



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, April 4, 2002
SEC(2002) 340

COMMISSION STAFF WORKING PAPER

BOSNIA AND HERZEGOVINA

Stabilisation and Association Report

[COM(2002) 163]

BOSNIA AND HERZEGOVINA

Stabilisation and Association Report

TABLE OF CONTENTS

1. EXECUTIVE SUMMARY	3
2. POLITICAL SITUATION	4
2.1 Democracy and the Rule of Law	4
2.2 Human Rights and the Protection of Minorities	8
2.3 Regional Co-operation	10
2.4 Priority Areas Needing Attention in the Next 12 Months	13
3. ECONOMIC SITUATION	13
3.1 Current Economic Situation	13
3.2 Existence of Free Market Economy and Structural Reforms	15
3.3 Management of Public Finances	16
3.4 Priority Areas Needing Attention in the Next 12 Months	16
4. IMPLEMENTATION OF THE STABILISATION AND ASSOCIATION PROCESS	17
4.1 General Evaluation	17
4.2 Internal Market and Trade	20
4.4 Co-operation in Justice and Home Affairs	24
4.5 Priority Areas needing Attention in the Next 12 Months	26
5. FINANCIAL ASSISTANCE	26
6. PERCEPTIONS OF THE EU	27

1. EXECUTIVE SUMMARY

Bosnia and Herzegovina (BiH) faces a multiplicity of inter-related challenges. Some of the most pressing as defined in the General Framework Agreement on Peace (GFAP - Dayton Agreement) have been tackled with international assistance: military hostilities have stopped, refugees have returned in significant numbers to their homes, the institutions foreseen in the constitution have begun to function. This, however, is only a start. BiH must now look to a future as a self-sustaining European state by prioritising a targeted programme of reform that will enable it to take its place in the wider European order.

In terms of **political reform**, BiH must become a self-sustaining state based on the rule of law. This is a pre-condition for further progress. To achieve sustainability there must be a recognition among all sections of the BiH population that their future lies with each other and within BiH. All sides have an interest in building a state that can manage without international assistance and control. All BiH communities must therefore overcome the polarisation which has often made compromise so difficult and must build constructively on the foundations laid at Dayton. In some cases, the goal of sustainability and integration into European structures may mean that Entity powers may have to be ceded to the State. Republika Sprska (RS) in particular must consider that a strong state is compatible with a strong Entity, indeed that the former is a prerequisite of the latter. National and Entity sustainability can only be built on the basis of full BiH "ownership" of the reform process.

In terms of **economic policy** too sustainability is the watchword. Among the myriad challenges, two stand out in the short to medium term. First, since the war BiH has profited from massive, but abnormal and now declining, injections of foreign assistance. BiH must increasingly substitute this assistance with endogenous growth. Given limited domestic resources, it is essential that BiH create the conditions to attract FDI - and this will only be possible if there is the systemic and institutional stability and sustainability mentioned above. A particularly important building block for economic sustainability is the development of a functioning BiH internal market. Secondly, BiH must bring its public finances into equilibrium. Without state resources to match state responsibilities, the sustainability of even those reforms that have been introduced will remain in doubt.

Finally, if it is to reach its declared goal of integration into European structures BiH must progress decisively within the **Stabilisation and Association Process (SAP)** over the next twelve months. Delays in Road Map completion reflect the complexities of BiH's internal order, but, possibly, also willingness by some to hide behind those complexities. Regrettably, this has meant lost time and BiH falling behind its neighbours. The Road Map must be completed quickly in 2002. It is important that the Road Map and the SAP agenda are not additional requirements to political and economic reform. Rather, they identify the most urgent priorities and give orientation and direction by putting reform and the goal of sustainability in the context of integration into EU structures.

Since 1995 BiH has made progress. That progress must be built on in order to achieve the self-sustaining stability. This is essential, for only with self-sustaining states (not Entities or local authorities) can the EU conduct negotiations or sustain contractual bilateral relations.

2. POLITICAL SITUATION

2.1 Democracy and the Rule of Law

BiH is a State building a future on a difficult past. The Dayton Agreement stopped the war, but gave the new State a complicated constitution with highly decentralised structures. These structures accommodated inter-ethnic tensions but make forward-looking consensus difficult. BiH and its Entities are thus challenged to achieve the agreement necessary to make BiH's constitutional arrangements work and to fashion a properly functioning state, capable of managing the challenges of "ownership". Politicians must assume full responsibility and give a clear lead to a population which still remembers earlier grievances. They should no longer avoid difficult decisions in the hope that the High Representative will impose them instead. BiH must increasingly move to the "transition agenda" that other ex-socialist states have pursued. Ownership and a greater willingness in the Entities to find consensus are a pre-condition for progress in the SAP.

In addition to achieving consensus, BiH and its Entities must work practically to reinforce the functioning of the institutions of State. This may mean the transfer of some core competences to State level; it certainly means that State institutions must be consistently and properly funded. The rule of law must be established. For this a competent judiciary is required. This must be backed up by effective police forces which co-operate to fight crime and by a responsible penal system.

2.1.1. Assessment of democratic institutions and of attitudes to the state

Constitution. The Dayton Agreement which ended the 1992 - 1995 war established BiH as a highly decentralised state. Dayton gave extensive powers to two new Entities, Republika Srpska (RS) and the Federation of Bosnia and Herzegovina (FBiH) and only limited and specific powers to BiH's common institutions. Although six central ministries were subsequently created at State level, the central State remains highly constrained in its ability to exercise power. This state has no country-wide system of administration, no army and an at best embryonic judicial system. Moreover, limited formal powers are matched by a very limited ability to raise revenue - the BiH State must rely mainly on Entity contributions.

The Entities, on the other hand, enjoy wide powers, but are characterised by **asymmetric structures**. RS is centralised, FBiH decentralised. RS is divided into municipalities, but most powers are centralised in Banja Luka. As an Entity, RS enjoys powers over most policy areas including taxation, defence, police, social welfare and more. FBiH is constitutionally more complex than RS; it has 10 cantons and over 70 municipalities. As an Entity, FBiH has responsibility for defence, economic policy, customs, finance, energy policy, etc. All responsibilities not expressly assigned to FBiH belong to the cantons. Finally, BiH has a third region with wide legislative and administrative powers - the Brcko District created by the Final Award of March and August 1999.

The highly decentralised structure of the BiH State coupled with persistent ethnic polarisation have often blocked effective government. Calls to "re-open Dayton" have (justifiably) been treated with caution, but the international community has repeatedly urged the Entities to "build on Dayton". RS in particular, has however resisted such calls,

referring to a narrow interpretation of its Dayton identity and powers. If this persists, it will be a major brake on the SAP.

In summer 2000 the BiH Constitutional Court, in the "**Constituent Peoples case**" ruled that Entity constitutional provisions identifying a particular Entity with a particular people were incompatible with the State constitution. The Court confirmed the right of Bosniacs, Serbs and Croats as "constituent peoples" to equality throughout the territory. There can be no special privilege for any people through segregation based on territorial separation. A process of change to Entity constitutions was set in motion but has made slow progress. Even provisions of the State constitution which identify particular posts with a particular nationality may be revisited. The "Constituent Peoples decision" will have far-reaching implications for BiH's constitutional order.

Parliament. BiH has four major assemblies with legislative authority: the State-level Parliamentary Assembly, the bicameral FBiH parliament, the unicameral RS National Assembly and the Brcko District Assembly. In addition, the FBiH cantonal parliaments also have legislative authority in their areas of competence. The BiH parliament consists of two chambers: the House of Peoples and the House of Representatives. All legislation requires approval by both houses, but a proposed decision may be declared "destructive of a vital interest of the Bosniac, Croat or Serb people" by a majority of either Bosniac, Serb or Croat deputies and therefore blocked.

The BiH state parliament has faced several challenges. The willingness of some deputies to block State-level legislation which they see as incompatible with their particular Entity interests has depressed parliament's legislative record - and has raised questions about the level of identification with BiH State interests. The State parliament has also had to contend with a lack of experience and technical expertise on procedural and policy matters. Occasionally the two houses of parliament have adopted divergent legislative texts. The resources and experience of parliamentary staff need to be strengthened. Such work is underway with international support. Despite these difficulties there is agreement that parliamentary performance has gradually improved.

Following the last state-wide elections in November 2000, the Bosniac-dominated Party of Democratic Action (SDA) and nationalist Croatian Democratic Union (HDZ) were excluded from State and Entity governments through the creation of a reformist ten-party coalition. The Social Democratic Party (SDP)-led "**Democratic Alliance for Change**" formed government at State level with a narrow majority. In FBiH the SDP also leads a reformist coalition government. In RS, the more moderate Party of Democratic Progress (PDP) heads a government that is at least nominally free of the nationalist Serb Democratic Party (SDS) and is willing to co-operate with the "Alliance" at State level. Nevertheless, the Alliance is shaky and loyalties often lie with ethnic groups and Entities rather than with the coalition.

