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COMMUNICATION FROM THE COMMISSION

**on the preparedness of Serbia and Montenegro to negotiate a Stabilisation and
Association Agreement with the European Union**

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1. 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 Communication, which is based on the findings presented in the Commission staff working paper¹, assesses whether Serbia and Montenegro has progressed sufficiently in meeting the SAP political and economic criteria and in developing the capacity to negotiate meaningfully and subsequently implement successfully such an agreement.

2. Relations between the European Union and Serbia and Montenegro

Currently, the EU has no contractual relations with the State Union of Serbia and Montenegro. Since the fall of the Milosevic regime in October 2000, Serbia and Montenegro (formerly the Federal Republic of Yugoslavia – FRY) has benefited from various instruments of the SAP, notably autonomous trade measures covering almost all products and substantial financial support. As confirmed at the Thessaloniki Summit Serbia and Montenegro is a potential candidate for EU membership.

Over the past years, the EU has provided its policy advice through the EU-FRY Consultative Task Force, and then the Enhanced Permanent Dialogue (EPD). The EPD currently monitors and drives reforms on the basis of the European Partnership adopted by the EU Council of Ministers in June 2004 and of the corresponding implementation Plan finalised by Serbia and Montenegro's authorities in December 2004.

In 2002-2003, the FRY underwent a fundamental constitutional reform leading to the adoption of the Constitutional Charter of the State Union of Serbia and Montenegro on 4 February 2003². An Action Plan for the creation of a single external trade policy and an unhindered internal market was adopted in summer 2003. The adoption of these basic documents enabled the Commission to start work on a draft Feasibility Report. However, the attempts to achieve a minimum level of common trade policy and internal market integration did not achieve the desired results. Therefore, due to serious delays in the implementation of the Constitutional Charter and the Action Plan on trade and internal market and major deficiencies in the implementation of Serbia and Montenegro's international obligations, it was not possible to assess the feasibility of opening SAA negotiations.

¹ SEC(2005) 478.

² The State Union comprises two member states: the Republic of Serbia and the Republic of Montenegro. Throughout this Communication 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.

To help overcome the persistent constitutional stalemate and re-energise Serbia and Montenegro's progress towards the EU, a "twin-track" approach was proposed by the Commission in July 2004 and subsequently endorsed by the EU Council of Ministers and the political leaders of Serbia and Montenegro in October 2004.

3 Constitutional and legal issues

3.1 The twin-track approach in the Stabilisation and Association process

The State Union of Serbia and Montenegro as such is a **subject of international law** and possesses treaty-making powers. The two constituent Republics also possess **treaty-making powers** in their fields of competence. 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 the International Criminal Tribunal for the former Yugoslavia - 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, in the field of intellectual property rights, standardisation and certification. 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.

The **twin-track approach** responds to this complex institutional structure. In its conclusions of 11 October 2004, the **Council** expressed "its support for the twin-track approach, which would imply a single Stabilisation and Association Agreement with distinct negotiations with the Republics on trade, economic and possibly on other relevant sectoral policies. The Council reaffirmed its commitment to a strengthened State Union of Serbia and Montenegro based on the Constitutional Charter".

A **Stabilisation and Association Agreement** with Serbia and Montenegro would therefore cover matters of State Union competence and matters within the competence of the Republics. Negotiations would be held with the State Union or the Republics according to the repartition of competences as sketched above. The SAA as a whole would be a single instrument concluded by both the State Union and the Republics in accordance with their respective powers. This approach would enable the Community and its Member States to engage in contractual relations with Serbia and Montenegro, properly by clearly identifying the rights and obligations of the competent authorities, in full respect of the State Union under the terms of the Constitutional Charter.

The twin-track approach does not alter the authorities' responsibility to comply with the **political and economic criteria** of the Stabilisation and Association process, in particular with regard to international obligations.

The twin-track approach does not prejudge the **future of the State Union**. The Constitutional Charter includes a clause whereby each Republic has the right to withdraw from the State Union. This clause features a clear time indication: the relevant proceedings can be initiated

only after the expiry of a three-year period commencing from the adoption of the Charter in February 2003. Such a withdrawal would be subject to a referendum held in the Republic invoking the clause. The existence of this option is not ‘per se’ an obstacle to progress towards contractual relations with Serbia and Montenegro under the twin-track approach. It will, however, require a constructive attitude and strong political commitment on all sides to ensure Serbia and Montenegro’s capacity to engage in negotiations to establish contractual relations with the EU.

