have generally been lowered and simplified. There is currently a maximum rate of 30% on key agricultural products such as meats and cereals. Serbia also introduced variable special levies and charges as an alternative form of temporary protection. These additional charges apply to a considerable range of agricultural and some industrial goods (more than 200 items in total).

Serbia increased **special charges** on a large number of agricultural products by significant amounts in 2003. However, after the change of government in early 2004, Serbia has taken a more cooperative stance and has proposed to return to pre-2001 protection levels for most goods concerned and introducing a stringent phasing-out schedule for those items for which Serbia can demonstrate a specific need for temporary protection.

⁶ Article 2 (1) b) of Council Regulation, (EC) No 2007/2000 of 18 September 2000.

Furthermore, Serbia maintains export duties on a number of products (metals, steel scrap and rawhides) which would be inconsistent with the SAA obligations. In addition, further issues relating to increases in **non-tariff restrictions** on some imported spirits and fishery products, which hamper EU trade, as well as an import-ban on beef imposed (on BSE grounds) in 2001, still need to be resolved. A new import licensing system applying to some iron and steel products, introduced by both Serbia and Montenegro in the context of the Internal Market / Trade Action Plan (after licenses had already been abolished in 2001) also needs to be reviewed. Finally, the ban on imports of second-hand vehicles older than three years introduced in October 2004 would be inconsistent with the SAA obligations. More generally, the above proves that the Serbian Government must continue to steer a steady course of trade liberalisation and to increase significantly its efforts to ensure consistency and predictability in its trade regime. These efforts must be coupled with internal industrial and agricultural reforms to strengthen the foundations for export-led growth.

Montenegro

Montenegro's trade regime is characterised by low tariffs. Tariffs for most items range between 0 and 5%, with tariff peaks of 30% on some live animals, specific fresh and processed meat items, dairy products and some alcoholic beverages. Montenegro also operates additional charges as a temporary instrument of adaptation.

Legislation and administrative capacity to conduct trade policy and negotiations

Montenegro's reformed foreign trade law is already in force. However, Montenegro needs to continue to bolster its administrative capacity.

Serbia's draft bill for a similar law is in preparation. Serbia's policy-making capacity in the administration is sufficient to conduct a substantial commercial relationship with the EU and has improved under the new government.

The implementation of SAA obligations will confront Serbia and Montenegro with a number of technical difficulties. Firstly, as stated below under the 'Customs' chapter, management of preferential origin remains a key area for further improvement. Secondly, the republics cannot yet adequately certify potential exports in several sectors as meeting Community minimum industrial, veterinary and sanitary standards. Nor do they yet possess all WTO standards and certification capacities required to implement the SAA. While the systems of certification and control of origin appear to be adequate, they should be further improved. Both republics will therefore have to improve their respective implementation capacities in order to be in a position to respect fully the demanding SAA obligations.

3.3.3.1. Trade in industrial goods

As mentioned previously, Serbia's and Montenegro's industrial products have duty free access to the Community under the EU's autonomous trade measures. However, to date, despite an increase in industrial exports to the EU, Serbia and Montenegro have not been able to take full advantage of the trade benefits granted by the EU for industrial goods, due to supply-side issues. Both Republics show a substantial trade deficit in industrial goods with the EU. This illustrates the extent and depth of the challenge which Serbia and Montenegro face. Like in most transition economies, Serbia and Montenegro need to undertake significant structural change towards an economy with higher added value in export goods, especially in intra-industry trade with EU companies

3.3.3.2. Trade in agricultural goods and fisheries

Agriculture is a key sector in both Serbia and Montenegro. Primary **agricultural production** (including forestry) accounts for 21% of Serbia's GDP and 15.6% of Montenegro's. The food processing industry accounts for an additional 20 % of Serbia's GDP. These sectors (including fisheries) have considerable further growth potential, both in terms of production and trade.

Serbia introduced **special charges** on a considerable number of agricultural, processed agricultural and fisheries products after 2000 and increased them by significant amounts in 2003. Since the change of government in early 2004, Serbia has however taken a more cooperative stance and has offered preferential reductions of the special charges on agricultural products. These reductions broadly involve a return to pre-2001 protection levels (in tariff-equivalent terms) for the majority of goods concerned where Community exports seem to have been affected.

Further issues relating to increases in **non-tariff restrictions** on some imported spirits and fishery products, which hamper EU trade, still need to be resolved.

With regard to the standstill clause, it should be noted that **Montenegro** is considering similar duty increases on a variety of dairy products as a temporary measure to counter sudden surges in imports.

Serbia and Montenegro have benefited considerably from the inclusion of agricultural products in the EC's **autonomous trade preferences**. The only products excepted from duty-free access are beef, wine and certain fishery products, to which tariff quotas apply (which have, however, not been exhausted so far).⁷ Nevertheless, exports are so far concentrated on a small group of products (in particular, sugar and fruits & vegetables).

Similarly to the industry sector, Serbia and Montenegro need to continue their **structural reforms** in the field of agriculture, including the privatisation of processing plants, to boost their commercial competitiveness and thus prepare for a potential SAA.

Serbia and Montenegro should equally accelerate the harmonisation of **veterinary and Sanitary and Phyto-sanitary rules** with EU standards, not least to help its exports meet international requirements. Moreover, customs controls of agricultural exports must ensure compliance with the applicable rules of origin (see 3.7.4.1 on customs).

Serbia and Montenegro are currently registered as complying with EC rules on various meat products, important for its exports, but not yet for poultry, aquaculture, milk, eggs and wild game. In order to improve export performance for all agricultural products, the alignment of the respective standards in the Republics with the EU 'acquis' needs to continue. Also, the relevant institutions must be further strengthened.

As the Republics pursue distinct policies in this field, animal health and food safety controls continue to take place at specifically designated points along the administrative boundary line. Clearly, these controls should remain minimal in order to facilitate exchanges between the Republics and should be progressively replaced by mutual recognition. Furthermore, they should disappear under an SAA for goods of EU origin.

⁷ The EU intends to introduce tariff quotas on sugar from 1 July 2005.

3.4. Movement of workers, Establishment, Services, Capital

3.4.1. Movement of workers

An SAA would require both the EU and Serbia and Montenegro 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 Serbia and Montenegro would have access to the labour market during the period of the worker's authorised stay. Furthermore, the EU would be required to apply some of the rules on co-ordination of social security systems to Serbia and Montenegro nationals legally employed in the EU and to members of their family legally residing with them. For certain rules Serbia and Montenegro would also have to grant similar treatment to EU nationals legally employed in the country and their family members residing with them.

Access to the labour market and social policies are republican competences. Different republican rules would obviously make it difficult to attract EU nationals who intend to be active throughout both republics. Under distinct republican laws, foreign nationals legally residing in **Serbia** and **Montenegro** respectively already have access to employment. Once a work permit has been obtained by an EU citizen the same conditions in terms of social security as for national workers exist. Nevertheless, access is subject to the granting of a specific work permit and preference is given to nationals. New legislation is being introduced in Serbia which allows the government to set annual quotas for work permits. A similar quota system is being introduced in Montenegro.

Thus, Serbia and Montenegro do not yet ensure complete non-discrimination for EU workers who reside legally.

3.4.2. Establishment

Under an SAA, both Serbia and Montenegro would be required to grant EU companies the right of establishment. This right would be reciprocal. EU companies established in Serbia or Montenegro should be granted either national treatment or MFN treatment, whichever is more favourable on the territory of the entire State Union. During the transition period, the issue of extending these rights to EU or Serbia and Montenegro nationals wishing to establish themselves as self-employed independents would be examined. Notwithstanding the provisions governing on the free movement of workers under the agreement, special establishment provisions could be introduced for “key personnel”.

The legal framework for establishment is set on the level of the two republics. Both **Serbia and Montenegro** already operate a liberal regime under their respective Foreign Investment Laws (in force since 2002), granting foreign investors national treatment. However, there are still outstanding issues concerning the implementation of this freedom of establishment on the ground in particular regarding company registration. With the objective to improve this situation, the registration and incorporation process has been significantly eased in both republics. **Serbian** law transferring the business register from the inefficient commercial courts to an independent business registration agency was finally adopted in May 2004 and is being implemented as of January 2005. The law provides for a “one-stop shop” and provides that the registration should not take more than 5 days while the process has previously required an average of 40 days. In **Montenegro** a central registry exists as an independent agency within the commercial court and implements liberal incorporation rules. According to

Montenegrin authorities, this process of company registration takes an average of 3 working days.

There is, however, no link between the corporate registers of both Republics, meaning that two different authorisations have to be obtained in order to operate throughout the state. A policy of simple mutual recognition should be in place to resolve this problem and avoid additional restrictions to EU investments.

