

Report No. 32623-YU

Serbia and Montenegro

Republic of Montenegro: Economic Memorandum

A Policy Agenda for Growth and Competitiveness

October 27, 2005

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region



Document of the World Bank

CURRENCY EQUIVALENT

Currency Unit = euro

US\$1.00 = euro 0.79

(As of June 15, 2005)

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

ALMP	Active Labor Market Program	MOF	Ministry of Finance
CBM	Central Bank of Montenegro	MONSTAT	Montenegro Statistical Office
CEE	Central East Europe	MOT	Ministry of Tourism
CEED	Center for Entrepreneurship and Enterprise Development	MoTMA	Ministry of Transport and Maritime Affairs
EBRD	European Bank for Reconstruction and Development	MTEF	Medium Term Expenditure Framework
ECA	Europe and Central Asia	MVP	Mass Voucher Privatization
EPCG	Montenegro Electricity Company	NPL	Non-Performing Loans
EPL	Employment Protection Legislation	OECD	Organization for Economic Cooperation and Development
EU	European Union	PES	Public Employment Service
EUROSTAT	European Statistical Office	PICS	Productivity and Investment Climate Survey
FDI	Foreign Direct Investment	PRSP	Poverty Reduction Strategy Paper
FFCD	Frozen Foreign Currency Deposits	SEE	South East Europe
FIAS	Foreign Investment Advisory Service	SMEs	Small and Medium Enterprises
FSO	Federal Statistical Office	SNA	System of National Accounts
FTAs	Free Trade Agreements	SOE	State Owned Enterprise
GCA	General Collective Agreement	TMP	Tourism Master Plan
GFS	Government Finance Statistics	TSA	Tourism Satellite Account
GNI	Gross National Income	TTE	Travel and Tourism Economy
GRM	Government of Republic of Montenegro	TTI	Travel and Tourism Industry
HDI	Human Development Index	UB	Unemployment Benefit
HIF	Health Insurance Fund	UNDP	United Nations Development Program
HICP	Harmonized Index Of Consumer Prices	USAID	United States Aid for International Development
IFI	International Financial Institutions	WTO	World Trade Organization
ILO	International Labor Organization	WTTC	World Tourism and Travel Council
IMF	International Monetary Fund	ZCG	Railway Company
ISSP	Institute for Strategic Studies and Prognoses	ZOP	Payment Bureau

Vice President	:	Shigeo Katsu, ECAVP
Sector Director	:	Cheryl Gray, ECSPE
Sector Manager	:	Bernard Funck, ECSPE
Task Team Leader	:	Abebe Adugna, ECSPE

Table of Contents

ACKNOWLEDGMENTS	I
EXECUTIVE SUMMARY	II
1. RECENT ECONOMIC DEVELOPMENTS	1
A. Background	1
B. The Economic Reforms to Date.....	2
Macroeconomic Stabilization	3
Structural Reforms	4
C. The Results So Far: Macroeconomic and Poverty Outcomes	7
Growth and Employment	7
Inflation	10
Competitiveness	11
Internal and External Balance	13
Debt Position.....	14
Poverty and Social Welfare	15
D. The Challenges Ahead: Increasing Growth and Competitiveness.....	16
2. LABOR MARKET REFORM FOR GROWTH AND COMPETITIVENESS	20
A. Key Characteristics of the Labor Market.....	21
Participation and Employment.....	21
Unemployment.....	24
Wage and Productivity Dynamics	25
B. How Restrictive Are the Labor Regulations?	28
C. How Well Do the Collective Bargaining and Social Dialogue Function?.....	32
D. Institutions Dealing with High Unemployment	33
E. Conclusions and Policy Recommendations	36
3. FISCAL POLICY REFORM FOR GROWTH AND COMPETITIVENESS	39
A. Background	39
B. Is the Fiscal Position Sustainable?	41
C. Is the Composition of Expenditure Supportive of Growth?.....	42
The Economic Composition of Public Expenditure	42
The Functional Composition of Public Expenditure	45
Is Montenegro's Fiscal Policy Growth-Enhancing?	48
D. Budget Processes, Medium-Term Planning, and Growth	51
The Budget Formulation Process.....	51
Budget Execution and the Arrears Problem.....	51
Medium-Term Planning and Growth.....	54
E. Conclusions and Policy Recommendations	54
4. PRIVATE AND FINANCIAL SECTOR REFORMS FOR GROWTH AND COMPETITIVENESS	57
A. Characteristics of the Private Sector in Montenegro	57
B. Why Is the Informal Sector Large?	59

The Regulatory and Administrative Burden	59
Governance and the Institutional Capacity to Enforce Rules	62
C. What Other Constraints Limit Private Sector Investment and Growth?.....	65
Privatization and Enterprise Restructuring	65
Bankruptcy and Enterprise Exit	66
Contract Enforcement and Property Rights	67
Financial Intermediation and the Cost of Finance	69
D. Conclusions and Policy Recommendations	74
5. THE CHALLENGES OF GROWTH AND COMPETITIVENESS IN PRACTICE: THE CASE OF TOURISM.....	78
A. Introduction	78
B. The Contribution of Tourism to Montenegro's Economy	79
C. Visitor Trends and Targets.....	81
D. Tourism Assets, Products and Competitiveness	82
E. Policy and Strategy: Analysis and Recommendations	83
REFERENCES.....	93
ANNEXES	98
Annex 1. Montenegro--Chronology of Major Events, 2002-2004	98
Annex 2. Montenegro--Statistical Tables	101

List of Figures

Figure 1.1. Montenegro's Growth Compared to South Eastern Europe, 2000-2004	7
Figure 1.2. Trends in Employment and Unemployment, 2000-2003	9
Figure 1.3. Inflation by Major Component, 2000-2004.....	10
Figure 1.4. Trends in Montenegro's Competitiveness, 2000-2004	12
Figure 1.5. Fiscal and Current Account Deficits, 2002-2004	13
Figure 1.6. Official Grants to Montenegro, 2002-2004	13
Figure 2.1. Trends in Employment and Unemployment in Montenegro, 1997-2003.....	22
Figure 2.2. Long-term Unemployment in Montenegro Relative to Other Countries in the Region	25
Figure 3.1. Consolidated General Government Expenditure, 2002-2004 (percent GDP)	40
Figure 3.2. Consolidated Public Revenue and Expenditure, 2002-2004 (percent GDP).....	40
Figure 3.3. Trends in the Composition of Revenues, 2001-2004 (percent GDP).....	41
Figure 3.4. Sources of General Government Deficit Financing, 2001-2004	41
Figure 3.5. Composition of Current Expenditures, 2004.....	43
Figure 3.6. Capital Expenditure, Comparison with Other Countries in the Region, 2003-2004 (% GDP)	44
Figure 3.7. Wage Bill, Comparison with Other Countries in the Region, 2003-2004.....	44
Figure 3.8. Montenegro's Functional Spending by Major Components, 2002-2004	45
Figure 3.9. Montenegro's Functional Spending Compared to Other Countries, 2003-2004.....	45
Figure 3.10. Trends in Distortionary and Non-distortionary Taxation, 2002-2004.....	49
Figure 3.11. Trends in Productive and Unproductive Expenditures, 2002-2004	49
Figure 3.12. Central Government Arrears as at end-2004, by Functional Composition	53

Figure 4.1. Total FDI Achieved in Montenegro through Privatization, 1997-2004	58
Figure 4.2. Perceived Constraints to Doing Business in Montenegro	59
Figure 4.3. Montenegro's Costs of Administrative Barriers Compared to Regional Countries ...	62
Figure 4.4. Unsolved Bankruptcy and Liquidation Cases , 2003–2004	67
Figure 4.5. Duration of Bankruptcy Cases, 2004.....	67
Figure 4.6. Average Share of Sales Paid in Advance by Clients (percent)	67
Figure 4.7. Estimated Duration of Commercial Cases, 2004	68
Figure 4.8. Commercial Court Cases Solved, 2000-2004	69
Figure 4.9. Unsolved Court Cases, End of 2003 and 2004.....	69
Figure 4.10. Short-term Loans by the Banking Sector, 2001-2004.....	71
Figure 4.11. Long-term Loans by the Banking Sector, 2001-2004	71
Figure 5.1. Travel and Tourism, Contributions to GDP, 2000-2015 (percent)	80
Figure 5.2. Travel and Tourism, Real Growth Per Year, 2000-2015 (percent).....	80
Figure 5.3. Travel and Tourism, Contributions to Employment, 2000-2015	81
Figure 5.4. Travel and Tourism, Employment Growth, 2000-2015	81
Figure 5.5. Tourist Arrivals and Overnights, 2000-2004.....	81
Figure 5.6. Cost of 7 Night Vacation from London (4-Star Hotel, including Airfare).....	83
Figure 5.7. Cost of 7 Night Vacation from Belgrade (4-Star Hotel, including Airfare).....	83
Figure 5.8. Capital Investment in Tourism (Public and Private), 2000-2005	85

List of Tables

Table 1.1. Montenegro's Unit Labor Costs, 2000-2004	11
Table 1.2. Montenegro's Competitiveness, 2000-2004	12
Table 1.3. Total Public Debt of Montenegro, 2002 – 2005 (% GDP)	14
Table 1.4. Domestic Debt of Montenegro, 2002-2005 (in million euros)	15
Table 1.5. Montenegro's Human Development Index, 2000-2003	16
Table 2.1. Labor Force Growth and Employment-to-Population Ratios, Transition Economies.	21
Table 2.2. Employment/Population Ratios, Participation, and Unemployment Rates in 2003-04	22
Table 2.3. GDP Growth and Employment Dynamics, 2000-2004	23
Table 2.4. Incidence and Composition of Part-time Employment in 2003	24
Table 2.5. Duration of Unemployment in Montenegro	24
Table 2.6. The Dynamics of Average Wages in Montenegro, 2000-2004 (euros).....	26
Table 2.7. Net Monthly Wages in Euros, 2000 and 2004.....	26
Table 2.8. Undeclared Work in CEE and Baltic States and in EU Member States (pre- May 1, 2004)*	29
Table 2.9. Comparison of Additional Benefits to Workers Provided by the 1995 and 2003 General Collective Agreement (GCA).....	30
Table 2.10. Main Activities of the Employment Bureau of Montenegro in 2004 (January-October)	34
Table 2.11. Public Expenditure on ALMPs in Some Transition Countries.....	35
Table 3.1. Theoretical and Empirical Aggregation of the Government Budget into Distortionary and Non-distortionary taxation Productive and Non-Productive Expenditures, 2002-2004 (percent GDP)	48
Table 3.2. Montenegro's Capital Expenditure by Function, 2004* (euros)	50
Table 3.3. Budget Execution by Economic Items, 2002 - 2004	52

Table 4.1. Registered Businesses by Type, 2005.....	57
Table 4.2. Starting a Business.....	60
Table 4.3. Income Taxes, Social Contributions and Other Fees and Surtaxes on Wages in Montenegro (percent of gross salary)	61
Table 4.4. Recent Business Law Reforms in Montenegro and their Status of Implementation ...	64
Table 4.5. Key Recent Contract Enforcement Legislation and Implementation Status	68
Table 4.6. Structure of the Banking System, End-2004	70
Table 4.7. The Size and Structure of the Treasury Bills Market, 2003-2004 ('000 euros)	73
Table 4.8. Credit Information Sharing and the Cost of Creating Collateral.....	73

ACKNOWLEDGMENTS

This report was prepared by a World Bank team led by Abebe Adugna (task manager) and comprising of Lazar Šestović, Arvo Kuddo, Branko Radulović, Agnes Kiss, and Lejla Čatić (consultant).

The chapter on recent economic developments was prepared by Lazar Šestović and Abebe Adugna. The chapter on labor markets was prepared by Arvo Kuddo. The chapter on fiscal policy was prepared by Lejla Čatić and Abebe Adugna. The chapter on private and financial sector reforms was prepared by Branko Radulović. The chapter on tourism was prepared by Agnes Kiss. The team visited the Republic of Montenegro in February/ March 2005 and May 2005. The team would like to thank the Government of Montenegro for providing excellent cooperation during both visits, as well as providing extensive comments on the draft report.