Since the conclusion of GFAP, BiH has had numerous **elections** organised, supervised and run by the OSCE: general elections in 1996, 1998 and 2000; municipal elections in 1997 and 2000 and special elections for the RS National Assembly in 1997. Until 2000, these elections tended to reinforce BiH's ethnic divide by confirming the hold of nationalists in power in their respective regions and entities.

New elections are scheduled for October 2002. These should be conducted under the new Election Law passed in August 2001 and financed from BiH's own resources. These elections will be for six institutions: the BiH presidency, the House of Representatives of the Parliamentary Assembly of BiH, the House of Representatives of FBiH, the president and vice-president of RS, the National Assembly of RS and the ten FBiH cantonal

assemblies. Practical preparations have, however, been worryingly slow. This in part reflects the fact that the new 2001 law was passed with important lacunae (for in its final form it must reflect the principles required by the Constitutional Court decision on "Constituent Peoples"). For the 2002 elections, lacunae could be filled by existing electoral provisions, but the ruling Alliance would prefer not to hold elections until the required constitutional changes and legal amendments have been introduced. In November 2001 the High Representative appointed the national members to the Central Election Commission following BiH failure to do so. Failure to come to agreement would be a missed chance for BiH; failure to hold the elections would send a worrying message about its democracy.

Executive. In comparison with its Entity counterparts and in reflection of the limited powers given to the State by GFAP, the BiH executive is small. The new Alliance-based Council of Ministers with its rotating 8-month chairmanship, has functioned better than its predecessors. However, a number of laws have received Council approval, only to be blocked in parliament (perhaps because some Council members know that "unfavourable" laws may not pass parliamentary scrutiny, while necessary but unpleasant ones will be imposed by the High Representative). RS appears to have been keen to exert close control on Serbs within the Council of Ministers.

Local (as opposed to Entity) **government** reflects the outcome of April 2000 municipal elections. In RS effective local government and the provision of services is constrained by lack of resources. Ethnic discrimination has tarnished some municipalities. In FBiH local government has not been fully functional. Croats, particularly in Herzegovina after the March 2001 declaration of "self-rule", subscribed to their own institutions. Administrations in ethnically mixed cantons six and seven have been effectively divided in two. Police, judges, teachers of different ethnic groups in one FBiH canton may be paid from separate budgets. This illegal parallelism of local power structures is gradually being addressed.

President. In addition to Entity presidents, BiH has a directly elected presidential troika: one Bosniac, one Croat and one Serb. The presidency appoints its own Chair on an eight-month rotation basis. As in parliament, a dissenting member of the presidency can declare a decision destructive of the vital interests of his Entity.

The current presidency now has a common secretariat and is functioning well, but it is unable to drive reform alone. The presidency has declined in relative importance as the Council of Ministers has become more operational.

Civil Society. Associations which mediate and articulate citizens' concerns remain underdeveloped in BiH. Through the Civic Forum the High Representative initiated round-table debate among intellectuals, artists, religious leaders, etc. on scenarios for BiH's development. BiH would benefit from similar groups throughout its territory.

Armed Forces. Formally, there are two BiH armies, one in each Entity. In effect, three military forces can be identified - the integration of Croat forces (HVO) into the FBiH army has been difficult. The presence of three mutually suspicious armies within BiH is a factor of insecurity, and a major drain on financial resources. Reform, including downsizing, is ongoing.

The International Community. BiH's history explains another peculiarity of the BiH body politic: the pervasive role of the international community, in particular of the Peace Implementation Council (PIC), the Office of the High Representative (OHR) and SFOR. The involvement of the international community and the special powers of the High Representative to impose legislation and dismiss local politicians, have raised concerns

about overriding local authority, but have nonetheless been essential in driving reform and guaranteeing a secure environment.

Since the arrival in power of Alliance for Change-led governments, the BiH Council of Ministers has called for improved partnership with the international community. For the BiH side this is a way to obtain greater say over BiH development, while for the international community it is a welcome sign of increased BiH **ownership** of its own reform. To meet BiH's partnership aspirations and to promote ownership, the High Representative established a consultative Partnership Forum with leading State and Entity officials in October 2001. Initial results have been modest, but the Forum has potential.

In 2001 the High Representative was asked to initiate **streamlining** of the international civilian presence in BiH. The aim is to improve co-ordination and efficiency, to facilitate a reduction in international commitments and to promote BiH ownership. Streamlined international structures were introduced at the start of 2002. Streamlining should facilitate full BiH ownership, this being a pre-condition for successful functioning of the SAP - a SAA can only be concluded with a self-sustaining state.

2.1.2. Assessment of judiciary, law enforcement and respect for the rule of law

The war of 1992 - 1995 led to a complete break-down of law and order through much of BiH. This legacy has yet to be fully overcome. Although the BiH constitution defines BiH as a democratic state operating on rule of law principles (Article I), BiH undoubtedly has a way to go before ensuring that this principle operates uniformly.

Judiciary. Apart from the Constitutional Court (which has increasingly established itself as a respected arbiter) and the State Court of BiH (first imposed by the High Representative) which is yet to become operational, there is no judiciary at State level. In FBiH, there are 57 municipal, 10 cantonal and one Supreme Court(s). There are about 600 judges and 180 public prosecutors. Although procedure and the penal code are a Federation competence, court functioning and budget are cantonal responsibilities. The FBiH penal system cannot always ensure the application of sentences. Prisoners, many still under investigation, face overcrowding. In RS there are 28 municipal, 5 district and one Supreme Court(s). There are 300 judges and 80 prosecutors. Specialised courts for financial and administrative issues and a court police system are planned. The magistracy is, in theory, multi-ethnic, but its level of professionalism is deemed low. In RS thousands of cases remain unresolved in the courts. The RS prison system is also overcrowded, currently lacks facilities for minors and faces some administrative staff shortages. In both Entities the implementation of court decisions is weak. The judicial system lacks public confidence because of corruption, inefficiency and a history of political interference.

Reform efforts have begun. Until end 2000 the UN's Judicial System Assessment Programme monitored the technical, institutional and political framework in which the judicial system operated. In March 2001 an Independent Judicial Commission (IJC) was established with a mandate until end December 2002 with the aim of (i) improving the independence of the judiciary and (ii) improving the quality and efficiency of the judicial system. An IJC-monitored review of the judiciary has progressed slowly. Systemic change is needed to address political interference in the judiciary, the limited number of qualified judges, the cumbersome structure of the judicial system and the inefficiency of judicial proceedings. BiH courts need to be brought into line with European standards.

Police. At State-level there is a national INTERPOL office in Sarajevo which carries out international information exchange. Further, a **State Border Service (SBS)**, the first BiH state-wide, multi-ethnic law enforcement agency, was created by decision of the High Representative in June 2000 (and subsequently adopted by the BiH parliament). Full SBS deployment at land, sea and airport borders, with around 2600 officers is foreseen (subject to funding) for autumn 2002. A State Information Protection Agency is in preparation.

Otherwise, policing is an Entity competence. **FBiH police forces**, with around 11,500 police officers, enjoy wide autonomy. Local policing systems vary significantly, as do operational capacity and levels of pay. This complicates standardisation and the work of the Federation ministry. Staff composition is theoretically multi-ethnic - only around 5% are ethnic minority officers. Training needs to be improved. The **RS police service** is hierarchically organised. It has 45 police stations, four Public Security Centres and central services. It has about 7500 police officers. Many staff have been carried over from the Yugoslav system. Only around 4% of the force is non-Serb. Nationalist influences persist, as evidenced by the initial policing of the May 2001 Banja Luka riots associated with a stone-laying ceremony at the Ferhadija mosque. Poor equipment and lack of international contacts are major constraints. Inter-Entity co-operation on policing has been initiated but needs development. Co-operation is supported by the UN's **International Police Task Force (IPTF)** which through registration, screening and authorisation of officers helped develop policing standards. The IPTF mandate expires in December 2002, at which time a new EU Police Mission will take over responsibility.

General respect for the rule of law. Against resistance, sometimes local sometimes organised, the international community has insisted that rights and due process be observed irrespective of ethnicity or religious affiliation. Gradually this message has percolated through, although local infractions recur. Corruption remains a problem - the inter-weaving of political and business interests has a pernicious effect. Indeed, in the case of Herzegovacka Banka and Croat "self-rule", it called into question the very integrity of the state. The BiH parliament adopted the Anti-Corruption Strategy proposed by OHR.

2.2. Human Rights and the Protection of Minorities

BiH faces a fundamental dilemma: how to balance individual and ethnic group rights. BiH should aspire to the model of civic and individual rights more common in the EU. The improvement in the observance of human rights is welcome, but needs to be improved particularly in RS. The Entities need to come to rapid agreement on the practical implementation of the decision of the Constitutional Court on the "Constituent Peoples case". The alienation felt by Croats needs to be addressed. The GFAP-mandated human rights bodies need to be properly and consistently funded.