3.4.3. Trade in Services

A future SAA would provide for the progressive and reciprocal liberalisation of trade in services with both Serbia and Montenegro respectively, consistent with the relevant WTO rules, in particular Article V of GATS. Companies not established in the territory of the respective other contracting party would gradually acquire the right to provide services, in accordance with the GATS provisions and taking account, in particular, of progress in approximation of laws in the various fields. The agreement would contain a stand still clause. The implementation of this liberalisation would be closely monitored under the agreement, notably as regards financial services.

The legal framework for trade in services is set on the level of the republics. Both **Serbia** and **Montenegro** have amended legislation starting to opening up their economy to foreign service providers.

There is thus progress on which an SAA could build to liberalise trade in services with both Republics.

To allow EU service providers to provide services throughout the entire State Union without having to obtain duplicate authorisations, the principle of mutual recognition of republican licenses should be applied. Under the Internal Market and Trade Action Plan, mutual recognition has already been agreed for accountant and auditor licenses. In addition, the two republican Central Banks have continued a cooperation agreement covering information exchange and supervisory cooperation. However, there has been limited progress in the implementation of this agreement.

3.4.4. Current payments and movement of capital

In the framework of an SAA, both Serbia and Montenegro would commit themselves 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 will 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.

Both Republics have made substantial progress in liberalising capital movements, including foreign direct investment (which according to Serbia and Montenegro is granted national treatment). The repatriation of profits is also liberalised. These rules constitute a major economic and regulatory achievement and should in the long run help attract the capital needed for economic growth.

The pace of liberalisation (starting with long-term operations and then gradually liberalise short term transactions) is comparable to that of most other transitional economies. Current

payments are liberalised while short-term capital movements are still restricted in **Serbia**. Only banks and agencies licensed by the National Bank of Serbia can purchase and sell short-term securities. Long-term securities enjoy a more flexible regime. Serbian residents cannot invest in foreign investment funds, and loans between residents and non-residents are still partly restricted. Also, a foreign natural person or legal entity may found an insurance company only as a joint venture with a Serbian partner, and such a company is not allowed to carry out reinsurance activities outside Serbia.

Current rules on short term capital movements in **Montenegro** will be clarified by a new law on capital transactions scheduled to be adopted in the course of 2005.

In Serbia, the acquisition of **real estate** by non-residents is still subject to a reciprocity requirement based on treatment in the respective country of origin and should be further liberalised to allow for the further inflow of foreign direct investment

In order to ensure the particular free flow of payments *within* the State Union, the two republican Central Banks will have to find basic agreement on a system of **correspondent accounts**, meaning that operators are in principle free to choose either the Dinar or the Euro for financial transactions between the Republics. This should facilitate the free flow of both mutually exclusive legal currencies of the Republics throughout Serbia and Montenegro, by means of a clearing system.

Serbia and Montenegro has concluded a number of **bilateral investment treaties**, which do however not provide sectoral exclusions (e.g. in areas such as transport and audiovisual) in line with the EU 'acquis'. Nor do these agreements include Regional Economic Organisation Integration (REIO) clauses allowing more rapid liberalisation within a regional grouping without extending it to other third country partners. This could pose problems under a progressive rapprochement with the EU in this field.

3.5. Approximation, implementation and enforcement of legislation

An SAA would include provisions on the gradual approximation of existing and future legislation of Serbia and Montenegro to that of the Community. Serbia and Montenegro would have to ensure that from the date of SAA signature, approximation would begin to extend to all elements of the Community 'acquis' covered by the agreement. This would in particular apply to key areas of internal market and trade legislation. Both Serbia and Montenegro would thus have to agree binding deadlines for harmonisation in areas such as competition, intellectual, industrial and commercial property, public procurement, standards and certification, financial services, land transport, company law, accounting, consumer protection, data protection, health and safety at work and equal opportunities. In addition, both Serbia and Montenegro would undertake clear enforcement obligations notably in the field of competition and intellectual, industrial and commercial property rights.

Both Serbia and Montenegro have started to align their respective legislation to that of the Community, albeit so far in a somewhat uncoordinated manner, due to weak legislative and administrative resources. Furthermore, implementation and enforcement remain difficult, mainly due to the insufficiencies of the administrations and judiciaries. However, there have been efforts to create a legal framework for a market economy. Both Serbia and Montenegro have introduced a compulsory EU compatibility-check of draft bills.

To implement a future SAA, both Serbia and Montenegro would need to accelerate the further alignment of their legislation to that of the EC, and also ensuring that it is properly applied and enforced.

3.5.1. Competition

Any measures which could adversely affect fair competition in trade between the Community and Serbia and Montenegro respectively are incompatible with an SAA. In particular, Serbia and Montenegro, through operationally independent public authorities/bodies, would have to prohibit and police 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 state (public) aid which distorts or threatens to distort competition by favouring certain undertakings or certain products. Serbia and Montenegro would also commit themselves to apply these rules to public undertakings and undertakings with special rights, to adjust state monopolies of a commercial character so that no discrimination exists regarding the conditions under which goods are procured and marketed, and to ensure transparency in the area of state (public) aid by establishing comprehensive inventories of aid schemes and by reporting annually to the European Commission on the total amount and the distribution of the aid given, and by ., upon request, providing information on particular cases.

The development of competition policies in Serbia and Montenegro are still at an early stage. Old federal legislation is not enforced and new republican legislative frameworks are still under development. Under an SAA, Serbia and Montenegro would need to enforce competition rules in their respective jurisdictions in order to ensure free and fair competition domestically, between the two Republics and to safeguard fair bilateral trade with the Community. As a result, the adoption of legal bases and the establishment of functioning administrative structures for competition policy should be given priority.

Anti-trust/merger legislation has been subject to protracted discussions both within and between Serbia and Montenegro. Both republics have now prepared draft competition laws based on a common model. The draft acts still need to be adopted and their compatibility with EU rules ensured.

Furthermore, the institutional structures for their implementation are still under development, particularly in Montenegro where completely new institutions will have to be set up. In Serbia a new independent **anti-trust authority** will be able to draw on the experience and staff from the former Antimonopoly Commission of Yugoslavia. The authorities will need to be equipped to ensure an efficient enforcement practice, giving priority to cases with a serious effect on the market and ensuring deterrent sanctioning of infringements.

In addition to fully implementing these new laws, both Republics need to develop a **competition advocacy** and adopt a coherent horizontal approach to promote competition policy in the fields of market liberalisation, privatisation, restructuring, the screening of draft legislation regarding competition aspects, improved public procurement practices and an overall strengthening of the rule of law.

As to **the control of state aid**, full transparency, legal frameworks and institutions still need to be established in both Republics, As regards transparency, progress has been very slow towards setting up the necessary structures for coordination (e.g. within the Ministry of Finance) and information gathering, as well as towards establishing a comprehensive aid

inventory and reporting system for all aid measures in force, based on an EU-harmonised state aid definition. Serbia has, however, recently taken a first step by adopting a state aid report, but still needs to formalise and improve its ad hoc structures. Gradually, the SAA obligations will require an ex-ante control of all new aid measures and the alignment of existing aid measures, by operationally independent State aid authorities in both Republics, with the power to authorise or prohibit all aid measures and to order recovery of unlawfully granted aid.

In conclusion, enhanced efforts, both in the legislative and the executive realm, will be necessary for Serbia and Montenegro to be able to take on and implement SAA obligations.

3.5.2. Intellectual, industrial and commercial property

Before the end of a transition period, Serbia and Montenegro would need to guarantee a level of protection similar to that existing in the Community of intellectual, industrial and commercial property rights, including means of enforcement. 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.

Serbia and Montenegro's intellectual property **legislation** is currently being harmonised with the international conventions, including relevant WTO/TRIPS standards and the EU 'acquis'. The legislation is set on State Union level and overall policy input is provided by the State Union Bureau for Intellectual Property Rights (IPRs). The Bureau has recently been obliged to lay off a substantial part of its personnel due to cuts to the State Union budget. Serbia and Montenegro must ensure that the Bureau has sufficient administrative capacity (personnel, budget etc.) to perform its functions. The State Union Court should also act as a court of second instance in relation to IPR cases. The rules set on the State Union level are enforced by the respective republican administrations.

New laws on trademarks, designs and topographies of integrated circuits as well as geographical indications and copyrights and related rights were adopted in December 2004 at State Union level. The Law on Patents entered into force in July 2004, while drafted legislation on State Union level on geographical indications is still to be adopted in 2005. The approach to be followed in relation to the adoption of legislation on the protection of plant varieties is being discussed by the two republics, in particular to ensure compatibility with the UPOV Convention.

Serbia and Montenegro is a member of the World Intellectual Property Organisation (WIPO) and has already signed a number of **international conventions** in the field of copyright (Rome Convention, Geneva Convention), as well as the Paris Convention on the Protection of Industrial Property. In the framework of the republics' accession to WTO, Serbia and Montenegro will have to undertake to implement TRIPS.