The report benefited from comments by its peer reviewers, Edgardo Favaro, Balazs Horvath (IMF) and Magnus Alvesson (IMF). The report was prepared under the overall supervision of Orsalia Kalantzopoulos (Country Director), Cheryl Gray (Sector Director), Bernard Funck (Sector Manager), Carolyn Jungr (Country Manager), and Ardo Hansson (Lead Economist). Bernard Funck and Ardo Hansson provided detailed comments on the draft report. Bruce Courtney and Norman Hicks (Consultant) provided input at an early stage of the report. Valuable comments were also received from several other World Bank colleagues.

The production of the report would not have been possible without excellent support from Emily Evershed (consultant) in editing the document, and Armanda Çarçani in processing the document. The support of the Serbia and Montenegro Country office staff during the preparation missions is gratefully acknowledged.

EXECUTIVE SUMMARY

1. **Since the late 1990s, Montenegro has undertaken a series of reforms designed to move its economy from a socialist to a modern market-based economy.** Started in the late 1990s, Montenegro's economic reform program has gathered momentum since the early 2000s. Its reform program rested on two broad pillars: macroeconomic stabilization, and market-oriented structural reforms. With the implementation of currency and fiscal policy reforms, it has succeeded to rein in inflation and bring about macroeconomic stability. In parallel to the stabilization policies, it also implemented a number of structural reforms, including price and trade liberalization, privatization, public administration reform, financial sector reform, and labor market and business environment reforms. The government has recently updated its Economic Reform Program for 2005-2007 to guide the implementation of the remaining economic reforms.

2. **The macroeconomic and structural reforms have yielded modest economic recovery and transition.** Over the last four years, Montenegro achieved modest macroeconomic gains: real GDP grew by an average of about 2 percent per year over 2000-2004; inflation dropped from 24.8 percent at the end of 2000 to 4.3 percent at the end of 2004; Montenegro's consolidated budget deficit was reduced from about 8 percent of republican GDP in 2000 to about 3 percent in 2004; its current account deficit, although still high, is improving; and, its principal human welfare indicators such as poverty, life expectancy, and adult literacy have remained moderate and stable.

3. **Yet, significant challenges remain.** Three key challenges confront policy makers in Montenegro. First, past economic growth has been inadequate. With an average annual population growth rate of about 0.5 percent per year, the per capita income grew by only 1.3 percent per year over 2000-2004. How to move Montenegro to a higher growth path in order to achieve a higher standard of living for its citizens is the first challenge. Second, the limited growth recovery has not been accompanied by employment growth: registered employment *declined* by about 7 percent in 2004 relative to 1998, while unemployment remains high at about 23 percent. With the growth in joblessness, about 12 percent of the citizens of Montenegro have fallen below the consumption poverty line as of 2003. Therefore, reducing unemployment and enhancing job creation is another challenge. Third, despite reforms, Montenegro has become less competitive over the last four years. Its real exchange rate, based on movements in unit labor costs, has risen much faster than that of the EU zone and the United States. The much more rapid increase in labor compensation than in labor productivity (by 12.3 percent in 2004) has reduced the economy's competitiveness. Increasing competitiveness, especially in view of the country's strategic goal of EU accession and its small size, is the third challenge facing policy makers.

4. **This Memorandum, the first of its kind for Montenegro, sheds light on these key challenges.** The considerable data problems in Montenegro limit the ability to make evidence-based analysis and to draw conclusions. On the basis of the best evidence and information available, this report considers the various factors that may have constrained employment creation, growth and competitiveness in Montenegro. The report takes an in-depth look at Montenegro's labor market and at the extent to which, and areas in which the labor law and the collective agreements continue to be limiting. It examines the extent to which administrative and institutional capacity, property rights, contract enforcement, the high cost of capital, and low financial intermediation constrain growth and competitiveness in the private sector, and it takes a close look at fiscal policy, in particular at whether the current level and composition of public expenditure adequately supports growth. It also closely examines the challenges in tourism development, the main growth potential for Montenegro. Based on this analysis, the report provides a comprehensive, prioritized medium term policy reform agenda. This is presented in the table at the end of this section. The report delineates five themes as key priorities for Montenegrin policy makers to address in order to enhance employment generation, growth and competitiveness.

5. First, key labor market reforms need to be undertaken to increase employment, growth and competitiveness. Despite high unemployment, Montenegro's average net earnings more than doubled between 2000 and 2004. In contrast, the Montenegrin economy experienced a cumulative labor productivity growth of only 18 percent (2000-2004). Even this low productivity growth derived mainly from a reduction in over-employment within Montenegro's formal sector, associated with enterprise restructuring and privatization. The wage dynamics most likely indicate the strong voice of Montenegrin unions in putting pressure on wage levels. In contrast, employers are not well represented in collective bargaining and wage negotiations. The result has been rapid wage increases in the public sector and a new 2003 General Collective Agreement, which imposed even greater non-wage (cash and in-kind) and non-taxable costs on employers. Compared to the previous 1995 Collective Agreement, the 2003 Agreement expanded the list of supplementary benefits, with significant costs for all employers. Among other benefits, housing allowances and collective insurance for employees were added to the already extensive list of additional benefits to workers. It is estimated that the wage coefficients introduced in the 2003 General Collective Agreement were on average increased by 19 percent (Government of Montenegro, 2005), in part reflecting the strength of trade unions. In addition, Montenegro's labor regulations, although significantly improved in 2003, still hinder labor market flexibility. The relatively high labor taxation, coupled with poor tax administration, encourages informal sector employment. In order to facilitate job creation, growth and competitiveness, Government policies should help improve wage competitiveness and labor market flexibility. Specific measures include the following:

- *Control the rapid wage growth witnessed in recent years through:* (i) implementing more vigorously public administration reforms and the planned reduction in public sector staffs, many of whom earn wages well in excess of the average for the economy; (ii) nurturing the emergence of genuine private sector employers' organizations that would play a moderating role in the collective bargaining and wage setting process; (iii) in the meantime, playing an active role in the General Collective Agreement (GCA) process with a view to keeping nominal wage settlements in line with developments abroad and possibly re-opening negotiations on the recent GCA to that effect.
- *Relax some aspects of the labor regulations.* While the new Labor Law, adopted in 2003, has improved the flexibility of the labor market considerably, it has not yet assured full flexibility. The specific reforms should focus on: (i) relaxing the contracting rules for employing "non-standard" workers, including employees on fixed term and part time contracts; (ii) reducing the costs for employers to terminate regular (i.e., permanent) employees for economic reasons; (iii) permitting more flexible arrangements in working hours; and (iv) limiting non-wage costs to employers.
- *Reduce the high rates of labor taxation in a fiscally responsible way to encourage formal employment.* Recent reforms have helped reduce the payroll tax and contributions burden, yet the labor taxes (or payroll taxes) are still too high and among the highest in the region. Montenegro's tax wedge, one of the most important indicators of tax burden, stood at about 52 percent of the labor costs in 2004, while the comparative burden for the regional non-European member countries was 37.3 percent of total labor costs. A further phased and well-planned reduction in payroll taxes--compensated by equivalent increases in other taxes, and with adjustments to compensate the resulting lost income of the social funds—is desirable. The identification of alternative sources of revenue, such as the VAT or other indirect taxes, to make up for reduction in payroll taxes is critical to maintain the overall fiscal balance as well as the fiscal position of the health and pensions funds. Such reduction in payroll taxes should also be accompanied by improved enforcement of taxes, including through more aggressive use of bankruptcy as a means to deal with delinquent tax payers. In addition, reforms of the health and pension systems (early

retirement, disability, maternity leave and sickness benefit) may need to be pursued in parallel to tighten eligibility criteria and eliminate abuses in the systems.

6. **Second, enterprise privatization and restructuring is well underway but would need to be completed to increase growth and competitiveness.** The private sector's contributions to GDP and employment remain modest. The emerging private sector has not yet developed the critical mass to generate enough jobs to offset job losses in the public sector. Facilitating the privatization and restructuring of enterprises, and promoting the entry of new firms, is necessary to achieve that goal. Many companies that were privatized through the mass voucher privatization (MVP) program still lack strategic investors to re-equip them with new technology and improve their profitability and competitiveness. They also continue to be saddled by the high costs of excess labor and employment. There is thus an urgent need to:

- *Speed up the restructuring of the mass-voucher- privatized companies* by: (i) making budgetary allocations toward covering the social costs of restructuring—including severance payments for shedding off excess labor— for those companies in respect of which the Government agreed to fund such costs; (ii) strictly enforcing the new bankruptcy law for medium and large enterprises privatized through vouchers, that have continued to accumulate losses; and, (iii) strengthening the capacity of courts to deal with such bankruptcy cases.
- *Speed up the consolidation into majority shares of the companies' shares being traded on stock exchanges.* With diffused ownership and lack of majority ownership, the MVP has been fairly ineffective in inducing changes in management and corporate governance. Even where the MVP has led to management changes, the new management has continued to lack expertise in restructuring and developing viable business plans. Currently, shares of companies and investment units privatized through the MVP are slowly being consolidated through trades in stock exchanges. However, the speeding up of the consolidation of shares into majority ownership is needed to bring about management changes, good corporate governance, completion of the restructuring plans, and the introduction of new capital and technology to generate better profitability and shareholders' value, and employment.

7. **Third, key constraints facing Montenegro's emerging private sector, including businesses in the informal sector, must be removed.** The most highly visible feature of Montenegro's economy is the large and persistent informal sector, contributing perhaps about 30 percent of GDP and employing about 27 percent of the workforce (ISSP, 2004). The presence of a large informal sector is a symptom of a high regulatory burden, including the high labor taxation and the unreasonably onerous General Collective Agreements, and a poor public administration and institutional capacity for enforcing rules. In addition to the measures discussed above, the following specific measures are needed:

- *Remove specific governance and regulatory bottlenecks:* (i) speed up the issuance of business licenses and inspections; (ii) ensure greater transparency, and a more consistent application of rules, including an improved tax administration capacity to support rule-based tax collection; and, (iii) speed up the implementation of recently enacted business laws and regulations. The implementation of legislation aimed at improving the business environment—contract enforcement, access to finance, corporate governance, and business exit—has not yet begun in most cases. Speeding up the implementation of these laws will be critical to private sector investment and growth.
- *Reduce the backlog of commercial court cases and speed up contract enforcement:* Investors see the poor functioning of the court system as a major impediment to doing business (FIAS, 2004). The courts are too slow: it can take a year from the submission of a claim to the handing down of

a judgment. Overall, according to court statistics, about 40 percent of the commercial court cases are resolved within less than three months, 33 percent take up to six months, and about 28 percent take longer than six months. Speeding up the resolution of cases that take longer than six months—which in many cases also include bankruptcy and liquidation cases—is urgent. Specific steps may include (i) easing the resources and personnel constraints in the Montenegrin judiciary; (ii) ensuring that qualified and better trained judges are put in place, with better compensation; (iii) training court personnel; and (iv) upgrading the court system’s infrastructure, which should include including the development and computerization of the case management system/process.

- *Improve land title transparency and property rights.* Until recently, Montenegro’s lack of functional restitution law gave rise to uncertainty about the handling of existing and future restitution claims; it caused potential investors to postpone investments; and it drove interest rates up to compensate for security risks. However, the Restitution Law, under development for some time, entered into force on April 8, 2004; accompanying implemented regulations were passed, municipal commissions were formed, as well as the Fund for Indemnity and procedures of restitution for taken away properties. Indemnities based on the said Law have started but would need to be strengthened and sped up. In addition, the Government needs to vigorously enforce land property rights and control illegal construction. With regard to land title, registration is computerized and is not overly time-consuming or costly, the Cadastral Office does not have adequate, reliable land information. The lack of transparency and discretionary public access to land information makes land title transfers risky for investors and complicates the planning and approval activities of municipalities.