3.2 The current status of Kosovo

The current status of Kosovo raises specific legal questions in view of an SAA with Serbia and Montenegro. United Nations Security Council Resolution 1244 (1999) establishes “*an international civil presence in Kosovo in order to provide an interim administration for Kosovo under which the people of Kosovo can enjoy substantial autonomy within the Federal Republic of Yugoslavia, and which will provide a transitional administration while establishing and overseeing the development of provisional democratic, self-governing institutions*”. All legislative, executive and judicial powers of the authorities of FRY and now Serbia and Montenegro are thus suspended as regards Kosovo. Therefore, Serbia and Montenegro cannot undertake international obligations covering Kosovo under UNSCR 1244. At the same time, UNSCR 1244 formally reaffirms the commitment to the sovereignty and territorial integrity of the Federal Republic of Yugoslavia (now Serbia and Montenegro).

An SAA with Serbia and Montenegro must comply with UNSCR 1244. This implies that an SAA with Serbia and Montenegro must not prejudice the future status of Kosovo.

Moreover, Kosovo’s current legal position should not be an obstacle to Serbia and Montenegro’s progress in the framework of the Stabilisation and Association process if the other pertinent conditions for such progress are fulfilled by Serbia and Montenegro.

It follows from the above that – in present circumstances - an SAA with Serbia and Montenegro cannot apply to Kosovo. Therefore this Feasibility Study does not assess the situation in Kosovo.

Regardless of the conclusion of an SAA with Serbia and Montenegro, Kosovo will continue to benefit from the various instruments of the SAP. Kosovo is currently covered by the various basic elements of the SAP (trade preferences, EC assistance and reform dialogue).

4. Assessment

4.1 Political criteria

The **functioning of democratic institutions and the respect for rule of law** in Serbia and Montenegro have improved – although this has been slow and sometimes partial especially owing to the legacy of the past regime.

Some progress has recently been made towards constitutional and legal certainty but it remains open to challenges. The recent agreement to revise the Constitutional Charter concerning the State Union Parliament direct elections is a particularly welcome development. The functioning of the parliaments and the executives has improved but it is still affected by structural weaknesses.

There are ongoing efforts in both Republics to tackle public administration reform through intensive legislative activities. However, implementation of this reform is still at a very early stage. The level of administrative capacity remains generally low. In Serbia, although unevenly distributed across the various levels and branches of the administration, there is a core capacity to deal with European integration and notably with the negotiation of an SAA. In Montenegro, while efforts have been made to reinforce the European integration structures, this capacity is affected by the lack of human resources throughout the administration. At the State Union level, administrative capacity is constrained in particular by the lack of stable budgetary allocations. Army reform has continued but much remains to be done to ensure effective democratic control.

The overall respect for **human and minority rights** has significantly improved over the recent years, but considerable further steps are needed at both the level of legislation and of enforcement. Accession to the Council of Europe in 2003 and ratification of its key human rights instruments were a major step forward, but difficulties as to their full implementation still persist, in particular concerning the Office of the Government Agent for the European Court of Human Rights and the jurisdiction of the State Union Court. Respect for minority rights saw progress, but occasional incidents occur. Police ill-treatment needs further comprehensive action. Little progress has taken place in relation to the investigation of crimes committed during the previous regime. Freedom of speech is generally respected, but restrictions to independent media persist. There is no anti-discrimination legislation and human rights institutions, such as the Ombudsman, need to be established at all necessary levels and strengthened.

As regards the respect of the **United Nations Security Council Resolution 1244 on Kosovo**, 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 has recently made significant progress in meeting its international obligations concerning **co-operation with the ICTY** after a period where co-operation had been seriously deficient. There are no more backlogs with regard to waivers to witnesses. Access to documents has substantially improved, though this process is still sometimes obstructed by parts of the administration and the army. In recent months, a significant number of indictees has been transferred to The Hague.

Overall, the political criteria are sufficiently met at this stage for opening SAA negotiations.

4.2. Economic criteria

Good progress has been achieved in macroeconomic stabilisation, due to more appropriate fiscal policies in combination with relatively tight monetary policies. Despite a recent resurgence, inflation has been reduced considerably, supporting public confidence in the currency and domestic banking system and providing a better environment for investment and growth since end 2002. Important structural reforms have been carried out. In the area of public finance, more fiscal transparency and modern budgetary rules were introduced, strengthening expenditure control and improving the overall tax policy framework. A conducive legal and institutional framework for the privatisation of socially and state-owned companies has been established. Market entry and exit conditions for companies have been improved and basic liberalisation with regard to price, trade and foreign exchange has been carried out. Crucial steps have been taken in financial sector development, including a reform of the banking sector and the strengthening of banking regulation and supervision.