The **Serbian** Criminal Code was amended to improve **enforcement** in this field, notably by introducing 'ex officio' prosecution for piracy and counterfeiting, the strengthening of right-holders as civil parties and through provisions on the seizure and physical destruction of illegal goods and their production facilitation. Temporary protective measures are also laid down in the new legislation and can be applied upon the request of third-party right-holders. Furthermore, Serbia's new Customs Law foresees increased border measures to prevent the import of counterfeit and pirated goods.

Since necessary by-laws, already prepared, have not yet been passed, **Montenegro's** Customs Code still needs to introduce such provisions. Furthermore, Montenegro's Penal Code does not provide for 'ex officio' prosecution of breaches of intellectual property rights; procedures can only be initiated by private suits. Montenegro is also adopting a framework law for the implementation of IPRs.

The State Union and Republican bodies need to enhance cooperation in ensuring the coherence of these various enforcement mechanisms.

Despite these positive changes, enforcement is still weak. Although both Republics have set up **Anti-Piracy Commissions**, it remains to be seen whether this will decisively improve the coordination between the administrative bodies. In addition, despite better practical cooperation, the administrative resources of all agencies concerned are, inadequate and lead to a persistent enforcement deficit.

Effective protection of intellectual property rights, as required by an SAA, is therefore not currently guaranteed. Combating counterfeiting and piracy would therefore constitute a significant challenge for Serbia and Montenegro under a future SAA. Both Montenegro and Serbia need to make significant progress on enforcement, including the establishment of a comprehensive strategy for the protection of IPRs to improve inter-agency coordination.

3.5.3. Public procurement

Under an SAA, both Serbia and Montenegro would be required to ensure that EU companies are granted access to contract award procedures under treatment no less favourable than domestic companies, subject to a transitional period to be negotiated for EU companies not established in Serbia and Montenegro. Reciprocal arrangements would apply to the access of companies from Serbia and Montenegro to contract award procedures in the EU (subject to conditions in the utilities sector). . Serbia and Montenegro would need to progressively align their public procurement legislation to that of the Community. They would also need to strengthen the relevant institutions and judiciary so that public procurement procedures are properly implemented.

Legislative and administrative frameworks for public procurement, including Public Procurement Agencies, have been established through laws adopted in both Republics. Both Republics have gradually completed these frameworks through the adoption of by-laws.

Serbia adopted a new Public Procurement Law in 2004 with the intention to further align its legislation with that of the EU. **Montenegro's existing legislation** is highly prescriptive and differs from the 'acquis' in several key aspects, some of which would conflict with Montenegro's future obligations under an SAA. Montenegro, is currently reviewing its procurement legislation and is expected to adopt a new public procurement law the second half of 2005.

Institutions on the State Union level are currently not covered by any statutory public procurement rules. This should be remedied, for example by ensuring that legislation in both republics explicitly covers State Union institutions located on their respective territories.

Since July 2004, both republics apply a domestic preference scheme which does not apply to bidders from the other republic. New legislation should mutually reinstate the national

treatment granted to companies registered in the two Republics, thereby avoiding prejudice to the interest of future EU subsidiaries established in one of the two Republics.

Furthermore, the **administrative capacity** in Serbia's and, in particular, Montenegro needs to be enhanced. The situation in Montenegro suggests that enforcing national treatment as required by a future SAA would constitute a significant challenge.

3.5.4. Standardisation & Conformity Assessment

In order to comply with an SAA, both Serbia and Montenegro would need to gradually achieve conformity of their legislation with EU acquis comprising technical regulations and align to the European harmonised standards, as well as introduce the relevant legislation and establish the institutional capacity on standardisation metrology, accreditation market access and conformity assessment procedures. In particular, it would be required to i) promote the use of Community technical regulations and conformity assessment procedures, ii) conclude, when appropriate, Agreements on Conformity Assessment and Acceptance of Industrial Products, iii) foster the development of quality infrastructure: standardisation, metrology, accreditation and conformity assessment; and iv) further promote Serbia and Montenegro's participation in the work of specialised organisations (CEN, CENELEC, ETSI, EA, WELMEC, EUROMET etc).

The State Union Bureau for Standardisation and the Bureau of Measures and Precious Metals play a lead-role in the definition of EU-compatible **technical standards** and regulations. Draft Laws on Standardisation, Accreditation, Metrology and Technical Conformity Compliance are being finalised on State Union level. They aim at compatibility with the relevant EU and WTO provisions, in particular as regards rules on technical barriers to trade.

Since technical standards are largely defined on State Union level, both Republics follow the same technical rules which are now being brought in line with European and international standards. There is also a developing set of legislation on republican level, for instance regarding product quality and environmental standards. Both Republics need to continue their efforts to align their regulations with the 'acquis' to create conditions favourable to trade and avoid further barriers. More specifically, internal consultation mechanisms, screening or the notification of draft technical regulations prior to their adoption need to be introduced to avoid non-tariff barriers and further regulatory complexity.

There is thus progress in alignment with EU standards. However, a variety of norms (e.g. quality legislation, food safety, rules on chemicals and packaging etc.) are regulated by the republics, in a somewhat uncoordinated manner.

Veterinary and phyto-sanitary policies and institutions are equally under republican control. Republican bodies perform the relevant controls for animal health, food safety and related issues. In this context, **Serbia** has drafted a number of laws in the area of food safety, establishing a legal framework for further alignment on the EU 'acquis'. Montenegro has adopted a new veterinary law and has recently established a department for veterinary issues.

3.5.5. Consumer protection

In order to meet its obligations under an SAA, Serbia and Montenegro would need i) to develop active consumer protection policies, in accordance with Community law, ii) to harmonise their legislation on consumer protection and independent and effective

administrative structures and enforcement powers to ensure to ensure essential health and safety requirements and the safeguard of consumers' economic interests and iv) to guarantee consumer representation, information and education.

A comprehensive consumer protection law was adopted at the federal level in 2002, introducing major improvements compared to the prior situation, but it has remained essentially unimplemented. The new constitutional arrangements transferred this sector to the republican control, and **Serbia** adopted recently a new law on Consumer Protection which aims at aligning rules to those of the EU. **Montenegro** is working on similar law, expected to be adopted in the first half of 2005. The coordination between their efforts should continue to provide for overall consumer protection and to promote the alignment with relevant 'acquis' provisions. These rules should be properly applied and enforced.

Enforcement is gradually improving but remains weak. **Serbia** has established a programme for consumer protection and is setting up a Council for Consumer Protection. Positive steps have been taken to improve republican inter-agency cooperation in the implementation of the rules in this field, e.g. between the market inspectorate, customs etc.

In conclusion, despite a number of legislative and administrative steps, consumer protection in both Serbia and Montenegro is still weak. In view of the commitments under an SAA, **Serbia and Montenegro** would need to develop overall consumer policy strategies to frame both legislative, institutional and enforcement efforts.

3.6. Justice and Home Affairs

3.6.1. Reinforcement of institutions and rule of law

Under an SAA, the contracting parties would attach particular importance to the consolidation of the rule of law in Serbia and Montenegro and the reinforcement of the relevant institutions in the administration in general and in law enforcement and the judiciary in particular. The guarantee of a safe, efficient and predictable legal space is a logical precondition for the operation of an effective SAA. Authorities and a judiciary working in line with proper democratic and professional standards are not only essential for establishing the rule of law for the immediate benefit of the citizen but also for international cooperation and as regards the economic development including attracting foreign investment.

3.6.1.1. Police

Democratic control and a clear legal framework for police and security forces are preconditions for strengthening democracy and the rule of law in Serbia and Montenegro, not least when considering the specific position of the security agencies in the Milosevic regime. Some initial steps have been undertaken to strengthen and formalise the existing good inter-agency cooperation at the operational level between the Ministries of Interior of the two Republics. The National Bureau of Interpol in Belgrade (NBC) was integrated into the Serbian Ministry of Interior following the abolition of the old Federal Ministry of Interior. The Montenegrin authorities seek a separate bureau (and subsequently separate Interpol membership) to be established in Montenegro, claiming that the current set up undermines the effectiveness of regional and international cooperation in fighting organised crime.

In **Serbia**, the Law on Police is expected to be adopted after the adoption of the Public Administration Law (defining the responsibilities and authority of the Ministries). Efforts

were made to fully define police powers, introducing standards of internal and external (parliamentary) control. The law on witness protection is being drafted.

The new Code of conduct is already being implemented, notably through the office of Inspector General, with some first concrete results.

As far as the special security and intelligence services are concerned, Serbia has made some progress in reforming these agencies and in ensuring civilian control. However, there are still concerns at the lack of human rights safeguards, counterbalancing the powers of the new Serbian security agency (BIA). The role allegedly played by parts of the previous security services in the assassination of PM Djindjic has come under scrutiny; however, very little progress was achieved in fully investigating its role and responsibility.