8. **Fourth, the cost of capital needs to be reduced and financial intermediation improved.** Total credits from banks to the private sector amount to only 11 percent of GDP in Montenegro. This is quite low compared to the regional countries (42.3 percent in Bosnia and Herzegovina, 26.6 percent in Bulgaria, 57.3 percent in Croatia, and 42.7 percent in Hungary), though credits to the private sector began to rise from fairly low levels in 2004. Interest rates as well as spreads remain high: the real interest rate has ranged between 11 percent and 20 percent in recent years. The aggregate interest spread was about 7.6 percent in 2004 (down from 9.6 percent in 2003). Most investors in Montenegro would be hard pressed to find a project whose real rate of return would exceed 11-20 percent. The high cost of capital and the wide variability of interest rates are related to the weak framework for creditor protection and contract enforcement, the high country risk, and the low competition in the banking sector. Specific measures that the Government can take to reduce the cost of borrowing and improve financial intermediation are as follows:

- *Reduce the need for treasury bill financing through tight fiscal policy.* This would help reduce the budgetary burden of interest payments on treasury bills and would help create the conditions for the lower cost of capital in the economy by reducing the crowding-out of Government.
- *Establish an effective, broad-based institution, with full credit information on all borrowers,* to address the problem of asymmetric information in credit markets. At present, Montenegro has neither a Credit Registry nor a Credit Bureau.
- *Introduce more competition into the banking sector* through the completion of the privatization of Government-owned banks (in particular Podgoricka Banka), and by promoting leasing operations in view of the small size of the Montenegrin market.

9. **Fifth, the Government can help to increase employment creation, growth, and competitiveness by undertaking fiscal reforms.** Montenegro’s general government services (public

administration, public order and safety, and defense) and social protection each consume about a third (33 percent) of total general government expenditure. Education and health combined account for another 25 percent of total spending. Compared with other countries in the region, Montenegro spends substantially more on almost all of these functions--general public services, defense and public safety, education, and health in that order. Despite the fact that Montenegro started its public sector reforms a couple of years ago, the reforms have not yet resulted in a reduction of public administration costs. Over the last three years public expenditure on general government services has grown instead of declining. To ensure fiscal sustainability, create a budgetary space for capital investment, and improve delivery of social services the following steps are necessary:

- *Control the wage bill, and develop a well-targeted public investment program.* The high wage growth has crowded out spending on public investment and on operations and maintenance—expenditures that are essential for growth. The wage growth thus needs to be controlled through (i) public administration reforms that would eliminate employment redundancies; (ii) other measures outlined under labor market above. Controlling wage growth is essential both for fiscal sustainability and to create a budgetary space for public investment. At 2 percent of GDP, Montenegro’s domestically financed capital expenditure is much below the level for other countries in the region. While the low numbers may indicate the need for more capital investment, in particular infrastructure investment, such a decision is best guided by two prior conditions: (i) that there is a trade-off between a public infrastructure investment program and macro stability/fiscal sustainability, and whatever investment in public infrastructure needs to be made within the broader macroeconomic and fiscal constraints; (ii) that a rigorous public investment project appraisal and screening system is put in place to rank public investment projects, and fund only those which are strongly growth-oriented and whose economic and social returns are high enough. In Montenegro, there is a need to do both a strategic assessment of what infrastructure investment may be needed, and which of the many potential infrastructure projects warrant investment based on their economic and social returns.
- *Improve the budget processes and develop a comprehensive plan to eliminate arrears.* This can be done through: (i) undertaking a better and more realistic revenue projection as well as speedy expenditure decisions to be implemented by budget users in the event of revenue shortfalls; (ii) strengthening the commitment control system of spending agencies through better staffing, the upgrading of accounting standards, and transparency; and (iii) developing a time-bound plan for clearing arrears, identifying the most costly ones and retiring those first.
- *Strengthen the link between policy priorities and the budget, especially with respect to tourism development and implementation of the Poverty Reduction Strategy Paper (PRSP).* In the medium to long term, there is a need to develop a comprehensive medium-term expenditure framework as a basis for public expenditure planning, comprising the central government, the social funds, and local governments, and reflecting fully the policy commitments of the Government. The PRSP should also be allocated a budget, with concrete monitoring and an evaluation framework. Montenegro’s main potential source of growth, tourism, should be supported through multi-year budgeting and the Government’s Tourism Master Plan (TMP) needs to be provided with concrete budgets and interim implementation targets.

10. **Finally, tourism holds considerable promise for Montenegro’s export-oriented growth and employment creation.** In the past the manufacturing sector and the metal industry, in particular the most important aluminum company, KAP, played a dominant role in the Montenegrin economy. To date, KAP is the single most important exporter, accounting for more than 40 percent of total merchandise exports; it contributes significantly to value-added and employment in the economy. However, that may be changing. Tourism in Montenegro has recently shown strong growth in absolute terms and relative to the

economy as a whole. According to the World Tourism and Travel Council, the contribution of the travel and tourism industry (TTI) to Montenegro's economy is estimated at 8.5 percent of total GDP and 9.1 percent of total employment in 2005. The same study suggests an even more rapid growth in the future: with a projected average rate of increase of over 10 percent per year over the next decade. By 2015 the tourism industry would account for about 13.6 percent of GDP and 14.5 percent of employment, and the broader tourism economy should account for about 21.1 percent of GDP and 22.5 percent of employment. Even though these projections could be overly optimistic, they are suggestive of Montenegro's considerable potential in tourism development.

11. However, turning this promise into reality requires substantial and well-targeted investments as well as the implementation of most of the policy recommendations outlined above. In many ways the tourism sector illustrates the challenges of competitiveness and growth faced by Montenegro. To realize its tourism potential, Montenegro needs to overcome stiff competition from neighboring countries and other destinations worldwide, many of which currently offer a more competitive combination of quality and price to the same target markets. Several specific measures are needed in that regard:

- *Facilitate the conditions for private investment in tourism by:* (i) Focusing the effort to attract private investment to the coast on international flagship operators; (ii) strengthening land use planning, and property rights and controlling illegal construction at tourist sites; (iii) putting in place supportive, not oppressive, legislation and regulations, and sorting out a thorough review of the body of tourism regulations required for maintaining basic standards (health, safety, environment, etc.) and protecting consumers' interests, versus those that should be left to market-based mechanisms; and, (iv) reducing the cost of capital and increasing access to credit for (domestic) private investment.
- *Help address the public infrastructure constraints-- in particular in water, roads, and waste management—for coastal tourism development.* The water shortage during the short tourism season needs to be overcome; an adequate solid waste management system, including capital investment in landfills and strict and consistent enforcement of anti-dumping laws, needs to be put in place; and a strategy needs to be developed to use road and other transport infrastructure to steer tourism development to new areas. The Government needs to play a coordinating role in areas where donor infrastructure investments are ongoing, and play a complementary role of filling the investment gap in the context of its comprehensive public investment program (see recommendation on public investment above).
- *Help capture the potential employment benefits of tourism.* The potential employment benefits of tourism are not being captured. Local employment in the tourism sector is relatively low and is projected to grow at only a modest rate of 1.7 percent in 2005. The main reasons seem to be the short tourism season and the high labor taxation (or, conversely, the low non-resident taxes) that favor non-Montenegrin employment, but it would be important to carefully assess the reasons why Montenegro is not capturing the employment benefits, and to decide what adjustment, if any, should be made to labor regulations and collective agreements. Also, help address the shortage of skilled labor and inadequate training facilities for tourism services as better skills at the service level are urgently needed to improve quality and competitiveness in the existing facilities. The first private faculty of tourism, management and trade, established in 2004 by Atlas Mont Bank in Bar, is a promising training facility which must be encouraged.
- *Continue to diversify the tourism product, based on Montenegro's strengths.* Most of the attention for both public and private investment continues to be directed at expanding and upgrading coastal tourism, with relatively little attention given to non-coastal tourism. A diversified approach to tourism which promotes landscape-based tourism in Montenegro's hills

and mountains is important. Specific plans, programs and incentives need to be developed and implemented to catalyze non-coastal tourism investment and development with the coastal tourism development.

12. Given the small size of Montenegro's domestic market, its future growth and prosperity will depend to a large extent on how successfully it develops its exports oriented tourism industry in a sustainable and environmentally responsible way.

Montenegro: A Policy Reform Agenda for Employment, Growth, and Competitiveness

Policy Measure	Timeline for Implementation
Labor Market Reform	
Rein in the rapid wage growth witnessed in recent years through: (i) establishing a more balanced collective bargaining and wage setting process whereby the voices of employers (including Government) are strengthened; (ii) undertaking a more vigorous implementation of public administration reforms and the reduction in public sector staffs many of whom earn wages well in excess of the average for the economy; and, (iii) promoting greater decentralization of bargaining to the firm level.	Short-term
Relax some aspects of the labor regulations. While the new Labor Law, adopted in 2003, has improved the flexibility of the labor market considerably, it has not yet assured full flexibility. The reforms in labor relations should focus on: (i) relaxing the contracting rules for employing “non-standard” workers, including employees on fixed-term and part-time contracts; (ii) reducing the costs for employers to terminate regular employees for economic reasons; (iii) permitting more flexible arrangements in working hours; and, (iv) limiting non-wage costs to employers.	Medium term
Reduce the high rates of labor taxation in a fiscally responsible way to encourage formal employment. A further phased and well-planned reduction in payroll taxes—compensated by equivalent increases in other taxes, and with adjustments to compensate the resulting lost income of the social funds—is desirable. To decrease such high rates in a fiscally responsible way, reforms of the health and pension systems (early retirement, disability, maternity leave and sickness benefit) need to be pursued in parallel.	Medium term
Introduce or expand, through the Employment Bureau, other active labor market programs including: (i) employer contact services, which refer the best qualified applicants to employers; (ii) vacancy and job fairs designed to assist local employment agencies in matching labor supply and demand; (iii) job clubs for those with low self-confidence who have been unemployed for extended periods of time; and (iv) virtual enterprises to develop teaching and training skills for operating a real enterprise.	Short-term
Improve labor market data and information. Special and more detailed regular labor force data are needed to monitor employment, underemployment and unemployment; seasonal, occasional and informal employment; earnings and incomes; working time, by occupational and professional groups and regions; and work in the informal sector and in households. The absence of regular and reliable information on the labor market limits effective labor market monitoring and interventions.	Long-term
Fiscal Policy Reform	
Reduce/control expenditures on the wage bill, transfers to households, and interest payments, which have risen significantly over the last three years. The high wage growth has crowded out spending on public investment and operations and maintenance—expenditures that are essential for growth. It should be controlled through: (i) public administration reforms that would eliminate employment redundancies; (ii) controlling of wage and salary increases.	Short-Medium term
Increase the allocation toward well-targeted infrastructure investment that will support tourism development and growth. At 2 percent of GDP, Montenegro’s domestically financed capital expenditure is much below the level for other countries in the region. Capital investment in infrastructure, at only about 0.4 percent of GDP, is even less. Increasing capital investment, in particular in infrastructure, is necessary. The challenge would be to: (i) do this in a way that would not compromise fiscal and macroeconomic sustainability; (ii) carefully target and fund only those infrastructure investments that are strongly linked to growth and tourism development.	Medium term

Montenegro: A Policy Reform Agenda for Employment, Growth, and Competitiveness

Policy Measure	Timeline for Implementation
<p>Eliminate/reduce subsidies and lending to public enterprises by imposing a complete hard budget constraint. Government subsidies and net lending now account for about 1.6 percent of GDP. State-owned enterprises still lack hard budget constraints and budgetary discipline. This problem could be overcome through (i) increasing the transparency around which state-owned enterprises receive subsidies and transfers from the Government; (ii) completing the privatization of these enterprises where privatization is an option; and (iii) where privatization is not feasible, by improving the management of such enterprises and defining strict financial performance criteria that would phase out subsidies and budget transfers.</p>	Short-term
<p>Increase the productivity of current expenditures on education and health care services. In the health sector the management of public health funds should be improved, the reforms of primary health care including prioritization of treatment programs, should be continued, and public procurement procedures should be improved through improved legal framework for procurement. In education the disproportionate staffing cost should be reduced through school consolidation, and vocational training programs should be realigned to those demanded by the labor market.</p>	Long-term
<p>Improve budget processes and eliminate arrears by: (i) undertaking a better and more realistic revenue projection as well as making speedy expenditure decisions in the event of revenue shortfalls; (ii) strengthening the commitment control system of spending agencies through better staffing, the upgrading of accounting standards, and transparency; and (iii) developing a time-bound plan for clearing the current stock of arrears, identifying the most costly ones, and retiring those first.</p>	Short-term
<p>Strengthen the link between policy priorities and the budget, especially with respect to tourism development and implementation of the Poverty Reduction Strategy Paper (PRSP). The Government budget generally, and public investment particularly, should be geared toward supporting the realization of the growth potential of tourism. The Ministry of Tourism should move toward a multi-year budgeting and program implementation. In the medium to long term, there is a need to develop a comprehensive medium-term expenditure framework as a basis for public expenditure planning, comprising the central government, the social funds, and local governments, and reflecting fully the policy commitments of the Government. The PRSP should also be allocated a budget, with concrete monitoring and an evaluation framework.</p>	Medium-Long term
Private and Financial Sector Reforms	
<p>Simplify and speed up the issuance of business licenses and inspections. Business operating licenses take a long time to be issued, and licensing and inspection activities are not conducted in a fair and transparent way (FIAS, 2004). A draft Law on Licensing, prescribing a faster and more efficient registration and listing of business activities, should be implemented as quickly as possible.</p>	Short-term
<p>Improve governance and regulation through: (i) greater transparency, and a more consistent application of rules, including an improved tax administration capacity to support rule-based tax collection; (ii) speeding up the implementation of recently enacted business laws and regulations. The implementation of legislation aimed at improving the business environment—contract enforcement, access to finance, corporate governance, and business exit—has not yet begun in most cases. Speeding up the implementation of these laws will be critical to private sector investment and growth.</p>	Short-term