Increased refugee returns are welcome, but the implementation of property laws needs improvement, again especially in RS and Croat-dominated cantons. This is a matter not only of human rights but would also be a signal to potential investors that rights, property and investment are protected.

2.2.1. Civil, political, economic and social rights

The BiH constitution guarantees "**the highest level of internationally recognised human rights and fundamental freedoms**" (Art. II.1) and establishes that the rights and

freedoms of the European Convention for the Protection of Human Rights and Fundamental Freedoms and its Protocols apply directly in BiH, taking precedence over all other law (Article II.2). GFAP annex VI also provides for the establishment of an Ombudsman (now at both State and Entity levels) and a Human Rights Chamber (eventually to be merged with the Constitutional Court). Annex VII protects the right of refugees and displaced persons by guaranteeing their right to return to their homes, to repossess them or be compensated for property lost since 1991.

Initially observed in the breach, basic rights are increasingly implemented. Where political will lacked, the Entities have been harried towards observance; where obstructionism took place, the High Representative dismissed the guilty parties. Political freedoms have been secured; BiH has a wide spectrum of political parties, although the High Representative has banned some politicians and one major party (the Serbian Radical Party) for obstructing GFAP implementation. The operation of the human rights bodies (**Ombudsman and Human Rights Chamber**) has been hindered by the failure of the State to provide adequate funding in 2001, while the work of the RS Ombudsman was held back by unwillingness to agree salary levels in line with international norms. In general, the implementation of decisions by the human rights bodies has been better in FBiH than in RS. Economic rights such as the right to property are gradually being restored as the **Commission for Real Property Claims** and other bodies oversee the implementation of property laws. Trade union and workers' rights are protected, although undermined by economic debility. The death penalty has been abolished.

Freedom of expression and **media freedom** are largely observed. There is legislation on freedom of access to information while a defamation law upholds freedom of expression by eliminating liability for expressions of opinion and true statements. There is a developing press sector overseen by a Press Council. However, governments of all shades still try to influence the media, e.g. by trying to engineer favourable appointments. Pressure on journalists, and even threats to their person, continue in areas of particular sensitivity (e.g. Herzegovina), but a Free Media Help Line now provides journalists with a mechanism to report incidents and threats. Access to information is aided by the development of a public service broadcasting system and the issue of broadcasting licences by the Communications Regulatory Agency.

The **NGO sector** remains under-developed in BiH. A State law on Associations and Foundations was adopted in December 2001, allowing NGOs to register at State level.

2.2.2. *Minority rights and refugees*

Given BiH's recent history and mixed population, it is not surprising that the rights of its various peoples are a defining issue in politics. Beyond a draft Law on Minorities and initiatives to establish a Council on National Minorities and an Advisory Board on Roma, the constitution seeks to build confidence among **BiH's peoples - Bosniacs, Serbs, Croats and Others**. Thus, in addition to the decentralisation of power, there is a constitutionally guaranteed right to block legislation considered destructive of a national "vital interest". This has frequently been invoked and has often taken precedence over considerations of effective or efficient government.

Despite such constitutional provisions, Croats in particular feel that their group rights have been abused. A number of disputes with the international community culminated in 2001 in the illegal proclamation of Croat "self-rule" involving inter alia attempts to withhold tax and customs revenues and withdraw the Croat component from the FBiH army. Croat "self-rule" proved unsustainable, but the **alienation of many Croats** persists. Some have argued for the creation of a third Entity for Croats or the complete

cantonisation of BiH, ensuring that Croats control defined areas in which they are a majority. The international community has rejected these demands and argued that Croat concerns should be addressed within the Constitutional Commissions established by the High Representative to follow up on the July 2000 "Constituent Peoples" decision by the Constitutional Court. In fact, work in the **Constitutional Commissions** has been stalled. While RS would accept an institutional arrangement protecting non-Serbs rights, FBiH has argued for constitutional arrangements that would be symmetrical in both form and substance in both Entities. This is not acceptable to RS. Arguably, this should be a case for BiH ownership, but the proximity of 2002 elections and the danger of further politicisation may force the High Representative to intervene.

Most international observers hope that BiH will eventually move from notions of **group / ethnic rights** towards a system based on individual and civic rights, but this seems unlikely in the short term.

The **return of refugees and displaced persons** remains the principle unresolved rights issue, although there has been significant progress. In January 2002 approximately 490,000 displaced persons remained inside BiH (some 458,000 internally displaced people, around 24,000 refugees from Croatia, 9,500 refugees from FRY and further asylum-seekers from third countries). Minority returns (i.e. those returning to areas in which they are not part of the dominant ethnic group) have increased dramatically. UNHCR registered almost 81,000 minority returns in the first 11 months of 2001, a figure 20% above the previous year. RS was long unwelcoming, but even here rates have improved and the trend is expected to continue in 2002. Social and economic reintegration is critical to the long-term success of returns. The **implementation of property laws has also improved**. By end 2001 some 40% of the 250,000 property claims filed had been resolved (repossessed): 48% in FBiH, but only around 29% in RS. Despite progress, returns are hampered by poor living conditions and unemployment. Local security has improved, but cases of obstruction or harassment continue, particularly in RS and some Croat parts of FBiH. BiH will have to assume full responsibility for returns (including funding) over the coming years.

2.3. Regional Co-operation

Implementation of Dayton is central to BiH's very existence and future stability. Unfinished Dayton business should therefore be speedily concluded. In particular, fuller RS co-operation with ICTY is essential. The delivery of indictees, especially Karadzic and Mladic, to The Hague would help eliminate the notion of Serbs' "collective guilt".

BiH must exploit its changed regional environment (end of the Tadjman and Milosevic regimes) to build mutually beneficial relations with its neighbours and to integrate into regional and euro-atlantic structures. Such integration will help overcome minor bilateral irritants and will bind BiH into a stable web, thus maximising its internal stability. Such integration is also a preparation for the system of regional agreements which will be required under an SAA.

2.3.1. Multilateral Relations

The Republic of Bosnia and Herzegovina, the Republic of Croatia and the Federal Republic of Yugoslavia are parties to the **Dayton Agreement**. In general, military components of the agreement have been correctly implemented, but civilian aspects relating to boundary demarcation, human rights, refugee returns, national monuments and

public corporations have required longer to realise and have progressed only with the benefit of concentrated input from the international community. The current "streamlining" exercise seems to recognise that at least several years are still required for satisfactory implementation.

Under GFAP article IX, the parties are obliged to co-operate with the **International Criminal Tribunal on the former Yugoslavia (ICTY)**. FBiH co-operation has been adequate; suspects, including three generals and a serving minister, have been transferred to The Hague. RS co-operation has recently improved, but remains inadequate. The most important indictees, Radovan Karadzic and Ratko Mladic, remain at large. In October 2001 the RS National Assembly adopted an (unnecessary) Law on Co-operation with ICTY. The law was widely seen as a delaying tactic, but tolerated by the international community because it further limited RS room for manoeuvre. RS has promised to start apprehending anyone publicly indicted by ICTY and has begun to exert pressure on suspects to give themselves up.

BiH has been an **OSCE** member since 1992. Under a Dayton mandate, OSCE established its present mission to BiH in December 1995; it has been active in a number of fields including organising and supervising elections. BiH has also worked with the **Stability Pact for South Eastern Europe**. It has co-operated with Zagreb and Belgrade under the Stability Pact Agenda for Regional Action (AREA) on technical issues related to cross-border returns (data exchange, pension and social rights, education, citizenship, etc.). It has also signed a Letter of Intent with Croatia, Slovenia and FRY on rehabilitating the Sava River Basin. In the context of trade, BiH has signed the Stability Pact Memorandum of Understanding on Trade Liberalisation and Facilitation and is now expected to establish free trade agreements with other signatories by end 2002. In parallel, preparations for membership of the **World Trade Organisation** continue. BiH hopes to accede in 2002.

BiH hopes to join **NATO's Partnership for Peace** but accession has been hindered by intra-BiH disputes over command structures and the need for further military reform. In 1995 BiH applied for membership of the **Council of Europe**. Gradual progress in establishing the required institutions, laws and standards, in particular the passage of the Election Law in summer 2001, will likely allow membership in 2002. BiH must implement a series of post-accession requirements.

2.3.2. Bilateral Relations

BiH foreign policy is "aimed towards the permanent guarantee of peace, security, stable development of democracy and of the country in general ..." As a function of this general orientation, BiH attaches particular importance to developing good relations with its immediate neighbours.

BiH and the **Federal Republic of Yugoslavia (FRY)** have established diplomatic relations. Both countries wish to develop contacts. An Inter-State Council for Co-operation has met and a Border Commission been established. An agreement on dual citizenship is in preparation. Inter-parliamentary co-operation was initiated following a FRY parliamentary delegation visit to Sarajevo in late 2001. Business links are developing and a free trade agreement giving BiH preferential, asymmetric treatment was signed in February 2002. Talks on a readmission agreement have been launched. Not all issues have been resolved. Among the more tractable: final border demarcation and BiH's lawsuit against the FRY before the International Court of Justice for alleged genocide.