Montenegro's Police Law is still in parliamentary procedure and is delayed along with the act on security services, by a dispute between coalition partners over the method for selecting the head of the security service. A new witness protection law has been adopted.

3.6.1.2. Judiciary

The two republics have two autonomous judicial systems, formally only linked by the authority of the State Union Court.

The Constitutional Charter stipulates that the **State Union Court** should be seated in Podgorica and financed by the Republic of Montenegro, whose authorities have not yet found an adequate solution. The State Union Council of Ministers decided that temporary premises for the State Court would be provided in Belgrade and the bulk of its budget would come from Serbia. The State Union Court has inherited more than 1000 unsolved cases from the former Federal Constitutional Court and Federal Court. The transfer of around 3500 administrative cases from the former Supreme Military Court has not yet been resolved. The actual scope of the State Court powers (especially regarding human rights and vetting of the constitutionality of republican acts) remains to be clarified.

Judicial cooperation between the **republics** is based on the mutual recognition of court decisions in both civil and criminal matters. The proper functioning of this principle is vital for the legal protection of individuals and for the enforcement of an SAA. The two republican Ministries of Justice signed a Memorandum of Understanding in June 2004, addressing the need for better information exchange and coordination in various areas.

The transfer of powers of **military justice** to civilian courts took place on 1 January 2005, after the State Union and republican parliaments adopted the necessary legislation. In Serbia, military departments have been set up in the district courts. It remains to be seen how these structures will work.

In **Serbia**, the judiciary faces a serious crisis and is under political pressure. On the basis of the Serbian Government's strategy of judicial reform, several laws crucial for enforcement and efficient administration of justice were adopted (e.g. Civil and Executive Procedure laws, Company Law, Law on Bankruptcy Procedure, Law on Corporate Registry and Agency for registration, Law on peaceful settlement of labour disputes). Several other important laws have been finalised – draft Criminal Code, Law on execution of penal sanctions, the Law on juvenile offenders, draft Law on protection of participants in the criminal proceedings (witness protection law). In view of its implementation, the important judicial reform in

Serbia needs the support of the legal professions. Involving these professions in the reform process and training the practitioners will contribute largely to the success of the current reform efforts

The Ministry of Justice is responsible for the budget of the judiciary which remains inefficient due to the high number of employees. To improve the efficiency of the judicial system, various efforts are being undertaken to deal with the sizable backlog of cases and to shorten procedures. This situation is particularly serious in the Belgrade Commercial Court, which stands at the centre of economic and corporate litigation. It is malfunctioning and there are cases of corruption involving some of its judges.

Serbia adopted specific legislation on war crimes in 2003. A War Crimes Prosecutor was appointed, premises for specialised court chambers were equipped and special police units and detention facilities are under development. There are war-crime related trials in Serbia ongoing, however they are still few and mostly concern lower ranking officers. This is due to the lack of a specific legal provision relating to command responsibility for war crimes. The Law on amendments to the Law on War crimes, (addressing the issue of admissibility of evidence) was adopted by the Parliament. Cooperation with the police is poor and in spite of clear legal obligations both the judiciary and the police are still subject to heavy political pressure.

The proclaimed independence of the judiciary was, on several occasions, seriously questioned: appointments and dismissals of Prosecutors have been carried out under political influence.

In **Montenegro**, following the earlier adoption of the systemic laws for criminal justice, the Law on State Prosecutor envisaging also a Special Organised Crime Prosecutor was adopted, together with the Witness protection law. The Special Organised crime prosecutor was appointed, but the issue of premises, equipment and financial support is not fully resolved. The administrative and appellate courts were established.

3.6.1.3. Prison System

In **Serbia** several steps were undertaken to address the serious situation in prisons: a new draft Law on execution of penal sanctions was finalised, introducing new standards of protection for inmates. The prison reform strategy has been completed. The opening of the first Prison Staff training Centre is a positive step towards creating a professional prison service.

In **Montenegro**, a new act on the enforcement of criminal sanctions is in preparation. In line with the Council of Europe recommendations the issue of infrastructure improvement is to be addressed.

3.6.2. Asylum, migration, control of external borders, visa issues

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

According to the Constitutional Charter, the State Union Parliament shall enact legislation governing “policy of immigration, granting of asylum, the visa regime and integrated border

management in line with the standards of the EU". Nevertheless, the actual scope of the State Union competence in these areas has been challenged by the Republics, with negative consequences on the development of the policies and the certainty of the law. In practical terms, the State Union Embassies and Consular Offices face difficulties in implementing the two visa regimes of Serbia and of Montenegro.

On **visa policy**, there have been steps to align Serbia and Montenegro's policy on state-level, but some exceptions for Montenegro (Albania, Russian Federation and Ukraine) remain, in contradiction to Constitutional Charter provisions. Differences also exist with respect to entry on the basis of ID cards alone. Montenegro allows this for EU citizens, Serbia does not. This creates problems at the administrative boundary line between Serbia and Montenegro, with the risk that foreigners who have entered Montenegro without-visa move to Serbia and then cross illegally the borders with neighbouring countries. Serbia and Montenegro's Foreign Ministry leads a Task Force drafting an action plan with a view to Serbia and Montenegro joining the Schengen white list. However, these efforts are presently deadlocked, due to a lack of cooperation from the Montenegrin side. In this context, the State Union is expected to adopt a visa law setting just the basic principles and procedures.

In 2003 Serbia and Montenegro decided to repeal the visa regime for around 40 European and non-European countries, including all EU Member States. They abolished the practice of issuing visa (tourist passes) at the borders, introduced visas for several African and Asian countries and tightened procedures for source countries for human trafficking. Serbia and Montenegro has a reciprocal visa free regime with all former Yugoslav Republics, except Slovenia.

A comprehensive solution is still to be found to provide for the effective establishment of a fully harmonised and unified visa regime throughout Serbia and Montenegro. There is no state-wide **integrated border management**. The distribution of competences between republican agencies and within the republics remains to be clarified. This is problematic, both in view of the proper functioning of border management and for Serbia and Montenegro's international obligations. Upon the Commission's insistence, a Memorandum of Understanding on integrated border management was signed in July 2003 to safeguard the proper use of EC assistance in this field, but remains without practical follow-up to date. An adequate body for border management has still not been established at State Union level.

In **Serbia**, the Government adopted a decision in October 2004, on the establishment of an inter-ministerial Commission, headed by the Minister of Interior, with the task of preparing the National Strategy for managing the services for the security and control of the state border crossing.

Furthermore, in January 2005, following the State Union Council of Ministers decree, the Ministry of Interior started a phased takeover of borders by civilian authorities. This is to be completed by end 2005. In **Montenegro**, civilian takeover of borders was finalised in December 2003. A new Border Directorate was established and several border crossing points refurbished and equipped. Further activities are planned to equip the border crossings, introduce IT and develop databases. The Law on the State Borders and the Law on Foreigners are being drafted. The National border management strategy is not finalised.

As regards **asylum policy**, the constitutional dispute on the division of competences affects the timely adoption of legislation in this field. Serbia and Montenegro is therefore seriously lagging behind other countries in the region. Outdated refugee legislation also makes difficult

the implementation of Serbia and Montenegro obligations under the 1951 Geneva Convention and 1967 New York Protocol. Progress in this area is also part of the Council of Europe post-accession commitments.

The Framework Asylum Law at the State Union has been adopted by the State Union Parliament. Two republican laws, covering the procedures, competent agencies and concrete rights, are at an advanced stage, with the significant assistance of UNHCR. However the new draft Montenegrin “implementing law” does not make any reference to the State Union framework law.

UNHCR currently handles most asylum cases in Serbia and Montenegro. In addition to the inadequate infrastructure and limited human resources, there are no systematic mechanisms to identify asylum seekers at land, sea or air borders. A referral system was recently established at Belgrade International Airport with UNHCR support. Further training activities for border guards and police officers on the international protection of refugees and border procedures have been agreed with the Ministry of the Interior of Serbia. In Serbia, there is only one reception centre for asylum seekers and refugees with very limited capacity and inadequate infrastructure. In Montenegro at present there are no reception capacities, though these are planned for 2005.

Positive developments can be noted in the area of **readmission**. Serbia and Montenegro has so far signed readmission agreements with Italy, Slovenia, Slovakia, Hungary, Denmark, Belgium, Germany, Sweden, Switzerland, Bulgaria and Croatia. Negotiations are ongoing with Portugal, France, the United Kingdom, the Czech Republic, Austria, Lithuania and Latvia. The implementation aspects of these readmission agreements is monitored by the Ministry for Human Rights and Minorities, but without impact in terms of overcoming the considerable social and economic problems related to the return of Serbia and Montenegro citizens. In reality, within the context of migration management, the Ministries of Interior for both Republics are dealing with some aspects of readmission. While the readmission agreements are in general working well, implementation is heavily influenced by the scarcity of resources. In particular, from persons coming from Kosovo, Serbia and Montenegro has no access to a database allowing verification of their citizenship. In this case the authorities often simply refuse to deal with individual cases.