Montenegro: A Policy Reform Agenda for Employment, Growth, and Competitiveness

Policy Measure	Timeline for Implementation
Speed up the restructuring of companies privatized through the MVP by: (i) faster consolidation of the shares of these companies being traded on stock exchanges into majority shares; (ii) making budgetary allocations toward covering the social costs of restructuring—including the shielding of excess labor and severance payments – for those companies for which the Government agreed to fund such costs; (ii) strictly enforcing the new Bankruptcy Law for medium and large enterprises privatized through vouchers that have continued to accumulate losses; and (iii) strengthening the capacity of the courts to deal with such bankruptcy cases (see below, on courts).	Short-term
Reduce the backlog of commercial court cases and speed up contract enforcement through: (i) easing the resources and personnel constraints in the Montenegrin judiciary; (ii) ensuring that qualified judges are put in place; (iii) training court personnel; and (iv) upgrading the court system's infrastructure, including the computerization of case management.	Medium-term
Improve land title transparency and control illegal construction. Lack of transparency on land titles and registration represents one of the greatest threats to the future prospects of Montenegro's tourism industry, particularly in the few remaining high-potential tourism sites (e.g., Ulcinj, and inland areas close to national parks and other natural attractions). The Government needs to vigorously enforce land property rights and control illegal construction.	Medium-term
Reduce the cost of capital and improve financial intermediation through: (i) reducing the need for Treasury bill financing through a tight fiscal policy. This would help reduce the budgetary burden of interest payments on Treasury bills and would create the conditions for the lower cost of capital in the economy by reducing the crowding-out of Government; (ii) establishing an effective, broad-based institution, with full credit information on all borrowers, to address the problem of asymmetric information in credit markets. At the moment Montenegro has neither a Credit Registry nor a Credit Bureau; (iii) introducing more competition into the banking sector through the completion of the privatization of government-owned banks (in particular Podgoricka Banka), and by promoting leasing operations in view of the small size of the Montenegrin market.	Short-term
Tourism Development	
Diversify the tourism product, based on Montenegro's strengths. Most of the attention for both public and private investment continues to be directed at expanding and upgrading coastal tourism, with relatively little attention given to non-coastal tourism. A diversified approach to tourism which promotes landscape-based tourism in Montenegro's hills and mountainous areas is important. Specific plans, programs and incentives need to be developed and implemented to catalyze non-coastal tourism investment and development.	Medium-Long term
Focus the effort to attract private investment on flagship operators. Because Montenegro is currently relatively unknown in many prospective tourism markets, high priority should be given to attracting a few high quality "flagship" operators whose presence could help provide the reassurance that many travelers need in order to try out a new destination.	Short-term
Facilitate the conditions for private sector investment in tourism by: (i) strengthening land use planning, and property rights and controlling illegal construction at tourist sites; (ii) putting in place supportive, not oppressive, legislation and regulations and carrying out a thorough review of the body of regulations required for maintaining basic standards (health, safety, environment, etc.) and protecting consumers' interests versus those that should be left to market-based mechanisms; (iii) reducing the cost of capital and increasing access to credit for (domestic) private investment in tourism.	Short-Medium term

Montenegro: A Policy Reform Agenda for Employment, Growth, and Competitiveness

Policy Measure	Timeline for Implementation
<p>Help address the public infrastructure constraints-- in particular in water, roads, and waste management—for coastal tourism development. The water shortage during the short tourism season must be overcome; a strategy needs to be developed to use road and other transport infrastructure to steer tourism development to new areas; and an adequate solid waste management system, including capital investment in landfills and strict and consistent enforcement of anti-dumping laws, should be put in place.</p>	Medium term
<p>Help capture the potential employment benefits of tourism. The potential employment benefits of tourism are not being captured. Local employment in the tourism sector is relatively low and is projected to grow at only a modest rate of 1.7 percent in 2005. The main reasons seem to be the short tourism season and the high labor taxation that makes employers favor non-resident employment, but it would be important to carefully assess the reasons why Montenegro is not capturing the employment benefits, and to decide what adjustment, if any, should be made to labor regulations and collective agreements.</p>	Short term
<p>Help address the shortage of skilled labor and inadequate training facilities for tourism services. Better skills at the service level are urgently needed to improve quality and competitiveness in the existing facilities. A higher level of professional training in a wide range of skills, with an emphasis on modern information technology, management, and flexibility and “multi-tasking” is needed. Such training facility can be private sector-led. The Ministry of Education has recently introduced “tourism and catering” as a vocational stream, but this would need to be strengthened. The first private faculty of tourism, management and trade, established in 2004 by Atlas Mont Bank in Bar, is a promising initiative which must be encouraged.</p>	Medium term

1. RECENT ECONOMIC DEVELOPMENTS

A. BACKGROUND

1.1 **Serbia and Montenegro (SAM) is a union of two loosely affiliated republics,¹ the Republic of Serbia and the Republic of Montenegro.** Twelve years after the breakup of the Socialist Federal Republic of Yugoslavia in 1991, the Constitutional Charter of Serbia and Montenegro was enacted in February 2003 by the Parliament of Serbia, the Parliament of Montenegro and the Parliament of the Federal Republic of Yugoslavia to give birth to “Serbia and Montenegro,” a country that has come to replace the former Federal Republic of Yugoslavia.

1.2 **Montenegro is by far the smaller of the two republics in the State Union of Serbia and Montenegro.** Geographically, it is a small, mountainous, and picturesque area of about 13,214 square kilometers, located in the Western Balkans region of Southeast Europe, with about 293 kilometers of coastline on the Adriatic. According to the November 2003 population census issued by its Bureau of Statistics, Montenegro is approximately one-sixth the geographical size of Serbia, with 620,145 inhabitants (less than one-tenth of Serbia's population). Its economic base consists of significant deposits of natural resources (bauxite), aluminum, a great potential for tourism development, some tracts of arable land, and a pool of relatively skilled labor.

1.3 **Although much remains unclear about the political future of Montenegro,² EU accession remains an overarching strategic goal.** Following the “Belgrade Agreement” of 2002, Montenegro and Serbia agreed on the so-called “Action Plan for Harmonization of Economic Systems of Member States of the State Union of Serbia and Montenegro for the purpose of Preventing and Removing Obstacles to Free Movement of People, Goods, Services and Capital” (“Action Plan”), whose purpose was to bring the two economic systems together so that they could move jointly toward EU accession. In practice, however, the harmonization of tariffs and trade policy proved difficult, with the result that in October 2004 the EU proposed a “two-track” approach to EU accession. The twin-track approach allows the EU to deal with Serbia and Montenegro separately on issues relating to trade, customs and economic and sectoral policies, while seeking to reach an agreement with the union on international political obligations and human rights. Given its small domestic market, Montenegro’s EU (and WTO) accession³ and further regional integration will be fundamental to its growth and prosperity (see Box 1.1.). Maintaining its competitiveness in these markets, too, will be critical.

¹ In 2002, Montenegro signed the Accord on principles in relations between Serbia and Montenegro (“Belgrade Agreement”) with Serbia and the EU, which established a new State Union of Serbia and Montenegro. As presently constituted, the Union has limited responsibilities in the area of foreign affairs, defense, human rights, intellectual property rights, standardization and technical regulations, metrology and statistics. All other areas are at responsibility of the member states.

² The final shape of the Union with Serbia is unclear. Three years after the establishment of the State Union, the member states have the right to hold a referendum on withdrawal from the State Union.

³ The European Union (EU) published its feasibility study for the initiation of negotiations on Stabilization and Association Agreement (SAA) in May 2005. In October 2005, Serbia and Montenegro officially started the negotiations with the EU on the SAA.

Box 1.1. Montenegro: Why Regional Integration and EU Accession?

Market integration within the framework of the EU and WTO accessions is vital for a small economy like Montenegro's for several reasons.

First, in view of its small size, it is fundamental to increase specialization and efficiency in the production of goods and services. If Montenegro remained a closed economy, its economy would be forced to produce a larger range of products, under less than efficient conditions. The lack of specialization reduces efficiency and income. On the other hand, trade in goods would allow a small country like Montenegro to specialize in a smaller range of goods and services following its natural resource base, and importing other goods from the rest of the world. It would also enlarge the set of opportunities a consumer has well beyond Montenegro's own production possibilities. Trade in goods and services, however, depends on transportation costs, tariff and quantity restrictions and "behind the border barriers." That is why the issues of tax harmonization and the removal of barriers to the free trade of goods and services in the context of EU accession are important for Montenegro.

Second, regional integration and EU accession are also essential to reduce the cost of doing business and for risk diversification. The establishment of idiosyncratic institutions by small states like Montenegro may imply a higher per capita cost of providing public goods and higher costs of doing business. Indeed, empirical evidence shows that small states have higher costs of producing public goods (Alesina and Wacziarg, 1998). Furthermore, small size implies difficulties in diversifying risk within borders. For example, a bank forced to hold onto portfolio mortgages generated within the small Montenegrin market may face a larger risk than if it had access to a larger market.

Finally, regional integration and EU accession can help reduce the high income volatility that small states like Montenegro often experience. Empirical evidence suggests that there is a negative correlation between population size and the standard deviation of per capita income (Easterly and Kraay, 1999). This is not surprising since, with a given level of shock, the impact on consumption will be more rapidly felt in a small state. Regional integration may make it possible to smooth income and consumption arising from such shocks. Conversely, regulations imposing restrictions on the flow of capital and labor may prolong the cost of adjustment to shocks. Where feasible, trade in institutions, such as when a country adopts an institution of another country relinquishing its national institution or independent policy (e.g., the euro as a currency, a defense agreement which puts a small state under the umbrella of a larger regional power), may also help reduce costs, ensure stability and reduce risks.

Source: Based on Favaro (2003).

B. THE ECONOMIC REFORMS TO DATE⁴

1.4 Montenegro, like all other regional states, inherited a legacy of four decades of inefficient economic management and institutional policies that stifled growth and private initiatives. For nearly a decade following the breakup of the former Federal Republic of Yugoslavia, regional conflicts and international isolation crippled the economy and delayed the start of the transition to a market economy. Since 1997, however, Montenegro, with the support of the international community,⁵ has been engaged in a long series of reforms designed to move its economy from a socialist to a modern market-based economy. In 2003, the Government of the Republic of Montenegro formally adopted its Economic Reform Agenda (ERA) covering the period 2003-2007, and a Poverty Reduction Strategy (PRSP) aimed at reducing poverty. The ERA established a broad strategic vision of a liberalized, market-based economy, on which subsequent economic reforms have been based.⁶ The ERA has recently been updated to guide economic reform program for the period 2005-2007.

⁴ See Annex 1 for a chronology of main events in Montenegro, including dates of some key policy reforms.

⁵ Main donors in Montenegro include USAID, EAR, World Bank, UNDP.