A more systemic concern relates to FRY's **special parallel relationship** with RS, now codified in a formal agreement. An initial draft agreement was vetoed by the High Representative as inconsistent with GFAP and BiH's State powers. RS and FRY have established a Permanent Committee for Co-operation and the relationship has been pursued with vigour. In monitoring the relationship, the international community's concern is to prevent the hollowing out of the BiH State through agreements which are properly state-to-state matters. A further element of concern has been FRY payments to former Yugoslav military personnel who transferred to the RS army, but these were to be phased out by March 2002. In parallel with its special relations with Belgrade, RS has fostered links with Podgorica / Montenegro.

Finally, in Sarajevo FRY's ongoing constitutional debates are regarded with concern. For Sarajevo, independence for Montenegro or Kosovo should not have a knock-on effect on BiH. However, there is a worry that holding a referendum on the future constitutional order of these areas could set precedents for BiH / RS.

Changes in **Croatia** have created the conditions for improved bilateral relations with BiH's other neighbour. Croatia has developed more transparent relations with BiH and now supports the integrity of the BiH State. It has renounced a special parallel relationship with FBiH. Although concerned about BiH Croats, Zagreb has been helpful to Sarajevo on Croat "self-rule", making clear that the future of Herzegovina is within BiH (although some Croatian voices have advocated BiH constitutional change). Further, Zagreb has stopped assistance to the Bosnian Croat army and the payment of social allowances from Croatia has been redirected to avoid misuse. Improving relations are further evidenced by the December 2000 conclusion of an asymmetrical free trade agreement under which BiH benefits from a preferential three year transition period. Negotiations on an agreement on dual citizenship have started. Exchanges of parliamentary delegations and meetings of the BiH - Croatia Inter-State Council have taken place. An agreement on refugee returns was signed with Croatia in December 2001.

Nevertheless, some unresolved issues remain. In January 2002 Croatia banned the road transport of oil products through its territory on environmental grounds. BiH sees the ban as incompatible with existing agreements and prejudicial to its economy. Counter-measures have been taken. An agreement on state borders was signed in 1999 and has been provisionally applied, but issues linked to the definition and respect of borders still occasionally arise. In general, relations between RS and Croatia are less than optimal. Contacts across the long common border remain subdued. Unless changed, this will prejudice regional development.

Re-building relations with FRY and Croatia have dominated the BiH foreign policy agenda. Nevertheless, negotiations on free trade agreements with **other regional neighbours** are underway. Relations with **Albania** are at an early stage, but initial steps have been taken to prepare free trade negotiations. Likewise, relations with **the former Yugoslav Republic of Macedonia** are good but need further development. Free trade negotiations started in May 2001 and are ongoing.

Slovenia is one of the biggest foreign investors in BiH. Both countries have an agreement on the protection of investments, and an asymmetrical free trade agreement favourable to BiH was signed in October 2001. Slovenian estimates suggest that there are now around 200 BiH - Slovenian joint business ventures, creating around 2000 new jobs.

BiH is also keen to develop good bilateral relations with other states, particularly with **members of the Steering Board** of Peace Implementation Council. High profile visits have been made to the US, Russia, Germany, France and the UK. Given religious ties and assistance provided, BiH is also keen to maintain good relations with the countries of the Organisation of the Islamic Conference (OIC). These contacts have made the introduction of new visa requirements to bring BiH in line with Schengen requirements sensitive.

2.4. Priority Areas Needing Attention in the Next 12 Months

- Implement constitutional and legislative amendments necessary to comply with the decision of the Constitutional Court on "constituent peoples".
- Ensure implementation of adopted legislation, including the successful conduct of 2002 elections.
- Assume full operational and financial responsibility for human rights bodies. RS must improve compliance with human rights decisions and property law implementation.
- Co-operate with the Independent Judicial Commission on judicial reform and institutionalise inter-Entity co-operation in judicial and police affairs. Ensure full co-operation with IPTF and its successor.
- Develop local, Entity and State-level initiatives to counter Croat alienation.
- RS to identify and transfer ICTY indictees to The Hague.
- Ensure timely implementation of the Stability Pact Memorandum of Understanding on Trade Liberalisation and Facilitation.
- Integrate into regional and global bodies by meeting accession criteria.

3. ECONOMIC SITUATION

3.1. Current Economic Situation

In its economic as in political life, BiH must transcend an inheritance of socialist mismanagement and wartime destruction. With significant international input, including over €5 billion in assistance, BiH has established some important foundations: a largely reconstructed infrastructure, increasing macro-economic stability and a respected Central Bank. It must now build on this basis and avoid developing a "dependency culture". This is particularly important because international assistance is now declining. If it is unable to compensate with other resources (e.g. FDI), BiH will not sustain its initial post conflict "growth-bounce". Creating the conditions for SME- and FDI-led growth is a priority. BiH must thus reinforce its reform efforts.

Macroeconomic data¹ for 2001 indicate that **GDP growth** continued to decelerate and a rate of around 5-6% is now expected for 2001 as a whole. This compares unfavourably with higher rates in previous years. Some information points to a recovery of agricultural production from last year's decline due to a severe drought. Average industrial

¹ The quality of BiH economic statistics is poor. Thus, most of this analysis is based on estimates (largely produced by the World Bank and the IMF). It is also difficult to identify the size of the grey economy.

production is reported to have increased in the third quarter of 2001 by 6%, compared with the same period of 2000. The grey market is substantial and while it has provided a safety net for significant parts of the population, it needs to be gradually regularised.

Inflation remains subdued and the exchange rate of the Convertible Mark (KM) stable, supported by a strict adherence to the rules of the currency board. Maintaining credibility is the main monetary objective of the Central Bank which has not revised the KM 1:1 peg to the DM/Euro in connection to the switchover to the Euro. A significant inflation differential between the Entities remains, although some convergence has recently been observed. Inflation in FBiH is estimated at 1.7% in the first ten months of 2001, while in RS it reached almost 8% as of September 2001.

Wage policy is constrained by a tight monetary policy; in some sectors, wage payments lag by months. **Unemployment** in October was about 40% of the labour force (particularly high compared with the western Balkan average of 17% or that of the candidate countries at 12%). Labour shedding in privatised companies or downsizing by the military and the international community may increase unemployment in the medium term. However, registered unemployment figures may overstate the phenomenon, since a large part of the workforce is engaged in grey market activities.

BiH's **fiscal performance** gives reason for concern. The revenue base of the Entities derives mostly from indirect taxes (excises and customs), while the State budget, lacking own revenues, depends on Entity transfers to meet one of its main responsibilities - foreign debt service. General government expenditure was high at about 56% of GDP in 2001. Bloated public sector wage bills, subsidies, and unsustainable social security schemes are worrying and current levels of military expenditure (8% of total expenditure in RS and 25% in FBiH in 2001) appear unsustainable. As in 2000, when budget ceilings were not respected, corrective measures had to be taken in 2001. Re-balancing of 2001 budgets were carried out in FBiH and the State. While FBiH recorded higher than expected income (due to high customs revenues), the State recorded a deficit of around €30 million, in part due to costs associated with the State Border Service. RS did not re-balance its budget and had to cut excessive expenditures. A Council of Ministers' agreement to use Succession Funds obtained from former Yugoslav assets for long-term credits to the Entities, for economic development projects and to cover State budget arrears, stills awaits full parliamentary approval.

On the external side, the **balance of payments** was affected by an export recovery initiated in 2000 (partly due to reopening of the Yugoslav market) and a decline of imports (mainly due to reductions in donor finance for reconstruction). The current account deficit (excluding transfers) is expected to decline slightly in 2001 to around 20% of GDP, from 22.2% in 2000, but it remains high. During January-September 2001, exports represented about 37% of imports.

Foreign debt remains high, currently estimated at about 56% of GDP, partly because of a debt burden inherited from former Yugoslavia. However, debt service as a percentage of export of goods is relatively low, reflecting the concessional nature of much of the debt and favourable debt rescheduling. Debt service payments in 2001 amounted to €104 million. Debt payments will increase to €162 million in 2002 and will impose an increasingly large fiscal obligation in subsequent years.

Net FDI per capita stayed at around €39 in 2001 (projected), but remains one of the lowest in the region. Little progress has been achieved in improving the legislative

environment for FDI; it remains difficult and non-transparent with differing rules across Entities.

Following delays in policy implementation, in May 2001 the **IMF** favourably completed its final review for the Stand-By Arrangement (SBA) approved in May 1998. Negotiations are still underway for a new SBA which is expected to be signed in the first half of 2002. The **World Bank** is currently implementing operations relating to public finance reform, privatisation and banking reform and support to reform of the social benefits system.