3.6.3. Combating money laundering

Serbia and Montenegro 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 on the field, in particular the Financial Action Task Force (FTAF).

Money laundering is a serious problem in Serbia and Montenegro, although the authorities have started to address it. Competences in this field are vested at the republican level. A positive development was the ratification of the European Convention on Laundering, Search, Seizure and Confiscation of Proceeds from Crime.

In **Serbia**, the Administration for the prevention of Money Laundering, a Financial Intelligence Unit situated within the Ministry of Finance has been active since 2002. In

addition to its membership in MoneyVal, Serbia became a full-fledged member of the Egmont group in 2003.).

A new Anti-Money Laundering Law, in line with the international standards, will give wider authority to the Administration. Cooperation between all the competent state authorities must improve, in particular in view of their legal obligation to provide feedback on the persons and proceedings involved in money laundering, and on the effects of actions and measures undertaken.

In **Montenegro**, after the adoption of its own legislation in September 2003, the Administration for the Prevention of Money Laundering was established, becoming active in 2004. However, last-minute changes to this law (e.g. reduction of fines; exclusion of sport associations, tobacco companies, etc) provoke doubts as to the commitment to improvement. Several MoUs were signed with a view to improving regional cooperation, with the respective agencies from Albania and recently the former Yugoslav Republic of Macedonia. Their application for the Egmont Group membership was recently evaluated by the Serbian FIU, in its role as first evaluator. Good cooperation was established between the two agencies institutionalised through a MoU signed in 2004. The situation in Montenegro is very poor in this field. The authorities have made little progress in investigating leading figures of this republic, relating to illicit activities that seriously jeopardise the European Community's and its Members States' financial interests.

3.6.4. Preventing and combating crime and other illegal activities. Combating illegal trafficking and illicit drugs

Serbia and Montenegro would have to develop a framework for co-operation aimed at fighting and preventing criminal activities, notably organised crime. Serbia and Montenegro should devote particular attention to issues such as trafficking in human beings, illegal economic activities ('inter alia' corruption and illegal transactions involving goods such as counterfeit products, industrial waste and radioactive material), illicit arms trafficking and terrorism. SCG 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 reinforcing structures for combating illicit drugs' trafficking.

Serbia and Montenegro has only started to address the problem of organised crime.

In **Serbia**, the Ministry of Interior, and Ministry of Justice are jointly preparing a legal framework for combating organised crime, the National Strategy and Policy paper, with the strategy for the Interior Ministry and Organised Crime Department already finalised.

New measures in the draft Law on Police will provide for the further strengthening of the Criminal Intelligence and Analytical Units, as well as the establishment of new specialised Units in particular a witness protection specialised unit. There has been a significant fall in the number of registered illegal border crossings as a result of measures taken by the Border Police Directorate. These include intensified control both at border crossings and in the interior, better cooperation and coordination within the Ministry, and exchange through INTERPOL.

The Government of Serbia set up the Anti-trafficking Council, with a view to co-ordinating national and regional activities to combat human trafficking. Comprehensive measures have been taken in the field of prevention, prosecution and victims' assistance: shelters, SOS lines

and the Service for Coordination of Protection of Human Trafficking Victims have been set up.

The data protection law providing for implementation of the EU standards, as a precondition for agreement with Europol is being prepared jointly by the Justice and Public Administration Ministries.

The working group in charge of drafting the national strategy on drugs, addressing also the issue of the legislative deficiencies related to the incrimination of the precursor substances and preparatory activities is established.

Positive changes were made in the Serbian Criminal Code with the introduction of new offences (such as human trafficking, computer crimes, and child pornography) and stricter penalties for drug abuse.

Operation “Sabre” during the state of emergency led to significant results in breaking up the key organised crime channels and in resolving high profile cases, including political assassinations. However, this good work was to some extent undermined by questionable practices which not only violated basic human rights but may also have implications for the admissibility of evidence at future trials. A comprehensive approach to fighting organised crime is still not fully implemented due to serious resource problems, although efforts to address the issue are evident in the recent activities of the Ministry of Interior, Organised Crime Directorate and Ministry of Justice. A comprehensive plan of action-oriented measures for fighting organised crime, including money laundering, has been prepared, as a follow-up to the 2002 London Conference. It was presented for the first time to the EU in November 2003. In December 2004, progress in implementing these action-oriented measures was presented again to the JAI Ministerial meeting in two separate plans by Serbia and by Montenegro. Implementation efforts will have to continue.

Montenegro also has a new criminal legislation. It has already included a new criminal offence of human trafficking, and both republics have booked first successes in combating trafficking. Following the adoption of the National Strategy and Action plan against trafficking in human beings, the Ministry of Interior established an anti-trafficking team. Efficient cooperation between this unit, criminal police in the field and the border police directorate is however impeded by a serious lack of resources. A widely publicised human trafficking case in Montenegro demonstrated the extent to which, despite legislative reform, law enforcement hinges on practical implementation and the independence of the judiciary. The content of a recently published report by the Government founded Commission for Investigation of High Profile Human Trafficking Cases raised a number of questions regarding possible political interference into the investigation and the possible responsibility of former and current high level officials in the Ministries of Interior and Justice. The case poses a number of questions about the independence of prosecutors and the republic’s judicial system in general, the interlinking of personal and political ties and the entanglement of public bodies in illicit actions (as set out in more detail in an OSCE-Council of Europe expert report).

The unresolved issue of Montenegro’s Interpol status affects police work on the ground and cooperation with Serbian counterparts. Generally, the lack of inter-republican coordination is a serious impediment to overall efficiency.

The National Strategy for Fighting Organised Crime is still to be adopted. The OC Directorate established in 2003 has an extremely limited capacity in terms of staff and equipment. There seems to be, at present, little inter-agency cooperation and coordination between the Ministry of Interior and other bodies involved in the fight against organised crime. Several regional MoU's were also signed (with Macedonia, Albania, Slovenia, Slovakia, Bulgaria, Austria and UNMIK).

Serbia and Montenegro joined the Council of Europe's GRECO initiative (Group of States against Corruption) and ratified the European Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime. Even here the impact of the division of competences between the State and Republics can be seen; within GRECO the two Republics take turns as speaker and there is no consolidated state policy.

In **conclusion**, no comprehensive action had been taken yet to investigate financial crime, and Serbia and Montenegro's commitment to fight corruption has remained largely rhetorical. Comprehensive strategies are still lacking, as well as efficient institutions to implement them. Legislative progress was achieved with the adoption of the Laws on Financing of Political Parties in both republics as well as the Laws on the prevention of conflicts of interest, whereas codes of conduct for public servants are stalled. This previous legal vacuum has contributed to a very slow reaction to serious allegations against top government officials and ministers. Even the existing institutions in this field do not enjoy the necessary support from government. As this matter goes to the core of the transition from a totalitarian regime to a functioning democracy based on the rule of law, it is indispensable to achieve rapid improvements.

3.7. Co-operation Policies

A future SAA would imply the establishment of close co-operation in a wide range of policy areas. Co-operation would be designed to provide EU policy guidance and assistance to promote the economic and social development within Serbia and Montenegro. This process would not be limited to bilateral co-operation between the EU and Serbia and Montenegro respectively, but would also take place within a regional framework, i.e. special attention would be devoted to measures that foster co-operation between Serbia and Montenegro and their neighbours and thus promote regional stability.

3.7.1. Economic, monetary and statistical co-operation

Serbia and Montenegro should foster reform and economic integration into European structures by improving the formulation and enforcement of market-based economic policies. They should improve their capacity to provide information on macroeconomic performance and forecasts, to formulate economic policy and to develop the instruments necessary for its application. They should also take appropriate account in its policy development of the European Economic and Monetary Union. Serbia and Montenegro should develop statistical systems, capable of providing the timely, reliable, objective and accurate data needed to plan and monitor transition and reform.

The Government of **Montenegro** has established a secretariat for economic development. In **Serbia**, the Ministry of Finance has a department for macro-economic and fiscal analysis which is active in the Government's economic strategic planning.

Statistics is crucial for the negotiations of an SAA. The distinct negotiations envisaged with the two Republics will face difficulties in the current absence of EU trade data with Serbia and Montenegro respectively as these data only exists for the State Union.

Master plans for the modernisation of the statistical system have been under implementation since spring 2002 but are considerably delayed due to the insufficient human and financial resources of the offices. New statistical laws have also been prepared but have not yet come into force. Statistical production is still weak with many data produced according to old standards and methods.