⁶ See Republic of Montenegro Economic Reform Agenda, 2003. The main goals of the ERA are the establishment of an open economy based on the private sector, the creation of a favorable business environment attractive for

1.5 Montenegro's economic reform program since 1997 has rested on two broad pillars: macroeconomic stabilization, and market-oriented structural reforms, including extensive price and trade liberalization, privatization, public administration reform, financial sector reform, and reforms aimed at improving the business climate and the labor market.

Macroeconomic Stabilization

1.6 Currency reforms. A cornerstone of the Montenegrin stabilization program was the adoption of first the DM and then the euro as the legal tender in the Republic. In November 1999, the Montenegrin Government declared the Deutsche Mark (DM) an official parallel currency to the Yugoslav dinar. One year later, in November 2000, the Central Bank of Montenegro (CBM) declared the DM the sole legal tender in the Republic. On January 1, 2002, the euro replaced the DM as Montenegro's official currency.

1.7 Both economic and political factors underpinned Montenegro's adoption of the DM, and subsequently the euro, as the official currency (Bogetic, 2002). The economic rationale had to do mainly with the monetary policy of the federal government, which resulted in two devastating hyperinflations in 1990 and 1992-93. The political reasons largely reflected Montenegro's growing estrangement from Milosevic's policies of the late 1990s, and the consequent decision by the Montenegrin authorities to take control of some state functions that were previously in the federal domain (e.g., customs, foreign representation). While the currency reforms—in particular euroization—laid some solid foundations for stability and economic recovery, it has also reduced policy flexibility (see Box 2.2). Inflation (CPI) fell from 67 percent in 1999 to 24 percent in 2000, and has continued in a gradually declining trend. Since 2002, inflation in Montenegro has been held to single digits.

1.8 Fiscal reforms. Fiscal reform in Montenegro started in 2001. Many laws were adopted with a view to establishing a more transparent and efficient collection of budget revenues. A new value added tax replaced a previous sales tax system in 2003; the Treasury of the Republic of Montenegro was established; fiscal cash registers were introduced and tax identification numbers applied; and most recently, the monopoly of the domestic payment services (the former payment bureau, called ZOP) was abolished, allowing commercial banks to initiate and settle inter-bank payments without the mandatory intermediation of any institution or agency. The establishment and enforcement of the *Law on Public Procurement* has raised the level of transparency as well as the efficiency of public expenditure control. Revenues, which were previously distributed through extra budgetary funds and other institutions, have been centralized within the Budget of the Republic. The introduction of a medium-term expenditure framework has been initiated, and programmatic budgeting is being developed on a pilot basis in two institutions: the Ministry of Transport and Navigation and the Institution for the Execution of Penalties (penitentiary). The internal audit was established in 2004 within the Ministry of Finance, and the Supreme Financial Institution for Auditing was established in April 2004.

1.9 The Government has, however, made progress in containing fiscal deficits. Supported by the IMF programs in Serbia and Montenegro,⁷ Montenegro's consolidated budget deficit was cut from about

foreign investors, accession to the EU and the WTO, and the reform and development of various sectoral policies. The Economic Reform Program deals with Business Environment and Trade, Fiscal Reform, Financial System, Privatization, Reform of the Pension System, Sectoral Policies (Tourism, Energy, Agriculture), Public Administrative Reform, Judicial Reform, Civil Society, Information Society, Macro-Economy and Statistics, and Management of the Reform.

⁷ The macroeconomic policies of SAM were supported by three successive IMF programs. The first program, the Emergency Post-Conflict Facility, was approved in December 2000 and was followed by a Stand-by Arrangement

8 percent of republican GDP in 2000 to about 3 percent in 2004. Chapter 3 of this report will examine whether this fiscal deficit is sustainable, and where the Government might tighten and/or reallocate expenditures to support the goal of macroeconomic stability and faster growth.

Box 1.2. The Costs and Benefits of Euroization

Euroization has several benefits. First, it eliminates the risk of a nominal devaluation of the country's exchange rate. This can in turn help avoid a sudden stop in capital flows motivated by fear of devaluation; and lower the cost of borrowing from international market, through reduced country risk. As such, it can contribute to building a stronger financial system, and facilitate financial integration. Second, euroization can help rein in inflation. The reason is simple. Under euroization there is no domestic monetary authority that could expand the quantity of money. Third, euroization also makes commercial integration with the rest of the world easier because it eliminates the transaction costs associated with currency exchange. Finally, euroization can have a disciplining effect on fiscal policy, although it does not prevent fiscal indiscipline. While the Central Bank cannot monetize fiscal deficits under euroization, the authorities can still engage in fiscal profligacy through excessive borrowing to finance large fiscal deficits.

On the other hand, euroization has several costs. Among these are: (a) the sacrifice of an independent monetary policy; (b) the loss of the lender of last resort; (c) the sacrifice of the inflation tax; and (d) the loss of seigniorage. An independent monetary policy is clearly lost under euroization. For example, if the authorities believed that some insulation of the domestic financial system is needed for the purposes of, say, improving its stability, through the imposition of capital controls, they would find such measures difficult to accomplish, because it would always be possible for private agents to convert their assets to euro cash. Second, the lack of a lender of last resort puts even greater importance on the need to have a strong banking sector supervision and management of liquidity in the financial system. Third, euroization limits policy flexibility, and puts the full burden of adjustment to shocks on prices, fiscal policy, and most importantly structural reforms including labor market reforms.

Structural Reforms

1.10 Parallel with stabilization policies, the Republic of Montenegro also implemented a program of structural reforms, including price and trade liberalization, privatization, public administration reform, financial sector reform, and labor market and business environment reforms.⁸

1.11 **Price liberalization.** Beginning in 1998, the Government of Montenegro launched a concerted reform effort to liberalize prices and foreign trade. Most price categories were liberalized by the early 2000s except for some public utilities such as electricity. Even in electricity, continued price adjustments since 2001 have further reduced the need for electricity subsidies, although full cost recovery prices are not yet in place. Overall, Montenegro's pricing policy is based on market principles, and price liberalization is almost complete. Only a small number of products are currently subject to administrative price control, including medicines for human consumption, oil and derivative products, and postal services, while local authorities may control the prices of certain utility services

1.12 **Foreign trade liberalization.** In June 2000, Montenegro significantly liberalized its foreign trade regime. The Government adopted a temporary regulation taking over the jurisdiction of customs from the federal authorities, pending the preparation of the new Customs Code. According to the Temporary Act on Custom Tariffs, only Montenegrin laws and institutions regulate all international

of SDR 200 million approved in June 2001. A three year Extended Arrangement (EA) of SDR 650 million was approved in May 2002 and spans the period through end-December 2005.

⁸ For a more detailed description of the structural reforms agenda after 2003, see the Government's Economic Reform Agenda of 2003. The Government is currently revising and updating its Economic Reform Agenda for 2005-2007.

transactions. All customs rates, previously determined by the federal legislation, are now set by Montenegro's authorities. The trade reform has significantly simplified Montenegro's trade regime by substantially reducing and simplifying licenses, quotas and tariff rates and structure. According to the new Law on Customs (January 30, 2002), imports face six tariff rates; 0, 1, 3, 5, 10, and 15 percent. The average duty is a low 3.5 percent. Most notably, the tariff structure contains no high, very protective peaks. More than 95 percent of imports are no longer subject to quota or license requirements. Manufacturers importing equipment, materials and components face reduced but constrained tariff rates and difficulties with customs procedures. Firms with export opportunities which are entitled to obtain rebates on import tariffs paid for materials or components used in their production do not often receive these rebates, as there is no effective duty drawback system. In the context of its participation in the SEE Stability Pact, Montenegro as a member of the state union along with other signatories has established a network of 28 bilateral free trade agreements (FTAs) in the region and all the 28 agreements are being implemented.

Box 1.3. Montenegro's History of Privatization

State-owned companies in Montenegro were transformed, under the *Law on Ownership and Management Transformation* (RM OG No. 2/92, 27/94, 23/96), in the early 1990s. Under that Law, employees were granted 10 percent of shares free of charge and up to 30 percent more, to be paid in installments with a discount based on the working period that had been spent in a company. The remaining 60 percent or more of the shares were transferred to three state-owned funds: the Development Fund (60 percent), the Pension Fund (30 percent) and the Employment Fund (10 percent). Approximately 350 companies were involved in this process. Subsequently, 117 of these companies were sold through different methods of sales including direct sales of majority or minority stakes and auction sales.

The Privatization Council was established in 1998 to manage the privatization process. Based on proposals made by the Privatization Council, the Government has since issued an annual privatization plan and conducted privatizations of state-owned enterprises in accordance with the annual plans. The plans contain the number of shares in each company to be privatized or given back to former owners of industries nationalized after World War II.

The Government earnestly embarked on the privatization process with the launching of the mass voucher privatization (MVP) of 2002. Through this process, more than 400,000 citizens of Montenegro acquired vouchers for free and exchanged them for shares of companies or investment units of privatization investment funds. About 66.47 percent of voucher points were invested in privatization funds and 29.05 percent directly in the companies. More than 200 companies, covering about one-fourth of the socially owned companies, were privatized through the MVP process. Today, shares of companies and investment units are traded on the two stock exchanges, NEX Montenegro and the Montenegro Stock Exchange. Yet the trade in shares is slow, so that new majority owners are not found quickly.

Overall, Montenegro has to date privatized more than 60 percent of the former socially owned capital. In addition, about 80 percent of the capital in another 179 firms has been privatized, as has 70 percent of the capital in 27 companies. However, in some of the largest companies there is still a little private capital, but the Government plans to relinquish majority shares in these companies through international tender in the near future (2005).

1.13 Privatization. Montenegro's privatization program dates back to the early 1990s when some state-owned companies were transformed, under the *Law on Ownership and Management Transformation*, to employee ownership (see Box 1.3). However, the privatization program was launched with renewed vigor in the late 1990s with the establishment in 1998 of the Privatization Council (to oversee the tenders and auctions in large enterprises) and the launching of the mass voucher privatization (MVP) for small stakes in selected enterprises in 2002. In the MVP program, completed in 2002, vouchers were distributed to all citizens, and widespread share ownership was established for more than 200 socially owned companies, comprising about 25 percent of the state-owned companies in Montenegro (see Box 1.3).

1.14 Montenegro has recently accelerated its privatization plans and expects to wrap up the privatization of its biggest companies in 2005.⁹ In mid-2004 the largest steel producer Niksicka Steelworks was privatized. In 2005, the local telecommunication monopoly, Telekom Montenegro, and the largest aluminum producer, Kombinat Aluminum Podgorica (KAP), contributing about half of the nation's merchandise export, were sold. An international financial advisor for the privatization of Podgorička Banka, the largest state-owned bank, was selected in February. The authorities have prepared a time-bound strategy for the privatization of majority and minority-owned equity stakes in the remaining state-owned banks. Besides, hotels and other minor assets have been privatized. Another 120 small and medium-size companies are expected to be offered for sale on the stock market.

1.15 Public administration reform. Montenegro adopted its public administration reform program in June 2003. Soon after the adoption of the program, the Government made some effort to reduce employment in the public sector, mainly in the police and education sectors (some police officers were laid off in August 2003). In March 2003, the Government adopted an employment and wage policy action plan, which foresaw a reduction of redundant public employees—especially in the education sector—by 3,000, as well as a larger differentiation of salaries to increase the incentives for qualified staff in public administration. In 2003-2004, the Ministry of Education and Science conducted a rationalization of the education system, which reduced the number of employees by 728 workers. In 2004, the Ombudsman Office was established and staffed. New procedural legislation (administrative litigation) and the Code of Conduct for civil servants were prepared, and regulations governing the status of civil servants were developed, with the aim of introducing professionalism and more transparency through obligatory public competition for all posts apart from ministerial posts and a very limited number of personal advisers. Most recently, a separate organizational unit for human resources management has been established, and a new salary law introduced to decompress the salary system and create a transparent reward system for civil servants (although it remains unimplemented to date). The Ministry of Justice has led the introduction of many of these reforms, and today an adequate legal and regulatory framework exists in Montenegro for public administration reform, but the more difficult phase of institutional building is yet to be fully implemented.