However, macroeconomic stability is not yet sufficiently achieved. In Serbia, inflation has recently accelerated and the current account deficit has risen substantially between 2000 and 2004 raising serious concerns about its sustainability. External debt is relatively high, and rising debt service obligations will continue to put a strain on the country's balance of payments. Hence, fiscal restraint continues to be crucial accompanied by further fiscal adjustment against the background of new expenditure priorities related to restructuring costs and important public investments. This calls for a further prioritisation of spending, in particular a better targeting of social transfers as well as a further rationalisation of public administration. Further progress in formalising the grey economy would facilitate fiscal consolidation by broadening the tax base. However, fiscal policy should be supported by a strengthening of the export sector. This calls for further significant improvements in the business environment, the restructuring and privatisation of large companies, improving the competitiveness of Serbian and Montenegrin industry. Here a new impetus is needed, in both Serbia and Montenegro. The WTO accession process will require further reforms and lead to multilateral trade liberalisation. In addition, the privatisation of banks and non banking financial sector should be completed to support financial sector development.

In conclusion, Serbia and Montenegro has implemented a **critical mass of initial reforms towards establishing a functioning market economy** in a relatively short period of time. However, further vigorous stabilisation efforts, embedded in an IMF programme, and structural reforms are necessary in order to address considerable remaining challenges.

4.3. Ability to Assume the Obligations resulting from an SAA

The State Union of Serbia and Montenegro and its two Republics have progressed in the implementation of the European Partnership's priorities and should be in a position to liberalise the movement of goods, workers, services and capital with the European Union, possibly with different liberalisation schedules. Both Serbia and Montenegro have embarked on trade liberalisation with their neighbours.

Negotiation and implementation of the demanding SAA obligations will constitute a challenge. Given the substantial amount of bilateral trade, the SAA will require significant commitments on the side of both Serbia and Montenegro – since neither is a WTO member - in political, administrative and financial terms. The process of bilateral trade liberalisation with the EC would require further efforts in structural reforms, to reinforce both Republics' capacity to resist the competitive pressure arising from an SAA, improve export performance and reduce current account deficits. One of the key elements to consider in this respect is for both Republics to possess the necessary standards and certification capacities to trade with the EU. The Republics will also need to ensure that the objective of trade liberalisation is understood and shared by the domestic economic stakeholders.

Both Serbia and Montenegro must prove that they are able to continue to sustain their commitments to reform and to regional trade liberalisation in order to be able to function as reliable long-term partners in the implementation of an SAA. In particular, they should respect the obligations and procedures agreed under the FTAs, and an ability to comply with the “standstill” condition under the Community's autonomous trade measures.

Serbia and, in particular, Montenegro will have to improve the capacity to conduct three separate negotiation processes at the same time, i.e. the SAA, the WTO accession process and the regional process for further development of the FTAs. Both Republics will also need to establish solid consultation mechanisms to involve domestic stakeholders in the process.

Sustained efforts will be necessary **to improve legislative and administrative capacities** in all areas in the future Agreement.

Both Republics should continue to develop - and avoid creating new barriers to - movement of goods, services, persons and capital on the Serbian and Montenegrin market. In this context, the two republican Central Banks will have to complete the agreement on a fully operational system of **corresponding accounts to ensure** free flow of payments within the State Union.

Following the adoption of the new legislation on **Intellectual Property Rights**, Serbia and Montenegro must adopt and implement comprehensive strategies to adequately enforce the legislation and protect IPR. Serbia, and in particular Montenegro, should pursue their efforts to create transparent and open **public procurement** procedures ensuring fair and non discriminatory conditions of competition for EU suppliers. In the area of **competition**, both Republics should adopt legislative and administrative frameworks including anti-trust, mergers, state aid, and liberalisation and state monopolies. The two Republics should continue to strengthen the administrative capacity to fully implement the agreement in the area of **customs** (including rules of origin) and **taxation** in order to raise revenue collection and compensate for the impact of the agreement on the level of their customs duties. The State Union of Serbia and Montenegro as well as both Republics should strengthen considerably their institutional capacities in the area of **statistics**. The **electronic communications** sector policy needs to be further developed towards liberalisation. Furthermore, as regards **transport and energy**, Serbia and Montenegro should ensure the interconnection and interoperability of appropriate infrastructure, and implement their commitments under the South East Europe Energy community treaty.