Institutional capacity varies. Serbia and Montenegro has three statistical offices, one on State Union level and one for each Republic. After the transfer of a considerable number of staff from the State Union office to the Serbian office the latter is in a better position concerning human resources than the other two offices. However, all three offices need substantial development of their administrative capacity and in terms of infrastructure, human and financial resources in order to be able to deliver timely, reliable and accurate statistics in accordance with EU standards."

3.7.2. Investment promotion and protection, industrial co-operation, small and medium-sized Enterprises (SMEs), tourism

Both Serbia and Montenegro should aim to create a favourable climate for private investment, both domestic and foreign, in order to promote economic and industrial revitalisation. In particular, it should aim at establishing a legal framework conducive to investment, the implementation of suitable arrangements for the transfer of capital and the promotion of investment opportunities. In the fields of industrial co-operation, SMEs and tourism, Serbia and Montenegro should develop policies aimed at promoting the modernisation and restructuring, the reinforcement of the SME sector and the development of tourism.

Attracting foreign direct investment is a major challenge for Serbia and Montenegro. Investment promotion, industrial cooperation and policies designed to foster SME growth, all of which are conducted at the level of the Republics, are key.

Both Serbia and Montenegro have yet to establish stable, transparent and predictable conditions for foreign investors but improvements have been registered. **Serbia** has been active promoting itself as an attractive **investment** location. First successes have been registered through the privatisation of key enterprises. It has also established an Agency for Investment and Export Promotion and has adopted an Action Plan for the removal of administrative obstacles for foreign investors. However, traditional industry still suffers from chronic under-investment and insufficient commercial banking capacity. Interest among local authorities in attracting FDI also varies regionally. While FDI has been growing, a continuous inflow is needed to ensure the long-term economic sustainability. Serbia has also recently paid special attention to reducing the tax burden imposed on earnings.

Montenegro is also making efforts to attract foreign direct investments by further liberalising the FDI inflow regime. The establishment of a new Montenegrin Investment Promotion Agency is experienced to be delayed due to lack of adequate budgetary funding and commitment to institutional reform

Despite these efforts FDI remains relatively low in both Serbia and Montenegro (see also chapter 2 of this report).

At the Thessaloniki Summit, Serbia and Montenegro signed the **European Charter for Small and Medium-Sized Enterprises**, committing itself to respect key principles and best practices to achieve growth and development. Both Republics are registering good progress in implementing the charter's 10 lines of action.

Serbia, with a large number of SMEs, is trying to create an investment friendly environment for the development of SMEs by simplifying administrative procedures and reducing costs. A SME Agency was established in 2001, and has since formed 10 regional SME agencies. The agency provides technical assistance and training for entrepreneurs, and helps facilitate access to commercial credit. A new strategy on SME development was adopted in 2003, and the SME Agency has also been involved in the drafting of other laws relevant to the business environment, especially the Law on Private Entrepreneurs. Serbia also created a guarantee fund for bank loans to high-quality SMEs.

Montenegro has established a SME Agency in 2001, active in promoting and diversifying SME development and to improve SME financing. Montenegro adopted its SME strategy in 2002. Montenegro has now started to look at rationalising and speeding up licensing procedures at municipal level through a pilot project, which, once mainstreamed in all municipalities could further modernise the whole company start up process.

Whilst Montenegro has a network of 7 regional business support agencies, it still lacks an SME support infrastructure of a more specialised nature such as incubators, clusters and technology parks/centres. Serbia is better endowed in this respect.

In both republics **business advocacy systems** are weak and need reform. There is a wealth of entrepreneurship education and training in both republics, however without mainstreaming in the education curriculum. Both republics have yet to seriously tackle the information dimension of SME policy and develop SME web portals, e-business and online access for SMEs. Both republics have started to look at the competitiveness of SMEs and continuous efforts in this field are warranted.

Finally, both **Montenegro** and **Serbia** adopted new bankruptcy legislation in 2002 and 2004 respectively. A new Company Law was adopted in November in Serbia. Montenegro has drafted similar legislation. While Montenegro already has a relatively liberal company registration system in place, Serbia has established a new system as of 1 January 2005.

3.7.3. Agriculture and agro-industrial sector

Co-operation in this field would aim at helping both Serbia and Montenegro to modernise and restructure their agriculture and agro-industrial sector. In particular, it would include i) increased 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.

Agriculture is a crucial sector both in Serbia and in Montenegro. Primary production stands at 21% of Serbia's GDP and 15.6% of Montenegro's (in 2004), with food processing contributing a further 20 percentage points. The agriculture sector employs approximately 10% of the work force in Serbia. The sector faces a number of major challenges in particular in terms of competitiveness, market efficiencies, infrastructure and farmers' access to finance.

The framework governing agriculture is set on republican level. Structural reforms have commenced in both Republics. **Serbia** has recently adopted an ambitious agricultural development strategy and a framework law on Agriculture which aims at approximate agricultural policies to those of the EU and which prepares for a future participation in the Common Agriculture Policy. A significant number of new sectoral laws are in preparation, for instance on seeds, plant protection, veterinary issues and organic farming. Steps to improve the agriculture sector's competitiveness have been taken.

Montenegro is also preparing a new strategy for the agriculture to be adopted in the course of 2005. The Montenegrin strategy also shares the objective to align to EU policies, including food safety, and aims at developing the rural areas through encouraging the private sector development and increasing exports. However, despite these efforts, reforms of the agricultural sector need to be accelerated in both Republics.

Both Serbia and Montenegro are starting to exploit better their potential in the food sector, through the certification of veterinary and sanitary and phyto-sanitary laboratories and the reinforcement of border inspectorates. This has already helped Serbia and Montenegro to achieve market access for meat products and will continue to play an instrumental role in underpinning its export performance (see 3.3.2).

3.7.4. Customs and Taxation

3.7.4.1. Customs

Serbia and Montenegro need to ensure that their customs authorities are able to meet the demands resulting from the liberalised, preferential trade under an SAA, in particular regarding the proper certification of origin and investigation and enforcement methods. Serbia and Montenegro would also have to further develop their customs infrastructure, ensure proper revenue collection and simplify formalities regarding the carriage of goods in their respective remits.

The proper functioning of customs services is a key requirement for entering into an association agreement. In this context, the two **Republics pursue distinct customs policies**, including separate customs laws and administrations. The internal customs boundary line functions in practice already today much like an external border. Cooperation between the Serbian and Montenegrin customs authorities is satisfactory. The management and implementation of the distinct trade-related parts of the SAA will therefore be done in close cooperation with the respective republican customs services. The two republican administrations have also concluded an agreement on customs cooperation and on joint action in the World Customs Organisation (WCO).

New **Customs Codes** are in force in both republics and legal fine-tuning is ongoing to further align customs procedures on EU standards. Furthermore, the administrative reform of both customs services is continuing but needs to progress further, especially in Montenegro. The enforcement powers of customs agents in both Republics have been strengthened

substantially, which is critical to implement the rules of trade. Further reforms will be needed to improve the fight against corruption

Still, the problems identified in 2002-2003 in the system of management and control of preferential origin with regard to sugar led to the temporary suspension of the EU's preferential arrangements for sugar imported from Serbia and Montenegro. The reforms implemented in response to this safeguard measure resulted in a strengthening of the customs administrations, notably in Serbia, which enabled the Commission to let the suspension expire in August 2004. Nevertheless, a general notice to importers concerning all products from Serbia and Montenegro remains in force as a precautionary measure. This illustrates that, even though both Republics have done substantial progress in the customs area, both Serbia and Montenegro need to make continuous efforts to deepen reforms to deepen reforms in customs and to properly enforce rules and legislation in this field in order to avoid abuse of their preferential access to the EU market.

While in Serbia the system of certification and control of preferential origin has been improved to a satisfactory level and should be strengthened, in Montenegro there is a need for significant further improvement. Both republics will therefore have to improve their respective implementation capacities in order to be in a position to respect fully the demanding SAA obligations

3.7.4.2. Taxation

Co-operation with the EU under an SAA would facilitate the reform of fiscal systems in both Serbia and Montenegro and help to further develop the tax administration in order to ensure effective tax collection and fight against fiscal fraud.

Taxation lies within the separate remits of the two Republics. The State Union of Serbia and Montenegro as such does not have a system of own resources, meaning that the financial needs of the state union are exclusively matched by direct contributions from the Republics which have separate taxation systems.

Tax reform has advanced in both Republics but should be pursued to ensure effective tax collection and fight against fiscal fraud. Tax administration reforms were geared to transforming public revenue agencies into more efficient and capable institutions, but the lack of competent staff still poses a problem. The transformation of the payments system into a modern, market-oriented system has also progressed in both Republics.

In **Serbia**, a substantial lowering of the number of taxes as well as the elimination of most tax exemptions have improved tax collection. A second generation of tax reforms was geared towards encouraging private sector development, investment and employment. Serbia has also adopted new laws on corporate and personal income taxes to reduce the tax burden as well as on excise duties, limiting the use of excise to only a few products. The key remaining reform was the introduction of a value-added tax in January 2005 as part of a broader tax package that also aims at a larger degree of fiscal decentralisation.