1.16 Financial sector reform. In the financial sector several reforms were carried out. The institutional framework for banking supervision has been strengthened over the past years with the introduction of new regulations on licensing, minimal capital requirement, asset classification and provisioning and large exposures. The finalizing of the privatization in July 2003 of the Montenegro Banka, formerly the largest bank in the Republic, contributed to banking sector stability. Since the sale of Montenegro Banka and the closure of some smaller banks, all banks operating in Montenegro are now considered to be liquid and to be in compliance with capital requirements. In 2003 the Ministry of Finance revoked all licenses given to offshore banks registered in Montenegro. An anti-money laundering law was adopted in 2004, and Montenegro became the member of the Egmont Group in Washington on June 29, 2005. The importance of membership is manifold, both for Montenegro and for the Administration for Money Laundering Prevention, and includes exchange of confidential information on money laundering. In January 2005, the Montenegrin Central Bank completed the transfer of the inter-bank payment system (known also as ZOP) from the Central Bank to the jurisdiction of commercial banks, a move which is expected to help consolidate financial transactions at commercial banks and reduce the banks' high transactions fees. The privatization of the last bank with majority public ownership, Podgoricka Banka, is currently under way.

⁹ Further details are contained in the Government's document: "Montenegro Privatization Plan for 2005".

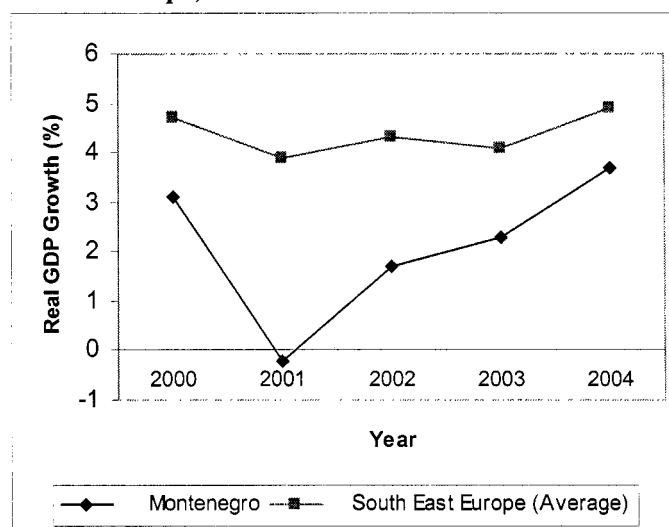
1.17 *Business environment reform.* Finally, several reforms aimed at improving the business climate and labor market flexibility were initiated in recent years (see Chapter 4). The Government enacted new enterprise, bankruptcy, and secured transaction laws to create a more favorable business environment. A new energy law was enacted, which provides a basis for the development of a regulatory framework, together with energy industry restructuring and liberalization. A new labor law, aimed at increasing labor market flexibility, was enacted in 2003.

1.18 In summary, Montenegro has made significant progress in terms of both macroeconomic and structural reforms. With the implementation of currency and fiscal policy reforms, it has succeeded to rein in inflation and bring about macroeconomic stability. In parallel to the stabilization policies, it has also implemented a number of structural reforms, including price and trade liberalization, privatization, public administration reform, financial sector reform, and labor market and business environment reforms. Yet, despite the progress, many structural reforms remain to be carried out. The Government's recently updated Economic Reform Program for 2005-2007 provides a framework for what economic reforms remain to be done over the coming years.

C. THE RESULTS SO FAR: MACROECONOMIC AND POVERTY OUTCOMES

1.19 Despite serious data constraints in Montenegro, available evidence suggests that the macroeconomic and structural reforms pursued since the late 1990s have supported four years of modest economic recovery and transition. Pervasive data problems exist in Montenegro, which highly constrain the ability to make evidence-based analysis and derive conclusions (see Box 1.4). Basic national accounts statistics are either too old (the latest official GDP figure available from MONSTAT, the Republican statistical office, is for 2002), or unreliable, apart from setting aside issues of whether their compilation meets internationally accepted methodology. Economic data on output are highly unreliable, as they include only statistics based on the large socially owned and state-owned companies, thus excluding an emerging private sector whose share in total output may be steadily growing. The quality of employment and unemployment data are questionable, as are the imports, exports and the balance of payments data. The analysis and conclusions below, while subject to the above caveat, are based on the best evidence and information that could be assembled for the Montenegrin economy.

Figure 1.1. Montenegro's Growth Compared to South Eastern Europe, 2000-2004



Source: MONSTAT.

Growth and Employment

1.20 With the reforms of the late 1990s and early 2000s, real output growth has shown modest recovery. With the advent of reforms, it was expected that the Montenegrin economy would grow rapidly. The actual results, however, show that growth is still sluggish.: average annual real GDP growth over

2000-2004 was only **about 2** percent, significantly below the regional average growth rate (Figure 1.1). Moreover, the recorded growth of output remains below its potential, as Montenegro's GDP remains far behind its pre-transition levels.

1.21 On the demand side, the recorded growth came mainly from high domestic consumption (both private and public) during 2000-2002. The latest period for which demand composition is available is 2000-2002. According to these data, both private and public consumption grew. While investment declined in real terms by 16 percent in 2002, it is estimated to have recovered in 2003 and 2004. Even so, Montenegro's investment, at around 20 percent of GDP, remains below the levels characteristic of leading transition countries.

Box 1.4. Montenegro –Key Statistical Issues

Montenegro's statistical system is weak, basic macroeconomic data are not available at all or are not timely, and their compilation does not fully comply with international standards.

Real Sector. Real sector statistics are compiled and published by MONSTAT, the statistical agency of Montenegro. MONSTAT has recently produced estimates of GDP by activity and by expenditure for 2000-2002. However, no official GDP estimates are available for 2003 and 2004, and no quarterly data are available. Generally, the methodology follows the *System of National Accounts (1993 SNA)*, but there are problems with the scope of the accounts and the basis for recording that are not broadly consistent with the international standards. Overall, the data quality is poor, and the data sources are in need of improvement. The statistical techniques used for the national accounts compilation also need further improvement. There is a master plan for the improvement of statistics, developed with the assistance of EUROSTAT, which has been approved by the Government but not fully implemented. Further, the restructuring and staffing plan for MONSTAT, although under preparation for some time, is yet to be approved and implemented.

Balance of Payments. Balance of payments statistics are currently compiled by the Central Bank of Montenegro (CBM). The principal sources of data are customs data on merchandise trade as processed by the Central Bank and information on foreign exchange transactions provided by banks and exchange bureaus. An IMF balance of payments technical assistance mission to the CBM in June/July 2004 provided recommendations to improve international trade statistics, external debt. Imports and exports are not accurately captured, especially with Serbia.

Government Finance. Fiscal statistics for Montenegro are compiled by the Montenegro Ministry of Finance. The principal data sources are the Republican Treasury and the budget execution reports of the spending ministries and the first level budget units. Montenegro now reports the Republican budget implementation data on a monthly basis. Fiscal data for the central government of Montenegro are based on the new GFS classification. Data for the Social Security Funds, reported directly by the funds, are compiled with significant delays and not on a GFS basis. A new chart of accounts was introduced in Montenegro in 2001, but it still needs to be fully implemented by local governments. Local governments are not yet integrated into the consolidated general government revenues and expenditures.

Monetary Accounts. Monetary and financial statistics are compiled by the CBM, broadly following the methodology set forth in the *Monetary and Financial Statistics Manual*. Estimates of cash in circulation are not regularly available. The Republic of Montenegro introduced new charts of accounts for the CBM (January 2004) and for the commercial banks (December 2003). The CBM is now compiling monetary statistics from data collected based on the new charts of accounts. The monetary and financial statistics mission of the IMF (2004) made recommendations to the CBM for improving (i) the classification of financial instruments, including loan-loss provisions and depreciation, (ii) the mapping between the charts of accounts of the CBM and other depository corporations with the respective sectoral balance sheets. While many of these recommendations have been implemented, there is still room for further improvement.

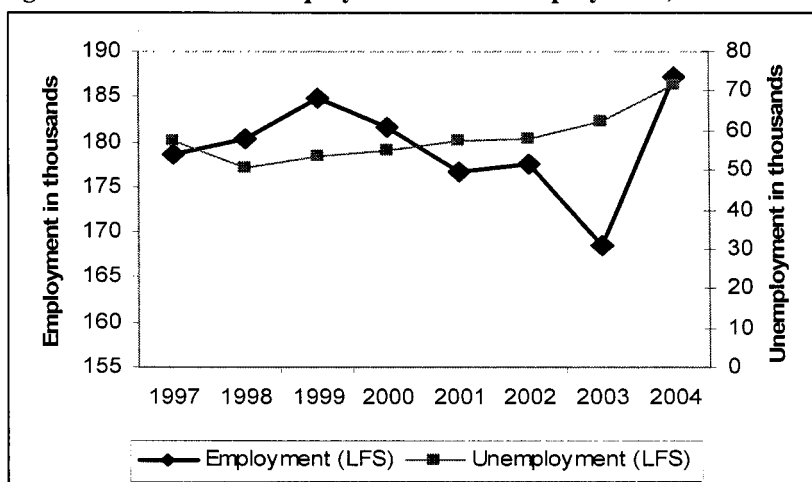
Source: Bank Staff assessment; IMF Statistical Note on Serbia and Montenegro.

1.22 **On the supply side, industry and agriculture contributed most to the growth of GDP during 2000-2002, but data are not available for later years.** Services, manufacturing, and agriculture are the most important economic sectors, with shares in GDP of about 60 percent, 25 percent and 13 percent, respectively. Within services, tourism plays an important role. Within manufacturing, the metal industry (which includes the most important factory, KAP) plays a dominant role. KAP is not only the single most important exporter, accounting for more than 40 percent of total merchandise exports, but it also has about 3,000 employees and contributes significantly to value-added in the economy. According to the available data, since 2003 the main sources of growth in Montenegro appear to have been industrial production and tourism, with annual increases of about 6 percent and 10 percent, respectively. (see Box 1.5 for possible drivers of growth).

1.23 **The limited output recovery was not accompanied by employment growth** (see Figure 1.2).

Like many other transition countries, Montenegro has faced “jobless growth” (or even “job loss growth”). Recorded employment has on average declined over the last 15 years. Labor Force Surveys for Montenegro show that the numbers of the employed in companies (so called “wage-earners”) declined by about 7 percent over 1998-2004. The 2004 Labor Force Survey shows that employment recovery has continued.

Figure 1.2. Trends in Employment and Unemployment, 2000-2003



Source: MONSTAT, Labor Force Survey (various years).

1.24 **Yet, average monthly net wages doubled**

over the last 4 years, from EUR 96.3 in 2000 to EUR 195.9 in 2004. Only in 2004, real wages in Montenegro went up by 9.11 per cent. This has led to a wage growth far in excess of productivity, thereby seriously endangering Montenegro’s competitiveness (see competitiveness section below).

1.25 **Unemployment persists as a structural problem in Montenegro.** It is exceptionally high, and long-term unemployment is widely prevalent. According to the 2004 labor force survey data (October), there were 71,800 unemployed at age of 15 and over, with the unemployment rate of 27.7 percent. In April 2005, the Employment Agency had 58,000 registered unemployed on the roster, a 23.5 percent decline compared to 2004, mainly because of the legalization of existing informal sector jobs. Long-term unemployment is widely prevalent. More than one-fifth of the registered unemployed are on the roster for more than eight years. The skills and work habits of many of the long-term unemployed have eroded and to a large extent the reintegration of this group into the labor market is complicated, at least without an upgrade of their human capital. Long-term unemployment constitutes an additional burden on the social funds and on the families of the affected. The persistence of high unemployment and growing under-employment even after more than a decade of economic growth suggests that the new private sector, comprised of small firms, has not yet developed the critical mass to generate enough jobs to offset the job losses in the old public sector. Facilitating the entry of new firms and the growth of small enterprises is necessary for faster job creation, the reduction of unemployment, and economic growth (see Chapter 4).