3.2. Existence of Free Market Economy and Structural Reforms

Structural reform and the transition to a free market economy are essential for BiH. Price liberalisation and the privatisation process must be completed. Privatisation must ensure the injection of new capital and know-how. It must deeply change corporate governance and not simply transfer ownership to the previous administrative elite. In order to enhance support to the market economy, the transparency of the privatisation process must be guaranteed. Further, while restructuring will inevitably have financial and social costs, it must also unleash an economic dynamism able to take up some of the inevitable slack. The government will have to cushion the transition judiciously.

To build popular confidence, further reform of the banking sector is necessary. In particular, the banking sector must be capable of assisting investment in the most promising areas.

Most **prices** (including interest rates, but excluding a few public services) **have been liberalised** and full current account convertibility ensured. However, structural reforms have been slower than expected.

Privatisation is being implemented through both mass-voucher schemes and tenders. Mass privatisation schemes were used to deal with citizens' claims against the state. Tender privatisation aimed to attract foreign investment to strategic companies. Results have been uneven at best. Both Entities have privatised a large number of small-scale enterprises, but failed to advance speedily with large-scale privatisation, although there has been progress in recent months. In FBiH 145 large-scale and six strategic companies were fully privatised by 2001. In RS, where it has been particularly difficult to attract foreign bidders, only three strategic companies out of the original 52 have been privatised, with negotiations ongoing for a fourth company. The impact of privatisation on **enterprise restructuring** and **corporate governance** remains uneven and delayed, insofar as citizens or privatisation investment funds are not always in a position to assess enterprise viability or impose industrial restructuring.

In the **financial sector**, the Payment Bureaux were closed at the beginning of January 2001 and their functions transferred to the banking sector. Substantial progress has been achieved in banking supervision and prudential regulations: minimum capital requirements are being gradually increased in order to ensure bank viability, and full immunity has been granted to supervisory agency officials. However, privatisation of state-owned banks has been slower than envisaged in both FBiH and RS. By end 2001, a draft law on deposit insurance was prepared, creating a State-level bank-deposit insurance Agency and covering depositors' assets up to €2500 in member banks. At present separate agencies exist in each Entity, but in RS no funds have been reserved to

cover relevant interventions and no RS banks have qualified for membership in the scheme.

3.3. Management of Public Finances

BiH's management of its public finances is a cause for concern. Expenditure control has improved, but the revenue side of public finances needs urgent attention. The imbalance between State and Entity resources is a concern, particularly because the State has accrued new responsibilities without identifying the new means to pay for them. Moreover, there appears to be no standardised and defined mechanism for identifying budgetary contributions to the State. The introduction of VAT may eventually alleviate the problem, but this will take time - which means that BiH faces several years in which scarcity of resources will call into question the sustainability of reforms and institutions already introduced.

Weak fiscal discipline and poor **public expenditure control** are a major source of concern, although institutional progress has been made. At the State level, a Ministry of Treasury was set up in October 2000 and work is underway to strengthen budgetary control of the State functions. At Entity level, Treasury departments have been established in the Finance Ministries and Single Treasury Accounts exist on both State and Entity levels. All government payments orders will pass through this account, thus ensuring greater fiscal transparency and control. On the **revenue side** there is an imbalance. The State has only minimal revenue-raising abilities (e.g. administrative charges for passports); only about 9% of the State budget was covered by own predictable and controllable sources of funding in 2001. Tax-raising powers are with the Entities. The State is thus dependent on the Entities for income. Moreover, the State has gradually accrued new responsibilities (elections, SBS, etc.). The State's 2001 budget was re-balanced with difficulty and in 2002 the difficulties will be even greater.

Tax reform, including the introduction of VAT (possibly in 2003 / 2004), could alleviate BiH's fiscal problems. However, this raises difficult issues of co-operation between the two Entities. Currently, tax reform is designed and monitored by the international community, including the EU's Customs and Fiscal Assistance Office. To date, only RS and Brcko District have adopted a Law on Tax Administration; FBiH's draft law remains in parliamentary procedure. Some steps towards tax harmonisation have been taken, but full harmonisation not yet attained. As regards **reorganisation of the tax administration**, progress has been made in FBiH with the establishment of control and investigation units and a debt management service. RS has only recently started establishing such units.

3.4. Priority Areas Needing Attention in the Next 12 Months

- Maintain macroeconomic stability and ensure continued IMF support through negotiation and implementation of a new Stand-By Arrangement.
- Reduce unproductive expenditure and downsize the public sector (especially the military), while increasing capital investment and protecting essential social expenditure.
- Reduce administrative barriers to FDI and harmonise fully Entity business laws.
- Drive forward strategic privatisation and implement banking reform (especially in RS).

- Agree with the Entities a mechanism for identifying budgetary contributions to the State and identify direct sources of income for the State budget.
- Harmonise tax systems, improve tax and customs collection and prepare the introduction of VAT.

4. IMPLEMENTATION OF THE STABILISATION AND ASSOCIATION PROCESS

4.1. General Evaluation

BiH is at an early stage of the SAP. Its first task is the completion of the Road Map. This limited agenda has helped BiH focus on a limited number of SAP-relevant reforms. Worryingly, however, the completion of even this limited agenda is lagging. This is symptomatic of several weaknesses, the most important of which is probably a lack of consensus within BiH on the importance of the SAP agenda. In the medium term proper and full implementation is as important as adopting legislation.

BiH has quickly developed a rudimentary administrative capacity. Further development will be needed to meet later (and increasing) SAP demands. BiH should use the SAP to maximise and justify the drive for reform.

4.1.1. Status

From 1996 BiH became a participant in the EU's **Regional Approach**. In fact, however, institutionalised contacts with the EU date effectively from June 1998 when, on the occasion of a first meeting with the BiH Foreign Minister, the EU Council of Ministers issued a "Declaration on Special Relations between the EU and BiH". In addition to encouraging further BiH reform and promising support for this effort, the Council proposed a joint EU - BiH **Consultative Task Force (CTF)** to help BiH establish a fully functioning State and to develop the technical prerequisites for closer co-operation with the EU. The first meeting of the CTF took place in June 1998 and since then 10 CTFs have been held, the latest in March 2002.

With the introduction of the SAP in 1999, BiH also became a participant. Under the SAP BiH now enjoys (i) **preferential EU trade concessions** and (ii) **CARDS assistance**. In future, it may also negotiate (iii) a **SAA** which would, in some ways, prefigure the rights and obligations associated with eventual EU membership. A SAA would, however, only be possible on the basis of further reform.

BiH is at an early stage of the SAP. In order to identify the most important issues for BiH under the SAP, the Commission in March 2000 developed a Road Map of 18 basic steps whose completion would help BiH function as a State and would indicate a level of political willingness to reform commensurate with a developing political relationship.

Road Map

I Political Steps

- Adopt an election law and provide election finance
- Adopt a Civil Service Law
- Establish a Permanent Secretariat in the Presidency. Agree on Chairmanship of the Council of Ministers and adopt necessary legal amendments and procedures.
- Adopt new Rules and Procedures for the Parliamentary Assembly
- Adopt single passport
- Implement the Law on State Border Service and ensure funding.
- Allocate sufficient funding for the Constitutional Court of BiH

II Economic Steps

- Abolish Payment Bureaux
- Establish a State Treasury
- Remove all trade barriers between the entities
- Establish a single BiH National Institute for Standards
- Adopt Law on Competition and Consumer Protection
- Implement Foreign Direct Investment Legislation and adopt Restitution Legislation

III Steps in the fields of Democracy, Human Rights and Rule of Law

- Implement property laws
- Stronger engagement at all levels to create conditions for sustainable returns
- Implement decisions of the Human Rights Institutions and ensure adequate funding
- Approve and implement Laws on Judicial and Prosecutorial Service in the Federation and Law on Court and Judicial Service in the RS
- Co-operate with OHR in implementation of Public Service Broadcasting at State and Entity level.

Since the aim of the Road Map has been to provide a focus for the most crucial reform efforts in the context of SAP, the CTF in BiH has concentrated primarily on this agenda since its introduction in March 2000. Initially, the CTF worked with the expectation of a fairly rapid achievement of the Road Map steps. At the November 2000 Zagreb summit the objective of completion was set for the first half of 2001. This target was not met, but there is reason to hope that completion will be achieved in the first half of 2002. Currently, eight Road Map points are "completed", while a further ten are "in progress". (These are headline figures. Some points "in progress" are closer to completion than others. Some steps, e.g. implementation of property laws and execution of human rights decisions, will take substantial further effort.)