In the area of **justice and home affairs**, the establishment of the State Union Court and the restriction of military jurisdiction are positive developments that need to be followed by effective implementation. As regards visa asylum, migration and integrated border management, the concrete articulation of competences between the State Union and the Republics remains problematic despite some recent progress. While the reform of the judiciary has started in both Republics, the independence as well as the efficiency of the judiciary remains weak. The police and security services are also areas where legislative and administrative reforms are long awaited. The fight against organised crime, money laundering and corruption, which are serious challenges to the rule of law, is at a rather early stage.

5. Overall conclusion

Since the fall of the Milosevic regime, Serbia and Montenegro has progressed significantly in the SAP political and economic criteria and in developing the capacity to negotiate and implement a Stabilisation and Association Agreement. The reform process remains fragile, however, particularly because of the legacy of the past regime.

The European Commission considers that **Serbia and Montenegro is sufficiently prepared to negotiate an SAA**. Therefore, the Commission recommends to the Council the opening of negotiations and will accordingly present a draft mandate.

However, Serbia and Montenegro needs to continue, in a sustained way, its preparation as outlined in this Communication with a view to the negotiations. In particular, the Republics of Serbia and Montenegro need to provide the Commission with a clear description of their respective trade regimes in full respect of the standstill clause in the Autonomous Trade

Measures. The described levels of trade protection will form the basis for the negotiation of the liberalisation schedule.

In order to progress through the various stages of the process, both before and during the negotiations, Serbia and Montenegro **must continue to co-operate with the ICTY**, and achieve full cooperation without delay.

Furthermore, the Commission also considers that the State Union and the two Republics should continue to implement the European Partnership priorities through its Action Plan.

The Commission will continue to monitor closely the progress made by Serbia and Montenegro. In particular, it will report on developments in the SAP Annual Report that will be issued in the autumn of 2005.

The pace at which a country draws closer to the EU depends essentially on its speed in adopting and implementing the necessary reforms. Continued focus by the authorities on European integration is, therefore, key to the sustainability of the process.

Over the coming months, in line with the European Partnership, the authorities should pay special attention to, and make further significant progress concerning, the following issues that are particularly relevant for an SAA:

- With regard to **constitutional issues**, the common understanding of Serbia and Montenegro's authorities at the level of the State Union and of the Republics on the Constitutional Charter and in particular on the **distribution of powers** enshrined in the Constitutional Charter should be followed by consistent and constructive implementation. The State Union level and the two Republics need to further coordinate their efforts to benefit fully from the twin-track approach in negotiating an SAA. The **revision of the Constitutions** of the two Republics needs to proceed smoothly and in line with European standards.
- The democratic functioning of the **parliaments** and **executives** needs to be strengthened. The revision of the Constitutional Charter provisions concerning the **State Union Parliament** direct elections should be adopted without delay. The role of **European Integration structures at the administrative, governmental and parliamentary levels** needs to be reinforced so that the compatibility of legislation with EU norms is more systematically ensured.
- As regards **human rights** and the protection of the **minorities**, continued concerted efforts need to be made, notably as concerns the situation of internally displaced persons and refugees, in line with the obligations undertaken when joining the Council of Europe.
- Sustained efforts must be made to reform the **public administration**, to ensure budgetary sustainability and develop a stable, professional and independent civil service, in particular in Montenegro. Both Republics must fully commit themselves to sustaining **legal and economic reforms** and strengthening **administrative capacity** particularly competition, intellectual property rights, public procurement, customs and taxation. Both Republics need to pursue with determination the reform of the judiciary as well as of the police and security services. The fight against organised crime and corruption must be stepped up and it should deliver concrete results.
- There is a need for further clarification of the articulation of competences in practice between the State Union and the Republics in a number of areas including intellectual

property rights, standardisation, visa, asylum, migration and integrated border management.

Should the Commission note at any time that the State Union and republican authorities have not lived up to their commitments and have not satisfactorily addressed the issues highlighted in this Communication, it will propose to the Council that the negotiations be suspended.

To support the efforts made by Serbia and Montenegro before the formal opening of negotiations and throughout the negotiation process, the Commission will further intensify discussions with the authorities in the context of the Enhanced Permanent Dialogue, in particular by setting up sectoral groups. The Commission is also committed to supporting this process through its financial assistance programme.