In **Montenegro**, a set of tax laws was approved in 2001 and has been gradually implemented, including legislation on personal income, corporate profit taxation and value-added tax. These measures have led to a marked increase in public revenues.

3.7.5. Employment, social policy, education and training, Research Technology and Development (RTD)

3.7.5.1. Employment and Social policy

Co-operation in this area under an SAA would aim at supporting Serbia and Montenegro in the reform of their employment policies, focusing notably on upgrading job-finding and career advice, promoting local development to assist economic restructuring. It would also promote social dialogue as a key driving force for economic and social reform as well as legal approximation on labour law, gender equality and health and safety at work. Regarding social security, Serbia and Montenegro would need to adapt their social security systems to the evolving economic situation and the new social requirements. Serbia and Montenegro should also encourage the adoption of comprehensive social inclusion and anti-discrimination policies and measures to improve the situation of the most vulnerable social groups.

The frameworks governing employment, social issues, education and training, research technology and development are set on the level of the Republics. To fight high **unemployment**, **Serbia** has introduced a number of policy and legislative changes. In 2003 the Parliament adopted a new law on employment and unemployment insurance. A new labour law has recently been adopted which harmonises Serbian legislation on ILO conventions and core labour standards and aims to align labour law to the EU 'acquis'. A new law on occupational health and safety has been drafted and should be adopted in the course of 2005. In October 2004, the Government established the Employment Council and are preparing a national employment strategy for the period until 2010. This strategy includes a reform of the republics' employment services. However, the funds available for their implementation remains low bearing in mind the number of unemployed and their needs. Reform projects have been introduced for the modernisation of the social welfare system.

Serbia is adopting anti-discriminatory legislation on the non-discrimination of disabled persons.

In relation to **social security**, **Serbia** is introducing voluntary (third pillar) pensions schemes and has also started to decentralise responsibilities in the field of social security to local authorities. It has signed bilateral agreements on cross border payments of pensions with its neighbours and several EU Member States.

Montenegro is currently revising its labour legislation to improve the flexibility on the labour market. Montenegro is also stimulating job creation through reduction in taxes and contributions by employers, with considerable success as the number of unemployed decreased by about 10% in the first six months 2004. Montenegro has also started to reform its pension system by amending its legislation on pensions and disability insurance. As part of the strategy reform of the welfare system, a new law on social welfare and child protection has been recently proposed, which should enable improved management for welfare benefits.

The public health situation in Serbia and Montenegro is poor and needs to be addressed. To a certain extent the poor life expectancy may be explained by the very high rates of smoking seen in Serbia, 46% amongst men and 30% amongst women, both significantly higher than the EU25 average. Also of concern in Serbia and Montenegro, the rate of overweight people among adults is estimated to be 58 percent which points to an exacerbated picture for chronic conditions in the future.

At the same time, children from marginalised population groups are still dying from preventable diseases and 75% of infant mortality occurs during the peri-natal period. The available data suggests that immunisation is particularly low among poor and Roma children.

3.7.5.2. Education and training, RTD

In the fields of education, training and RTD, co-operation could aim to help Serbia and Montenegro raise the level of general education, higher education, vocational training and 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.

The educational and research systems have been seriously affected by the events of the last decade, notably as regards infrastructure and the development of curricula. Various legislative and administrative efforts are ongoing to reform the education systems both in Serbia and Montenegro. **Montenegro** has adopted its education sector reform strategy. In 2003, **Serbia** adopted a new education law covering primary and secondary legislation and has drafted new legislation on higher education.

Serbia has been active in launching and promoting education and vocational education and training reforms by developing the basic legal framework. It has established new institutions, making steps in curriculum modernisation and starting awareness raising. Furthermore it has continued its capacity building for vocational education and training based on principles of Lifelong Learning. In **Montenegro**, based on the Strategy of development of the education system, the Government continued reforms in the sector, including new Law on university education and adoption of the new 9-year curriculum for primary schools.

In 2003, Serbia and Montenegro joined the Bologna Process, thus laying the basis for enhanced international cooperation and reform of its educational system. This covers notably university governance, management and finance. The Sixth Framework Programme for RTD is also open to participation by researchers from Serbia and Montenegro.

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

3.7.5.3. Culture and audio-visual

AN SAA would promote cultural co-operation, notably with EU Member States and with neighbouring countries, with the overall objective of increasing mutual understanding between individuals, communities and peoples. In the field of audio-visual, Serbia and Montenegro should take steps to promote the European audio-visual industry and encourage co-production in the fields of cinema and television. They would also need to gradually align their policies and legislation with those of the EC, including as regards matters relating to cross-border broadcasting and the acquisition of intellectual property rights for programmes and broadcasts by satellite or cable.

The frameworks governing culture and audio-visual policies are set on the level of the Republics.

The ratification of the Council of Europe Convention on trans-frontier television by Serbia and Montenegro is under preparation. Furthermore, Serbia and Montenegro would need to gradually align their legislation to the EC ‘acquis’ in this area, notably to the “Television

without Frontiers” directive. Co-operation between the EU and the Serbia and Montenegro would focus on these areas.

Internal media legislation remains problematic. **Serbia** therefore recently adopted a new broadcasting law. The appointment and the composition procedures of the Broadcasting Council, the supreme body governing licensing and supervision of electronic media in Serbia, was modified following irregularities in the appointment of its members.

In **Montenegro** the Broadcasting Agency is functional and has approved a number of by-laws regulating procedures for licensing. Certain irregularities in price dumping and tender procedures in this sector will have to be addressed.

3.7.5.4. Telecommunications, Postal Services and Information Society

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 further development of legal and regulatory aspects of telecommunications and postal services, ii) the progressive liberalisation of the sector, iii) the promotion of an investor friendly environment for the modernisation of Serbia’s and Montenegro’s telecommunications networks and their integration into European and world networks, iv) institutional reforms suitable for a liberalised environment and v) the promotion of European standards and regulatory approaches. Serbia and Montenegro should also aim at the progressive development of the information society, including co-operation in the area of electronic communications infrastructures.

Reforms in this field are underway in both Republics. The **Serbian** Telecommunications Development Strategy up to 2007 has been prepared and is pending before the Government. The Strategy envisages the liberalisation of the sector, the development of a fixed telephone network, the establishment of a cheap and quick internet and “Telekom” restructuring as priorities.

The Government is preparing amendments to the Telecommunications Law to further align Serbian legislation on relevant EU Directives and stress the importance of a liberalised and open telecommunications market. The Telecommunication Agency which is yet to be established until the members of the Telecommunication Agency Council are nominated the law on Telecommunications will not be implemented. Thus, the idea was to activate the law implementation by introduction of amendments.

A new law on Postal Services in Serbia is expected to be adopted during the first half of 2005. This law aims at aligning postal services to the provisions of the EU ‘acquis’.

In **Montenegro**, the Agency for Telecommunications was established in line with the republican law from 2000 to allow non-discriminatory functioning of telecom operators and to provide users with access to telecom networks and services on the same basis. Montenegro is also developing its telecommunication strategy, in order to align to EU rules and standards to simplify licensing systems and improve operators’ inter-connectability. In March 2005 the majority share of the Montenegrin telecommunication company was sold to the Hungarian operator Matav Telecom.

Currently there are two mobile operators in each of the Republics. The situation in Serbia is aggravated by cross-ownership of the two main mobile operators and the monopoly on telecommunications infrastructure that will expire only in June 2005. In addition, the

ownership structure of one operator, a part of which had been sold during the former regime, is contested. This seriously hampers privatisation.

3.7.6. Transport

In transport, co-operation under an SAA would contribute to the restructuring and modernisation of Serbia's and Montenegro's transport systems and improving related infrastructures, improving the free movement of passengers and goods, achieving standards comparable to those prevailing in the Community, aligning transport legislation to that of the EC, and allowing progressive mutual access to the EU and Serbian respectively Montenegrin transport markets and facilities.

Transport is a republican competence. However, the two republics have established a joint Civil Aviation Directorate which should perform tasks essential for realisation of rights and obligations in air traffic domain and for the application of international standards and recommendations.

Legislation in the field of transport will still need to be further reviewed in order to ensure progressive alignment with EC legislation. This will be of particular importance concerning the overall liberalisation of the sectors and the equal treatment of foreign operators, since certain institutional practices in Serbia still oblige international investors to operate domestically first for a period of three years before being eligible to start international road transport from Serbia.

In **Serbia**, new laws are being drafted in the area of road, rail, inland waterways and air transport. The law on railways, the key document for restructuring and reorganisation of the largely insolvent railway sector, together with the general transport sector policy document, is in the pipeline. Once the overall transport strategy is adopted, master plans for each of the transport sub-sectors should follow. Institutional work creating of project implementation units for each different transport sector has started, but should be further intensified.