Road Map	
Political Steps	Status (Jan. 2002)
Adopt an election law and provide election finance	Completed
Adopt a Civil Service Law	In progress
Establish a Permanent Secretariat in the Presidency. Agree on Chairmanship of the Council of Ministers and adopt necessary legal amendments and procedures.	Completed
Adopt new Rules and Procedures for the Parliamentary Assembly	Completed
Adopt single passport	Completed
Implement the Law on State Border Service and ensure funding.	In progress
Allocate sufficient funding for the Constitutional Court of BiH	In progress
Economic Steps	
Abolish Payment Bureaux	Completed
Establish a State Treasury	Completed
Remove all trade barriers between the entities	In progress
Establish a single BiH National Institute for Standards	In progress
Adopt Law on Competition and Consumer Protection	In progress
Implement Foreign Direct Investment Legislation and adopt Restitution Legislation	Completed
Steps in the fields of Democracy, Human Rights and Rule of Law	
Implement property laws	In progress
Stronger engagement at all levels to create conditions for sustainable returns	In progress
Implement decisions of the Human Rights Institutions and ensure adequate funding	In progress
Approve and implement Laws on Judicial and Prosecutorial Service in the Federation and Law on Court and Judicial Service in the RS	Completed

Co-operate with OHR in implementation of Public Service Broadcasting at State and Entity level.	In progress
---	-------------

The Commission has stated that on Road Map completion it will move to the next stage of the SAP, a Feasibility Report on opening negotiations on a SAA. This will measure BiH's current position and capabilities against those that will be required to implement an SAA successfully. If the Report outcome is positive, the Commission would seek a mandate to open SAA negotiations. To be able to progress through these steps successfully, BiH first needs to address the Road Map requirements more decisively than it has so far.

4.1.2. General Assessment of Administrative Capacity

The SAP agenda is comprehensive. As such, it makes a heavy demand on participating state's administrative resources. Moreover, the SAP agenda cannot be delivered by one ministry alone; it requires good co-ordination across government departments. Even the very limited Road Map requires such co-operation, often at different levels of government.

To state this is to indicate the huge challenge BiH faces. BiH is a new state with new and developing administrative structures. Moreover, it has a complicated constitution and a paucity of economic resources and experienced administrative staff. In many cases BiH had to **develop administrative capacity** from zero (e.g. border control, customs, trade, macro-economic management.). European integration, too, is a new focus. For this, a new Ministry of European Integration (MEI) has been established, but it remains small and starved of resources. Its work with other ministries has sometimes been dogged by rivalry and friction. The challenge of co-ordination is compounded by BiH's multiple layers of government and devolution of power. This means that some areas of SAP-related policy (e.g. elements of JHA) are outside central government control. Also, the need to achieve the agreement of both Entities and the co-operation of their respective administrations means that BiH is forced to move at the pace of the slowest. Further difficulties result from poor communications and a tendency between and within ministries to hoard information.

The difficulties should not blind to progress achieved. CTF meetings give BiH a flavour of the challenge and allow MEI to practice co-ordinating BiH's internal position vis-à-vis the EU. A comparison with early CTFs shows the extent of progress. Likewise, constructive, if occasionally difficult, work was done in the sectoral CTF Working Groups. Further, consensus-building has been facilitated by the creation of the high-level **Co-ordination Board for Economic Development and EU Integration**. BiH must now ensure that the work of economic development, e.g. that carried out in the framework of the Poverty Reduction Strategy Paper, is co-ordinated with the bilateral EU integration agenda and that resources are not wasted on double employi. Finally, BiH will not face the administrative challenge alone; CARDS foresees assistance in developing administrative capacity.

4.1.3. Impact of the prospect of an SAA on reform

SAP provides a reinforced incentive for reform by highlighting the prospect of association and gradual BiH integration into EU structures. Although this incentive may not be universally recognised (see section 6), SAP has influenced government policy; Road Map completion is a top government priority. At least as important is the fact that although BiH has an almost unlimited reform agenda, the Road Map provides focus and orientation by identifying key but discrete and achievable reforms. In practical terms, the

CTF meetings and recommendations have pushed reform up the national agenda. Further, SAP gives a "European rationale" for reform. Although they have not always done so, governments may justify difficult steps by referring to "EU requirements" (even though reforms would be necessary whether or not BiH aspired to EU integration). To make progress in terms of European integration, BiH must give priority to the SAP and shape its reform programme accordingly.

Of course, the effect of the SAP has not been as great as it might. Unfortunately, the Road Map has often been seen as a target in itself, instead of the start of a dynamic reform process. Its potential to initiate a dynamic development has been limited because the concern has often been just to "tick off the boxes". Long-term commitment is required to ensure the implementation of adopted legislation. Finally, potential has been underdeveloped because enthusiasm for progress is not always equally shared: RS has in the past disputed the compatibility of some Road Map points with its Entity interests.

In BiH the SAP has focused deliberately on Road Map implementation. This is a narrower agenda than in more advanced SAP beneficiaries. However, as BiH progresses beyond the Road Map, it will be expected to address the wider SAP agenda. The following section indicates the breadth of that agenda and points to specific areas in which the Road Map has had positive effect.

4.2. Internal Market and Trade

The creation of a BiH single economic space is a core Road Map priority. In a country of around only 4 million people, it makes no sense to divide markets. Economies of scale, such as they are, must be exploited. For Road Map purposes the removal of internal trade barriers will be declared "complete" when BiH complements legislation on industrial property with a law on copyright at State level. Obviously, this would not mean that the internal BiH market is "complete" - this will in fact be a multi-faceted, long-term undertaking.

BiH must recognise that steps to improve its internal market will also contribute positively to its external trading performance. Integration of the BiH market is a precondition for participation in the EU's single market.

4.2.1. Movement of goods

Paradoxically, in the case of BiH the movement of goods and services across international borders (from each Entity to FRY or Croatia) has often been easier than within BiH itself. In addition to lingering mutual suspicions, differing regulations, regulatory authorities, standards, taxation systems, laws, procedures and the absence of a functioning State-wide judicial system made inter-Entity exchange difficult (and encouraged corruption). Also, a weak internal transport and communication infrastructure hindered free movement.

The Road Map has insisted, with some success, on the removal of the most egregious **barriers to internal trade**. Most physical barriers to internal trade have been removed and restrictive inter-Entity trade decrees abolished. The legal framework for a customs union has been created. The Ministry of Foreign Trade and Economic Relations has invited and received reports on obstacles to freedom of movement and has established a list of possible trade barriers. The trend in inter-Entity trade is sharply upwards. In a further sign of problem awareness, both Entities and the State co-operated on a broad economic strategy for BiH entitled "Entrepreneurial Society - Bosnia and Herzegovina

Economic Development Strategy - Global Framework 2000 - 2004". Efforts are now needed to operationalise the strategy.

An important step towards improvement of the BiH internal market would be Road Map completion. Nevertheless, even the minimal Road Map agenda remains incomplete. A BiH Institute for Standards still needs to become operational (adequate institute funding is required.) Here lies an important link with BiH's wider trade regime: the EU is BiH's main trading partner. BiH enjoys EU autonomous trade measures (ATMs) and although exports to the EU have grown, BiH has failed to utilise ATMs fully because of the absence of State-level institutions able to deliver CE marking or certify compliance with EU safety legislation. This is particularly evident in the agricultural sector, where the absence of proper veterinary and phyto-sanitary controls prevents the export of potentially competitive products (e.g. meat) to the EU.

4.2.2. *Movement of persons, services and right of establishment*

Within BiH the **free movement of people** was significantly improved by the High Representative's 1998 imposition of standardised car licence plates making it impossible to identify the provenance of drivers. Regional movement is also fairly free since, with the exception of Slovenia, BiH citizens can travel within the territory of former Yugoslavia without visas. Visas are still required for EU states.

The BiH **service sector** remains under-developed although, in the absence of major productive capacity, private retailing has grown. Tourism has potential, but would require large investments in infrastructure and even further mine-clearance to become competitive. Nevertheless, BiH's low costs, competitive wages and fairly well educated workforce could yet make BiH attractive for other service industries with low start-up costs (although pre-conditions such as copyright legislation, a Road Map step, would have to be in place).

BiH laws allow foreign **establishment** in BiH, including the purchase of real estate. However, it is not yet possible to register a company at State (as opposed to Entity) level.

4.2.3 *Movement of capital*

The introduction of a single BiH currency, the Convertible Mark, in June 1998 was a major contribution to free **movement of capital** within BiH.

The abolition of the Payment Bureaux in January 2001 (a Road Map step) has reinforced the role of the nascent banking sector whose weakness constrains business development. In 2001 BiH had around 50 commercial banks, most privately owned and under-capitalised (and some reportedly corrupt). Lacking capital, these have tended to concentrate on transactions such as foreign exchange rather than on investment activities. Since state-owned banks, on the other hand, are saddled with many non-performing loans, they too are constrained in their investment activities. Consequently, the main source of large-scale investment credit has been international donors. Nevertheless, a banking reform programme which has increased deposit insurance (and has progressed faster in FBiH than in RS) and the entry of foreign banks have encouraged a new faith in the banking system. As a result domestic capital has flooded in. Assuming that banks can identify reliable domestic investments, this may contribute to BiH's long-term economic regeneration.

As regards **FDI** into BiH, it is significant that in late 2001 FBiH adopted a law on foreign investment (a Road Map step), making its legislation compatible with the 1998 State law on foreign investment policy. However, a World Bank-Foreign Investment Advisory

Service study in August 2001 identified numerous barriers to FDI. The BiH authorities have presented an Action Plan to reduce them. Improving the climate for FDI is vital given limited domestic resources and declining foreign assistance.