Box 1.5. Drivers of Growth in Montenegro

Sectorally, the services sector—in particular tourism—holds the greatest potential for growth. The manufacturing sector and the metal industry, in particular the most important aluminum company KAP, play an important role in the Montenegrin economy. KAP is currently the single most important exporter, accounting for more than 40 percent of total merchandise exports. It also contributes significantly to value-added and employment in the economy, although its contribution to the future growth of the economy will depend on the amount of investment, technology, and innovation that will be brought in by the new owner of KAP (i.e., Rusal). To a lesser extent, forestry (in particular wood processing) and agriculture also contribute to the growth of the economy.

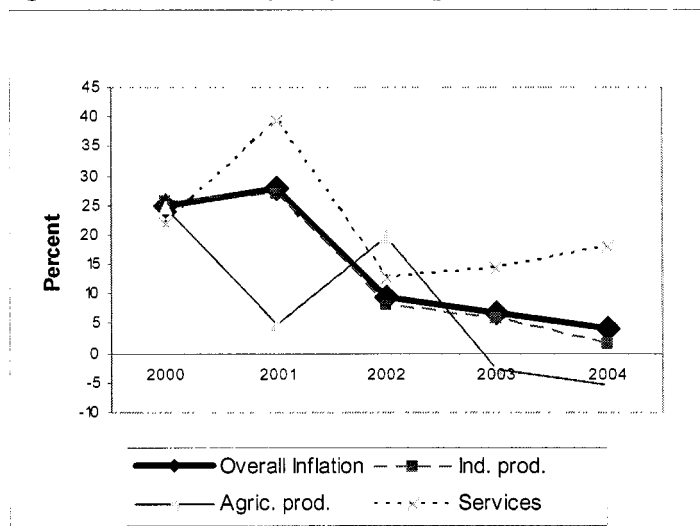
Geographically, Montenegro is characterized by huge differences (in terms of population density, and level of development) between its northern, central and southern parts. The northern region, primarily a mountainous region, is the least developed region and depends mostly on industry and small agriculture. The central region, including Podgorica, is more developed, and industry and services, and to a lesser extent agriculture, constitute the basis of its economic activity. In the southern region—i.e., the coastal area—services, tourism and transport provide the basis of the economy. These regional differences would need to be taken into consideration in designing a regional approach to development. The northern region has a good potential for landscape-based tourism, as it has many hills, mountains, rivers, canyons and lakes. To a lesser extent, it has the potential for timber industry, small scale agriculture and food processing. Tourism development in this area would be of great importance to the Republic to overcome the problem of the high seasonality of coastal tourism and the related economic activities. The central region has considerable potential for the further development of services (transport, tourism, financial services) and some agriculture and food processing. The southern part, besides tourism, could benefit from further increases of transport services (shipping, ports, land transport, etc.). There is also the possibility for the recovery of fruit production.

Inflation

1.26 Montenegro's adoption of the DM and then the euro as the sole legal tender helped rein in inflation. With currency reforms, inflation dropped from 24.8 percent at the end of 2000 to 4.3 percent at the end of 2004. By the main components of the CPI, the prices of services grew much more than the other components (Figure 1.3). On the other hand, the prices of agricultural products have decelerated since 2004.

1.27 With the adoption of the euro as the official currency ("euroization"), the role of monetary policy has been severely curtailed. The Central Bank of Montenegro (CBM) can no longer engage in any active monetary policy. Its role has been limited mainly to the supervision of banks and the privatization of the remaining state banks. The latest estimate available of the currency in circulation as of January 2003, shows the amount of euro 250

Figure 1.3. Inflation by Major Component, 2000-2004



Source: Central Bank of Montenegro.

million.

Competitiveness

1.28 The evidence suggests that over the last four years Montenegro has become less competitive.

¹⁰To be sure, competitiveness is shaped by a number of factors, including: factor endowments; the country's infrastructure and support systems such as transport, energy, and communications as well as research and development; government policies and the regulatory environment; enterprise structure, strategy, and competition; demand conditions; and exogenous events. While these are ex ante determinants of competitiveness, ex post competitiveness can be measured in a variety of ways.

1.29 One of the most useful indicators of international competitiveness is movements in the real exchange rate based on unit labor costs. With the adoption of the euro as the official currency, Montenegro has by definition fixed its nominal exchange rate to the euro zone. Yet its real exchange rate—adjusted for differences in Montenegro's rate of inflation for the euro zone or its trading partners more generally—may have moved significantly. Montenegro's main exports are aluminum and tourism, and its main trading partners are the euro zone countries and Montenegro's main exports are aluminum and tourism, and its main trading partners are the euro zone countries and the United States. Its main imports are oil and oil derivatives, fuel, pharmaceutical products and electricity. For exports, the biggest trade partners of Montenegro, besides Serbia and Kosovo, are mainly EU countries (Italy, Greece, Cyprus, Hungary) and Switzerland. For imports, its biggest trade partners are countries in transition—Serbia, Croatia, Bosnia and Herzegovina—followed by European countries—Greece, Italy, Germany, Slovenia and Great Britain. Given that Montenegro's larger share of exports go to the EU countries and regional states, movements in the real exchange rate against the euro zone may be a reasonable index of Montenegro's competitiveness.

Table 1.1. Montenegro's Unit Labor Costs, 2000-2004

	2000	2001	2002	2003	2004
Nominal GDP, million euros	1022.2	1244.8	1301.5	1433.0*	1535.0*
GDP deflator	23.1	22	2.8	8	3.1
Annual real GDP growth rate	3.1	-0.2	1.7	2.3	3.7
Real GDP in 2000 prices, million euros	1022.2	1020.2	1037.5	1061.4	1100.7
Employment (official data), in thousands	140.8	141.1	140.1	142.7	143.5
Average monthly gross wage (official data), euros	150.9	176.2	251.3	271	302.6
Total wage fund, million euros	206.1	241.3	342.9	363.9	398.3
Labor compensation, million euros**	300	342	478	507	539
Unit labor costs***	0.293	0.335	0.461	0.478	0.491
Unit labor costs index 2000=100	100	114.3	157.3	163.1	167.6

* Estimated.

** Includes wages and salaries in cash and wages and salaries in kind as well as employers' social contributions.

*** Calculated as the ratio of compensation per employee to real GDP per employee.

Source: MONSTAT and World Bank staff calculations.

1.30 Table 1.1 shows the evolution of Montenegro's unit labor costs for the period 2000-2004. The rise in the ratio of Montenegro's unit labor costs relative to those of the euro zone or of the United States

¹⁰ It is important to note that Montenegro embarked on price liberalization, currency reforms, and trade reforms during 2000-2002. The implementation of these reforms could in part explain the surge in wages and unit labor costs experienced during this period. The choice of 2000 as the base year for measuring trends in competitiveness is thus not ideal, as it could give a more alarming loss of competitiveness than is the actual case. Yet, data availability constrains the use of any longer period.

weighted by the nominal exchange rate suggests that Montenegro has become less competitive over time. The fall in this ratio indicates improved competitiveness. These indices are given in Table 1.2.

Table 1.2. Montenegro's Competitiveness, 2000-2004¹¹

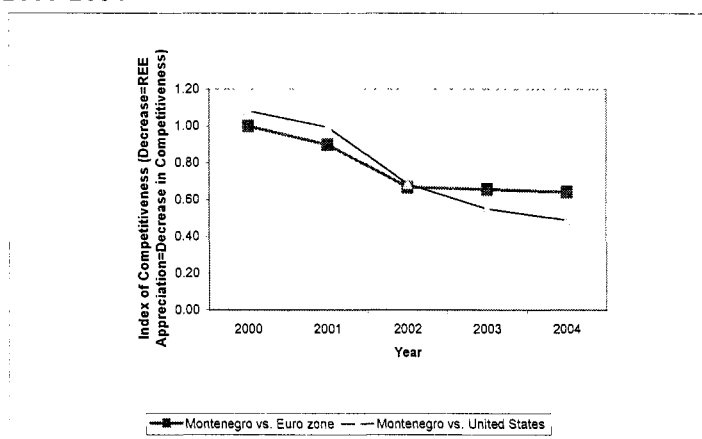
	2000	2001	2002	2003	2004
Nominal Exchange Rate (euro/ 1US\$)	1.0832	1.1171	1.0578	0.8838	0.8040
Unit Labor Cost Index (2000=100)					
Montenegro	100.0	114.3	157.3	163.1	167.6
Euro zone	100.0	102.8	105.0	107.1	107.6
United States	100.0	101.8	101.9	101.6	102.1
Index of Competitiveness					
Euro zone vs. United States	1.08	1.11	1.03	0.84	0.76
Montenegro vs. euro zone	1.00	0.90	0.67	0.66	0.64
Montenegro vs. United States	1.08	1.00	0.69	0.55	0.49

Note: Annual nominal exchange rate data between the US\$ and the euro are obtained from the Federal Reserve Statistics (Statistical Releases for January 3, 2005 and January 5, 2004). EU inflation (harmonized index of consumer prices, HICP) data are obtained from the European Central Bank ("Statistics Pocket Book, May 2004"). EU unit labor cost data are obtained from Eurostat ("Statistical Annex of European Economy").

Source: US unit labor cost and inflation data are from the US Bureau of Labor Statistics (www.bls.gov).

1.31 Calculations show that Montenegro's unit labor costs have risen much faster than those of the EU zone, thereby eroding its competitiveness (Figure 1.4). Total labor compensations have increased rapidly and are far ahead of labor productivity--by 12.3 percent only in 2004-- thus reducing the competitiveness of the Montenegrin economy. In addition, the presence of a relatively rigid labor regulation, which imposes additional costs, has contributed to the rapid increases in unit labor costs and appreciation of the real exchange rate against the euro zone. Montenegro's competitiveness has declined by an even greater magnitude against the U.S. economy, although USA is a minor trading partner of Montenegro, contributing only about 1 percent of the total foreign exchange earnings of the latter.

Figure 1.4. Trends in Montenegro's Competitiveness, 2000-2004



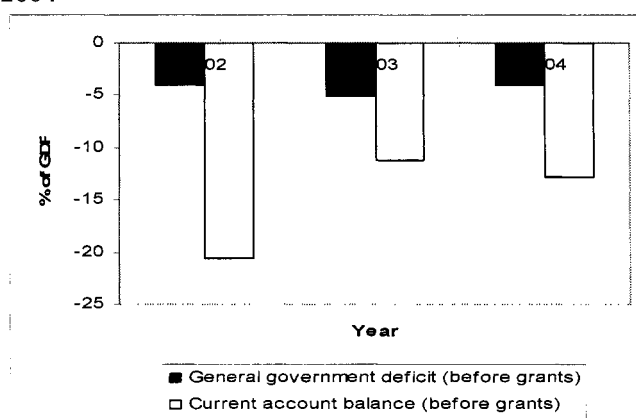
Source: Bank Staff calculations.

¹¹ Nominal exchange rate weighted by unit labor cost index. EU zone refers to the narrow definition, composed of 15 EU countries. All unit labor costs in the table refer to nominal unit labor costs, defined as the ratio of total labor compensation per employee to real GDP per employee. The decrease in the index of competitiveness means appreciation of the real exchange rate, and therefore a decline in competitiveness. To generate comparative trends, it is assumed that Montenegro adopted the euro since 2000 (although the actual adoption of euro came in 2002 and Montenegro was using the Deutsche Mark between 2000 and 2002).

Internal and External Balance

1.32 **One of the macroeconomic challenges facing Montenegro is that of maintaining sustainable internal and external balances.** Both the general government deficit and the current account deficit have remained high and unsustainable (at 4 percent and 12.8 percent in 2004, respectively) (Figure 1.5). Internally, loose fiscal policy characterized the early years of transition. Fiscal deficits before grants remained high at between 5 percent of GDP in 2001 and 3 percent in 2004. The high deficit was financed primarily through the huge inflow of foreign grants and concessional borrowing and through the domestic Treasury Bills market.¹² Expenditures on wages and social transfers not only constitute a significant proportion of public spending but are also much above average for the region. At the same time, the share of capital expenditures in total expenditures remained low. Also, arrears were accumulated in the central government accounts as well as in the social funds. Thus may be a need not only to reduce the overall public spending but also to shift public expenditure from current to capital expenditure (see Chapter 3).