In **Montenegro**, the government adopted the Law on Roads (June 2004) and the Law on Railways (February 2004). The road legislation envisages the rationalisation of the organisational structures responsible for road construction and maintenance and enables limited available funding to be more equitably allocated between new construction and maintenance of the existing infrastructure. The rail transport legislation allows for separation of infrastructure and operational activities of Montenegrin Rail Company which should encourage additional investment. These laws and other transport related laws that are currently in preparation (road transport law, shipping law, law on ports) will have to be fully implemented in practice. Despite the legislative progress there still remains a significant backlog of routine maintenance that has to be resolved in order to ensure an adequate standard of transport infrastructure. The current level of Government funding is insufficient to address this problem and raise major concern regarding the sustainability of ongoing investments from the donor community and IFIs.

Although the standards applied in the aviation sector in Serbia and Montenegro are considered to be relatively good and among the highest in the Western Balkan region, existing capacity should be further developed and brought up to Community level. Participation in the European Common Aviation Area (ECAA), which will develop comprehensive aviation relations with the Community, will help in this regard. To this extent it is also important that

Serbia and **Montenegro** accept the application of Community designation through the conclusion of a horizontal aviation agreement with the Community.

Relating to infrastructure, **Serbia** and **Montenegro** have signed with other transport ministers of the region, a “Memorandum of Understanding on the Development of the South East Europe Core Regional Transport Network”. This MoU foresees the creation of a co-ordination infrastructure including a Steering Committee and a Transport Observatory. Thus, the interventions in transport sector need to reflect the obligations undertaken under this MoU.

3.7.7. Energy, including nuclear safety

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

The framework governing energy is set on the level of the Republics. In **Serbia**, the reconstruction and further development of the energy sector has been somewhat delayed due to the limited capacity of the responsible ministry to set energy strategy and to enforce a comprehensive sector reform. However, the overhaul of the energy generation and distribution infrastructure undertaken so far has led to improved electricity supply, while electricity production has grown. Energy has become more efficient due to a substantial rise in the price of electricity, in spite of which fee collection improved. As regards legislative activities, the Law on Energy was adopted in August 2004 and should be followed by a comprehensive long-term policy strategy for the energy sector. The law provides the outline for the restructuring of Serbia’s electricity sector, the establishment of an independent energy regulator and unbundling of the electricity utility EPS. The law also enables the establishment of independent power transmission, system and market operation functions and companies comprising generation, distribution and trading. Although the implementation of the law was delayed, the establishment of the Energy Regulatory Agency is underway and the preparatory work has been done for the establishment of the Independent Transmission, System and Market Operator. Nevertheless, substantial additional actions are needed to further reform the energy sector, to improve energy efficiency and to reduce environmental pollution.

In **Montenegro**, the new Law on Energy, aligned with the EU directives, was adopted in June 2003 requiring the establishment of a market for energy and competition rules within two years after the law comes into force. Therefore, it is expected that the Energy Agency, which was established by the law as an independent regulatory body responsible for the development of the electricity market, will take over the regulation of prices in July 2005. A privatisation strategy for companies in the energy sector should be proposed by mid-2005. Actions are required in order to secure increased energy efficiency, reductions in energy consumption, the development of independent power producers and commitment to alternate energy sources, accompanied by a full respect for environmental requirements. The entry into force of the Energy Community Treaty, imply that the possible construction and new generating plants shall comply with the ‘acquis’ on environment (cf the Tara river project).

On the international level, Serbia and Montenegro has achieved observer status in the Energy Charter Process in June 2001, but the European Energy Charter has not been signed nor ratified yet due to the complex and unresolved institutional competencies. On the other hand, both Serbia and Montenegro engage in negotiations of the Treaty establishing the Energy Community in South East Europe (SEE) and in preparations for participation in a fully functioning regional energy market. With regards to that, Serbia and Montenegro should both secure its firm commitments to the “Memorandum of Understanding on the Regional Electricity Market in SEE and its Integration into the EU Internal Electricity Market” signed in November 2002 and its revisions of December 2003.

3.7.8. Environment

In the framework of an SAA, both Serbia and Montenegro would strengthen their co-operation with the EU in combating deterioration of the environment, in particular, but not exclusively, 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.

Both Republics are in the process of establishing a basic legislative framework on environmental protection. In **Serbia**, a number of laws in the area of environmental protection was adopted in December 2004, including a new Law on Environmental Protection (based on the provisions of the Aarhus Convention and other UNECE Conventions, harmonised with EU standards and including provisions on Environmental Impact Assessment) as well as legislation on Integrated Pollution Prevention Control (IPPC), Environmental Impact Assessment (EIA) and Strategic Environmental Assessment (SEA). Although the new law is based upon its principles, the State Union of Serbia and Montenegro has not yet signed the Aarhus convention. Progress should be made to improve access to information, public participation in decision-making and access to justice in environmental matters as promoted by the Convention. The EIA instrument may need further fine-tuning to be in full compliance with EU rules. Other important activities (establishment of an environment information system, creation of the Agency for Environment Protection and collaboration with the European Environmental Agency) are also underway.

The establishment of this ambitious legislative programme in the area of environmental protection were mainly driven by the Serbian Ministry established in 2002. In spring 2004 the new Government has abolished the previous separate Ministry and placed environment within a Directorate for Environmental Protection within the Ministry for Science and Environmental Protection. Still, on balance, the resources for environmental administration are scarce and environment needs greater prominence in the agenda of the present Government. While some taxes are directly earmarked for environmental aims, the use of financial instruments for the purposes of environmental protection, in line with the polluter-pays-principle, is still not developed.

In **Montenegro**, the draft EIA, SEA and IPPC laws are in the final stage of preparation and, after adopted by the Government, are expected to pass the Parliament in 2005. All mentioned drafts, as well as the implementing rules that are ready as well, have been harmonised with the EU legislation. In addition, a set of other laws (on waste, environmental noise, ambient air quality, protection from ionizing radiation, on non-ionizing radiation, on Environmental Fund) is under preparation, while establishment of Environmental Protection Agency is expected to take place in 2005. In relation to nature preservation, the Montenegrin Parliament also adopted a declaration in December 2004 to preserve Europe’s deepest river canyon

preventing the construction of a dam in the Tara River. However this declaration has no legal impact and the future of the Tara River Canyon remains uncertain.

Coordination of laws and policies between the Republics has commenced and the cooperation between the authorities of the two seems to function well. The international representation of the State Union (in which the Republics take turns and which also depends on the environmental subject being discussed) seems to function relatively well in practice. Serbia and Montenegro is participating in the various environmental regional initiatives promoted by the European Commission such as the Regional Environmental Reconstruction Programme (REReP) and the Balkan Environmental Regulatory Compliance and Enforcement Network (BERCEN). Serbia has not always approached these meetings with the same willingness to participate openly and constructively as displayed by the other participants.

Serbia and Montenegro should continue to make full use of environmental cooperation under an SAA, which would require the parties to cooperate in combating environmental degradation and enhance allocations of resources to an improved environment. At the same time, regulatory and institutional reform in Serbia and Montenegro must be accelerated to strengthen the basis for implementation of a consistent and effective environmental policy.

3.8. Financial cooperation

An SAA with Serbia and Montenegro would foresee the continuation of EU financial support in order to help the country to achieve the objectives of the Agreement. Financial co-operation would continue to support democratic, economic and institutional reforms, in line with the Stabilisation and Association process. Such assistance could further focus on different areas of approximation of legislation and co-operation policies covered by the SAA. Serbia and Montenegro should further strengthen the capacity to properly co-ordinate the resources available from the EU and other donors in order to ensure its optimal use.

Since 1998, Serbia and Montenegro have benefited from a total Community assistance of more than € 2.3 billion. The main instruments are the CARDS programme and budgetary support through macro-financial assistance. EC assistance in Serbia and Montenegro continues to put the emphasis on institutional capacity building and public administration reform, judicial and border police reform, the upgrading of veterinary and phyto-sanitary services, the protection of the environment and economic development in order to further strengthen the market economy and foster integration. This includes, in a horizontal manner, support to bolster the partner governments' capacities. The Commission is fully committed to support the Stabilisation and Association process in Serbia and Montenegro through its assistance programme. An enhanced political and technical dialogue between Serbia and Montenegro and the Commission is necessary to properly link and optimise the assistance to the implementation of the obligations under the future SAA, in particular to create the capacities to legislate, implement and enforce the provisions under the Agreement.

The EC assistance, CARDS and the future instrument under the new financial perspective 2007-2013, will require a strengthened coordination capacity within both on State Union and republican level. This capacity should be capable of identifying specific needs and coordinate donors support for the implementation and enforcement of a future SAA.