4.2.4. Customs

Customs policy is the responsibility of the State, but implementation and administration are at Entity level. Customs revenue remains with the Entity which collects it. With the assistance of the EU's Customs and Fiscal Assistance Office, BiH has introduced reforms (e.g. a single law on customs policy, a single Tariff Law and schedules, identical implementing regulations.) Mutual assistance agreements have been concluded between the Entities. Both Entities have established customs enforcement sections and are developing a computer system linking all customs facilities. In part, as a result of these efforts BiH has witnessed a steady increase in customs revenues (although this will again decline as free trade agreements come on stream).

Problems remain. Customs law is, reportedly, implemented differently in each Entity. Smuggling is rampant; corruption continues; fraud through incorrect description of goods persists (though seldom reported). Annual losses to the exchequer amount to hundreds of millions of KM. Further, since customs revenues remain with the Entity that collects them, there is an **incentive to undervalue** goods and thus reduce customs charges in order to maximise trade flows and revenue in the Entity. This contradicts the principles of the single market, disadvantages honest importers and robs the exchequer of revenue. To combat this, the international community has proposed a single customs revenue account with revenue distributed according to an agreed formula or the introduction of a single BiH customs service. Either suggestion is politically contentious, but current abuses are incompatible with a single market and will have to be addressed.

4.2.5. Competition and state aid

BiH has no codified system of state aid. This does not mean, however, that some individuals, companies or sectors do not enjoy special privileges. In fact, companies with good political connections often enjoy immunities (e.g. taxation waivers), while others without such patronage are subject to full or excessive taxes, fines, inspections and/or closure orders. In all cases, legitimate companies face unequal competition from smuggled goods.

In October 2001, partly in response to Road Map pressure, BiH adopted a **Competition Law**. The legislation has not yet taken effect. To be operative the law will require operational agencies such as a Competition Council (which will have to be financed from scarce State resources). An effective competition policy thus requires not only legislation but technical infrastructure, personnel and a change of mentality among entrepreneurs and those who have up to now supported or disadvantaged them.

4.2.6. Public procurement

The Entities have a decree or law on public procurement. There is, however, not yet any State legislation on procurement. Reports suggest that numerous exceptions to the existing tendering requirements exist and that there is no standardised documentation at State level for tendering purposes. The World Bank is completing a Diagnostic Study on public procurement. A Law on Public Procurement in State Institutions (which should take account of EU practice) is foreseen.

4.2.7. *Intellectual, industrial and commercial property rights*

A law on **industrial property** (a Road Map point) has been adopted in parliament, but a copyright law remains outstanding. The lack of these laws coupled with the continuing porosity of BiH borders have contributed to piracy and widespread counterfeiting. This constitutes a further disincentive to FDI.

4.3. Sectoral Policies

At this stage the SAP makes few demands on BiH sectoral policies. BiH is, however, expected to participate in regional initiatives and to develop an increasingly European perspective in these sectors. Such participation is a useful preparation for later SAP stages in particular for a SAA when specific commitments will be required.

4.3.1. *Industry and SMEs*

Industrial output fell as a percentage of GDP because of the war and the break-up of SFRY. Recovery has been slow, but the establishment of a BiH internal market in conjunction with privatisation should facilitate redevelopment and encourage the still minimal SME sector. Work on a comprehensive economic policy in the framework of a poverty reduction strategy is ongoing. A number of sectoral studies have been undertaken in sectors such as textiles, wood processing, metal and machine building, leather and shoes, etc.

4.3.2. *Agriculture*

Agriculture was disrupted by the war, but grew in relative importance as industry declined. Agriculture now accounts for around 16% of BiH GDP (1999 estimates). In fact, BiH has significant **agricultural potential**, but development has been hampered inter alia by disputed land ownership, limited agro-processing capacities and the absence of streamlined veterinary control and phyto-sanitary structures. Currently, veterinary and phyto-sanitary structures exist at district, Entity, and State levels, but work to develop state framework laws for both sectors is ongoing.

4.3.3. *Environment*

Because of a concentration of heavy industry, BiH was heavily polluted before the war. War and subsequent economic decline led to industrial closures - with beneficial environmental effect. Deforestation is a concern.

The Entities have responsibility for the environment, but inter-Entity co-operation is good. There is an **Environmental Steering Committee** at state level. This has improved co-ordination and facilitated the development of harmonised strategies and draft laws. However, the Entities need to put in place key environmental legislation such as laws on Environmental Impact Assessment. BiH is co-operating with neighbours on environmental issues through the Regional Environmental Reconstruction Programme (ReRep). In November 2001 BiH signed a declaration on co-operation in water protection in the Danube / Black Sea region.

4.3.4. *Infrastructure*

Much of BiH's infrastructure was destroyed during the war - although much was rebuilt with international post-war assistance. In **transport**, responsibility for regulation of inter-Entity transport lies with the State, but implementation with the Entities. Transportation Corporations, foreseen by GFAP, were agreed for road and rail but have

had minimal operational effect. The rehabilitation of internationally significant transport connections such as Corridor Vc is complicated by division into sections within BiH under the responsibility of different Entity transport bodies.

The **communications** infrastructure has developed sporadically. While fixed line telephone penetration has hardly risen, mobile phone use more than doubled in 2000. Inter-Entity fixed line telephone links have been restored, but enhanced co-operation between the Entities is required if a true national market for telecommunications services is to develop. National policy making and legislative development is required for national enforcement by the Communications Regulatory Agency

On **energy**, post war reconstruction has meant that electricity supplies are now fairly reliable. Both Entities have now adopted Electricity Policy Statements setting out a co-ordinated programme of power sector reform. Entity governments have presented their Parliaments new electricity laws incorporating these reforms. In February 2002 a State law on the transmission, regulation and operation of electrical power was passed. For the electricity industry the development of an independent State Regulatory Commission is essential.

BiH remains dependent on imports for oil and gas. The gas sector needs thorough reform. The Entities have proposed different strategies.

4.4. Co-operation in Justice and Home Affairs

Elements of justice and home affairs figure in the Road Map. However, this is also a sector which will figure increasingly as the SAP develops. BiH will be expected to orient itself increasingly on the acquis communautaire. Already, BiH's participation in regional initiatives such as the March 2001 regional conference on Asylum and Immigration is welcome, but it must now work to give concrete expression to the commitments into which it there entered.

To suppress illegal (im)migration BiH must ensure that the State Border Service is successfully and fully deployed and that its green and blue borders are properly policed. BiH will be expected to make a full contribution to combating organised crime, in particular the trafficking of vulnerable people and drugs. BiH's reaction to the threat of international terrorism has been widely commended. Like others it is challenged to balance the need for security with the protection of human rights.

4.4.1. Visa, Border Control, Asylum and Migration

Implementation of the law on the State Border Service, a Road Map requirement, is a precondition for effective **border control** and the implementation of an adequate visa, asylum and migration regime. Border control has been improved by co-operating with neighbouring states, by reducing the number of border crossing points and by regulating their activity. Of course, SBS control must be effective. Specific measures may be needed to tighten border security at some points, e.g. the BiH - FRY / Montenegro border. Already, SBS deployment has, however, facilitated the compilation of statistics on arrivals and departures, for example at Sarajevo airport. The discrepancy between the two figures has highlighted the extent of illegal (im)migration through / into BiH.

BiH's performance on **visa, asylum and migration issues** is mixed. It is gradually aligning its visa policy on Schengen requirements; it has introduced visas for nationals of states such as Iran, Tunisia and others and a visa requirement for Turkey is under consideration. Landing cards are now required at entry points. As regards asylum, BiH

is party by succession to the 1951 Geneva Convention on Refugees. Implementation legislation is not yet functioning and status determination is performed by UNHCR. A State Law on Immigration and Asylum has been operative since end 1999; its sections on asylum largely conform to international standards, but there is a lack of clarity with regard to application. Regarding illegal immigration, legislation is incorporated into the draft Criminal Code and the Criminal Procedure Code.

In March 2001 BiH took part in a regional conference in Sarajevo on these issues. This led to a Joint Declaration by the EU, BiH and its neighbours. In a subsequent follow-up meeting in Belgrade in November 2001, BiH and others undertook to work towards approximation on EU standards, common regional working procedures and common technical standards.

4.4.2. Money Laundering

Abolition of the Payment Bureaux, the establishment of a Treasury system (Road Map requirements) and the introduction of audit procedures, have helped to reduce the opportunities for misappropriation of public funds. This is, however, only a start. Significant legal and procedural lacunae exist which can still be exploited for the abuse and recycling of both private and state funds.

In FBiH **money laundering** is not a crime but only an administrative offence. In RS the Criminal Code defines money laundering as a crime, but there have been no reported cases of prosecution. In both Entities illegally acquired assets may be recycled into property or company investments. A number of high profile cases, including Herzegovacka Banka, have highlighted the extent of bank fraud and the glaring lack of a single State banking regulatory agency. A law on the prevention of money laundering is foreseen.

4.4.3. Drugs

Illegal drugs are reportedly present in BiH both for domestic consumption and in transit to major markets in western Europe. The facility of transit will be affected by full SBS deployment and improvements in customs administration. As so often, BiH's ability to interdict this traffic is hindered by the fact that competence is divided between two Entities. Nevertheless seizures of drugs, even on the Inter-Entity Boundary Line, have been recorded.

4.4.4. Fighting Organised Crime and Terrorism

While some local sources deny that BiH has mafia-style organised crime syndicates, other external observers have pointed to an unhealthy **mix of political and business interests** in BiH. Some political parties allegedly receive financial support and companies market protection in return. Certainly, the BiH public believes that corruption is widespread. Road Map steps such as laws on the Entity judicial and prosecutorial services (and even more peripheral measures such as legislation on competition and property laws) may make a contribution to establishing the rule of law. However, BiH needs to do more to support OHR's Anti-Corruption Strategy.

A further worrying phenomenon is the **trafficking of women and children** for sexual exploitation. Often, victims transit; others remain in BiH, working illegally or with corruptly issued documentation. The BiH Council of Ministers has adopted a draft action plan on trafficking. The intention is to focus on prevention. Actions planned include improved border security and legislation, including the adoption of a Criminal Code and

laws on Criminal Procedure and on Employment Relations. Awareness campaigns on trafficking are planned. As ever, funding remains a problem

Following the September 2001 terrorists attacks in New York the BiH authorities quickly pledged their support for the international anti-terrorist coalition and aligned themselves with an EU declaration on **terrorism**. The Council of Ministers adopted an Action Plan against Terrorism, and a Co-ordination Board against Terrorism with international participation was created. Some foreign citizens have been detained and a number deported, although others may have gone to ground. Some "humanitarian agencies" have been closed. An intensified review was initiated of cases in which BiH citizenship was granted to foreigners during/after the war and in 94 cases BiH citizenship was withdrawn. Security may be further augmented by the implementation of the Citizens Identification Protection System. In BiH, as elsewhere, there have been expressions of concern about the infringement of the human rights of alleged terrorist detainees.

4.5. Priority Areas needing Attention in the Next 12 Months

- Complete the Road Map and use it as a catalyst to dynamise reform (i.e. use "EU requirements" to push reform). Ensure full implementation of adopted legislation.
- Develop administrative capacity (in particular by adopting and implementing the Civil Service Law). Also, ensure co-ordination between the CTF process and the Co-ordination Board for Economic Development and European Integration.
- Prepare further customs reform to combat customs evasion and competitive undervaluing.
- Adopt and implement a State law on Public Procurement and legislation on intellectual property rights.
- Complete SBS deployment and align fully on EU standards on visa and entry policies. Adopt by-laws necessary for full asylum legislation with clear responsibilities within government at State and Entity levels.
- Align on European standards with regards to criminal legislation on trafficking / smuggling of human beings.

5. FINANCIAL ASSISTANCE

Overall, between 1991 and 2001 (inclusive), BiH received approximately €2.3 billion in EC assistance.

In 2001, €105.23 million in EC funds were allocated to BiH under the **CARDS** programme. CARDS Assistance offers a long-term assistance approach that addresses in a single programme the needs of the country and reflects the ambitious objectives of the Stabilisation and Association Process. It focuses on support for the reforms and institution-building necessary to implement the obligations of a future Stabilisation and Association Agreement.

The main focus of the **2001 programme** was on the following sectors:

- (1) Democratic stabilisation (refugee return, public broadcasting reform, institutional capacity-building including State level ministries, Constitutional Court, Customs and tax administration).
- (2) Economic reform and social development (including civil aviation, private sector and SMEs, university education and vocational training).

- (3) Justice and home affairs (Dayton institutions, State Border Service, integrated border management, Independent Judicial Commission).

In 2001, in addition to CARDS, BiH benefited from the following EC assistance: The EC contributed €13.5 million to the operational budget of **OHR** (53% of OHR's approved budget). Under the European Initiative for Democracy and Human Rights (**EIDHR**) BiH has been selected for projects in the following areas: confidence-building, women, Roma, human rights legislation and the "European Master". In addition, the Delegation has managed EIDHR micro-projects. In June 2001, the **European Investment Bank** signed a €40 million loan to BiH (subsidised through CARDS) earmarked for railway redevelopment. The second tranche (€20 million) of the €60 million package of **macro-financial assistance** decided by the Council in May 1999 was paid out in December 2000; the third and last tranche (€15 million grant) was released in December 2001 once sufficient progress had been made with the economic policy conditions attached to it. BiH also benefits from the **LIFE** programme for third countries targeting environmental management. **ECHO** phased out of BiH in 2000.

Implementation of project-related EC assistance is "de-concentrated" to the Commission Delegation in Sarajevo and has been relatively quick where it has been a question of continuing already existing activities (e.g. refugee return) or where institutions which already function have been supported (Dayton institutions, OHR). It has been more difficult where interventions aim at policy change or where new institutions are created. The complex political structure of the country and a still poor business environment have not facilitated implementation. An assessment of the impact of EC assistance on the beneficiary country shows that particularly positive results have been achieved in the areas of refugee return, SMEs and support to the Constitutional Court.

A number of established aid co-ordination mechanisms exist in BiH in which the Commission Delegation participates. Regular co-ordination meetings with EU Member States are held in order to ensure consistent and coherent interventions. The Delegation has strengthened its working relations with the BiH Ministry for European Integration, the national aid co-ordinator for EC assistance. However, improvement of co-ordination arrangements remains an important task in BiH.

The EC **Country Strategy Paper** for BiH defines the main assistance areas for 2002-2006 and the **Multi-Annual Indicative Programme** defines in more detail priorities for 2002-2004. These documents take into account the priorities of the SAP and focus on democratic stabilisation (refugee return, media), administrative capacity-building (customs and taxation, BiH State institutions), economic reform, social cohesion and development, environment and natural resources and justice and home affairs (the administration of justice, policing, asylum and migration) and integrated border management.

6. PERCEPTIONS OF THE EU

Although Road Map completion has been declared a top government priority, this has not been consistently pursued in BiH. There is evidence of varying levels of commitment to the SAP agenda. Too often lip service has been paid to "Europe" while other, often incompatible, agendas have been pursued.

The level of understanding of the SAP is limited, even among policy-makers and opinion-formers. It has not been possible to mobilise the general public in favour of the SAP agenda since the public remains largely uninformed. The EU is most often seen as

a donor. Better, more media- and consumer-friendly information and proof of relevance to BiH everyday life is required.

BiH has a clear state policy in favour of **integration into EU structures** through "fulfilment of the prerequisites for entering into Agreement on Stabilisation and Accession into European Union". The completion of the Road Map has been declared a top government priority, and some political leaders have voiced optimistic prognoses concerning future EU membership. Primarily at State level, further integration into EU structures through SAP is seen not only as a foreign policy priority, but as a motivating force and vehicle for internal reform. This stance appears, however, limited to a small circle of the political and administrative elite and is not consistently pursued. All too often political leaders, while paying lip-service to "Europe", have subordinated this objective to short-term or locally focused priorities.

Beyond the elite, the EU agenda does not figure prominently. There is evidence, for example, that even some leading opinion-formers have confounded the Road Map with the criteria for entry to the Council of Europe. Moreover, acute financial constraints mean that governments at State and Entity level have been unable to supplement EU publicity initiatives with their own information campaigns. Thus, while official government attitudes at State level are generally positive, wide sections of the **public remain uninformed** or unconvinced that the EU is relevant to their daily life. It has not yet been possible to mobilise public opinion around a "European" reform agenda.

Further, attitudes vary according to locality and local political climate. While the elite in Sarajevo may be critically supportive, regional centres such as Mostar seem to have other concerns. In the case of Herzegovina Croats, a desire for autonomy or outright independence provides a very different focus. Likewise in RS, in economically struggling eastern centres, Serb nationalism remains a driving force (and appears undimmed by declining economic fortunes). In the past the High Representative has seen himself forced to criticise the RS for blocking Road Map-related state-level legislation which was viewed with suspicion in Banja Luka. In fact, some observers have suggested that on the fringes of BiH's various nationalist constituencies, the hope remains that the international community, including the EU, will tire of engagement, will withdraw and will thus again open the door to the pursuit of nationalist and separatist aims.

Coverage of the EU in the major media outlets is generally fair. The introduction of the Euro, replacing the DM which was used in parallel with the KM, has been much discussed. CTFs have attracted press coverage and have been generally faithfully reported while visits by European politicians have attracted favourable publicity. The Commission Delegation is frequently asked to comment and provide an EU perspective on local and national developments. Perhaps inevitably, the EU is often seen in terms of its assistance programme to BiH. The implementation of projects figures prominently in press coverage.