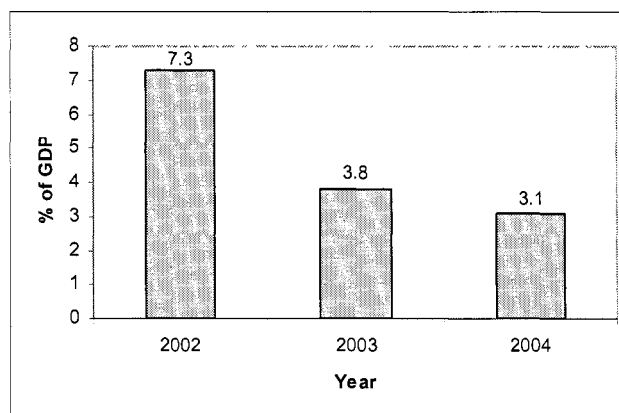
Figure 1.5. Fiscal and Current Account Deficits, 2002-2004



Source: Central Bank of Montenegro; IMF.

1.33 **Externally, the recorded current account deficit before grants¹³ has declined (from about 20 percent of GDP in 2002 to 12.8 percent in 2004), but it remains large.** Montenegro's merchandise exports are not diversified and remain largely dominated by the export of aluminum, which accounts for almost 50 percent of merchandise exports. Merchandise exports remained stable at about 25 percent of GDP in 2002 and 2004, while imports were reduced from about 57 percent of GDP in 2002 to about 53 percent in 2004. Recorded private remittances have almost doubled, from about 5 percent to about 9.5 percent, while net non-factor service receipts, which include mainly tourism receipts, have grown slightly.¹⁴ This resulted in a current account deficit before grants of 12.8 percent of GDP in 2004.

Figure 1.6. Official Grants to Montenegro, 2002-2004



Source: Central Bank of Montenegro.

1.34 **The financing of the high current account deficit has been made possible in part by the exceptionally high grants Montenegro received during the period.** Such grants, however, have

¹² Privatization revenues as source of financing deficit were low except in 2002.

¹³ Montenegro's Balance of Payments data prior to 2002 are unreliable. For 2002-04, imports are probably overestimated since a significant proportion is actually "exported" onwards to Serbia. Also some of the financing items in the capital account, such as the FDI data, may not be reliable.

¹⁴ Foreign trade statistics probably does not capture well the contributions of tourism to foreign exchange earnings.

progressively declined over time (from 7 percent of GDP in 2002 to about 3 percent in 2004) (see Figure 1.6), and are set to continue to decline further in the future.¹⁵ On the other hand, it is worrisome that foreign loans to Montenegro have been rising, from almost none in 2001 to about 7 percent of GDP in 2004. While it is not unusual for transition countries such as Montenegro to run a high current account deficit in view of low domestic savings and the current account deficit facilitating a capital replacement, there is a need for Montenegro to adjust to a lower current account deficit especially in view of the declining grants and rising loans and debt service payments. Furthermore, in the case of Montenegro, the high current account deficit has led to a high private sector foreign borrowing to finance it. This puts an even greater importance for a strong Central Bank banking supervision and monitoring to ensure sustainable financial sector development.

1.35 With euroization, such adjustment to a lower current account deficit will necessitate either domestic demand restraint through a prudent fiscal policy and/or the expansion of exports. Fiscal policy is discussed in detail in Chapter 3; opportunities for export expansion through tourism development are discussed in Chapter 5.

1.36 Montenegro is expected to receive substantially higher than expected privatization revenue in 2005. The government currently expects proceeds of €165-180 million in 2005. For fiscal sustainability and macroeconomic stability, it will be extremely important that the receipts are used to reduce the domestic debt (i.e. retiring the debt to domestic banks and amortizing T-bills falling due in 2005) and build up reserves instead of increasing deficit spending. Additional public investment spending is best considered after a strong macroeconomic and fiscal performance has been established.

Debt Position

1.37 Montenegro began its transition as a moderately indebted republic. The restructuring of debt toward the Paris club and bilateral donors and IFIs in 2001 helped improve the external debt position of SAM. With most of the debts of SAM currently being allocated between Serbia and Montenegro, the external debt of Montenegro is becoming clearer. At the end of 2004, the total debt stood at 31.8 percent of GDP, down from 32.2 percent of GDP in 2003. (Table 1.3). Although there has been a rise in the absolute amount of borrowing since 2000, foreign borrowing as a ratio of GDP records relative actually slightly fell. With an expected debt write-off to Montenegro of some 26 million euros by the Paris Club creditors by end-2005, the debt position could further improve.

Table 1.3. Total Public Debt of Montenegro, 2002 – 2005 (% GDP)

	2002	2003	2004	2005*
Domestic debt	19.6	17.4	16.6	11.6
Foreign debt	68.7	32.2	31.8	30.9
Total public debt	88.3	49.6	48.4	42.5
Memo: GDP (million euros)	1,301	1,433	1,535	1,644

* Data for 2005 cover only through end-September 2005.

Source: Montenegrin Ministry of Finance.

1.38 The total public debt –inclusive both of foreign and domestic debt—stood at about 48 percent of GDP as of end-2004. Total public debt includes debt for the repayment of Frozen Foreign Currency Deposits (FFCDs) whose repayment deadline is 2017; debt toward commercial banks; T-bills

¹⁵ USAID, Montenegro's main donor, expects its assistance to Montenegro to be lower in the next five years compared to the past five years. The World Bank's Country Assistance Strategy for Serbia and Montenegro envisages about US\$ 50 million in program and project aid to Montenegro over the next three years.

debt and other debts on behalf of Government institutions or for which guarantees were issued; local governments' debt; budget liabilities or arrears; and foreign debt. Of this, domestic public debt accounted for about 20 percent at end-2004 (or under 10 percent of GDP) (see Table 1.4). Total outstanding FFCDs as at end-2004 stood at about 8 percent of GDP (123 million euros). Debt outstanding for issued treasury bills at end-2004 was about 2 percent of GDP (37.4 million euros), while as of end-Sept 2005 it was decreased to 12.5 million euros (less than 1 percent of GDP). Budget liabilities or arrears have been reduced from some 100 million euros in 2002 to 61.8 million euros by end-2004. The repayment plan suggests that the Government will need to allocate between 1.5 and 2 percent (21 and 33 million euros for debt service) each year over the next six years. Montenegro has shown a lot of progress in containing public debt in recent years, but further control through clearance of the Treasury bill debt and arrears, the buy back of FFCDs, and controlled external borrowing would be necessary to ensure debt sustainability and macroeconomic stability.

Table 1.4. Domestic Debt of Montenegro, 2002-2005 (in million euros)

	2002	2003	2004	2005*
Credits	18.2	19.5	8.9	1.45
T-bills	9.8	19.7	37.4	12.5
FFCDs	127	127	123	118
Budget Liabilities/ Arrears	100.6	83.5	61.8	35
Local Government Debt	0	0	23	23
Total Domestic Debt	255.6	249.7	254.1	154.95
Domestic Debt (% GDP)	19.65	17.42	16.55	11.6
Memo: GDP (in million euros)	1,301	1,433	1,535	1,644

* Data for 2005 cover only through end-September 2005.

Source: Montenegrin Ministry of Finance.

Poverty and Social Welfare

1.39 With only limited economic recovery in Montenegro over the last four years, living standards remain low relative to historical standards. With only a modest average GDP growth of about 2 percent per year over 2000-2004, and with jobless growth, unemployment has remained high. According to the official poverty line for 2003,¹⁶ about 12 percent of the citizens of Montenegro fell below the consumption poverty line. Consumption distribution is highly concentrated around the poverty line, and about 25 percent of the population has a consumption level that is less than 50 percent above the poverty line.¹⁷ This suggests that even small economic shocks can have potentially large effects on poverty. Conversely, a sustained economic growth is likely to result in a disproportional decline in poverty.

1.40 There are significant differences in living standards among the different regions of Montenegro. Generally, the poverty rate in the northern region is twice that in the central and southern regions (14.9 percent in the north versus 6.5 percent and 6.8 percent in the central and southern regions, respectively). Relative to the national average, a larger percentage of households in the north receives social assistance (4.9 percent versus 3.9 percent for the national average) and private transfers (23.3 percent versus 19.3 percent for the national average).

¹⁶ According to the Poverty Reduction Strategy Paper of the Government of Montenegro, the official poverty line for 2003 stood at 116.2 euros per person per month.

¹⁷ See World Bank, 2003, Serbia and Montenegro Public Expenditure and Institutional Review, Volume 3: Montenegro.

Table 1.5. Montenegro's Human Development Index, 2000-2003

	2000	2001	2002	2003
Life expectancy at birth (years)	73.4	73.4	73.0	73.1
Adult literacy rate (%)	94.9	94.9	94.9	94.9
Combined primary, secondary and tertiary gross enrollment ratio (%)	75.28	72.61	73.4	75.19
Overall human development index (HDI)	0.760	0.766	0.773	0.789

Source: ISSP and UNDP.

1.41 **In the broader dimensions of welfare, Montenegro has fared relatively well** (Table 1.4). Life expectancy, at 73 years, has remained stable over the last four years. The level of educational attainment is generally high. The adult literacy rate stands at about 95 percent, and only about 5 percent of the population aged 16-24 is not in school or does not attend secondary school (Serbia and Montenegro Poverty Assessment, 2003). According to the population census of 2003, the number of illiterate population in Montenegro is only about 2.5 percent. Combined primary, secondary and tertiary gross enrollment stands at about 75 percent and has not changed much over the last four years. An overall human development index (HDI), recently calculated for Montenegro by ISSP and the UNDP,¹⁸ shows that it has slowly improved. An international comparison of such indices shows that Montenegro falls in the middle group in the HDI (between 0.5 and 0.8), with a level of development similar to those in Bulgaria, Russia, Macedonia, Albania, Bosnia and Herzegovina and Romania.

D. THE CHALLENGES AHEAD: INCREASING GROWTH AND COMPETITIVENESS

1.42 **Montenegro's macroeconomic and structural reforms, pursued since the late 1990s, have yielded modest economic recovery and transition.** Real GDP grew by an average of about 2 percent per year over 2000-2004; inflation dropped from 24.8 percent at the end of 2000 to 4.3 percent at the end of 2004; Montenegro's consolidated budget deficit was reduced from about 8 percent of republican GDP in 2000 to about 3 percent in 2004; its current account deficit, although still high, is improving; and, its principal human welfare indicators such as poverty, life expectancy, and adult literacy have remained moderate and stable.

1.43 **Yet, Montenegro needs to move to a higher growth path if it is to achieve a higher standard of living for its citizens.** The Montenegrin economy grew by an average of only 1.8 percent per year between 2000 and 2004. With an average annual population growth rate of about 0.5 percent per year, the per capita income grew by only about 1.3 percent per year. As demonstrated earlier, the country's competitiveness, too, has declined over the last four years.

1.44 **The key question, then, is why growth and competitiveness have been weak and what can the Government do to increase them?** According to a simple growth model¹⁹ in which low growth could be due to three principal factors—low social returns, low private appropriability, and the high cost of finance, or a combination of any of these—the low social returns could be due to lack of macroeconomic stability, or to lack of investment in complementary factors of production (human capital, technical know-how, infrastructure, or poor geography). Private appropriability could be reduced for a variety of reasons, including poor public administration, high regulation and poor property rights and contract enforcement, as well as the high costs of factor inputs.

¹⁸ The HDI has been calculated by the UNDP and ISSP, and takes into account average life expectancy, literacy rate, and GDP per capita based on purchasing power parity (as a proxy for the living standard).

¹⁹ See Rodrik, Hausmann and Velasco (2004). This model has recently been used as a framework to look into country-specific constraints to growth in a select set of client countries of the World Bank.

1.45 **Although Montenegro has shown considerable progress in attaining macroeconomic stability (inflation is single digit, and the twin deficits have been reduced), there are still concerns about its high fiscal and current account deficits.** Unless these deficits are addressed, they could pose a risk to continued macroeconomic stability and could also reduce social returns. Adjustment to a lower current account and to fiscal deficits is necessary, especially in view of declining foreign grants. On the other hand, there is no strong reason to believe that lack of growth has been due to insufficient investment in complementary factors of production (human capital, technical know-how, infrastructure, or poor geography). Montenegro enjoys a unique geographic location, being on the coast of the Adriatic Sea, with easy connections to the regional states as well as Western Europe. The labor force is relatively well educated, and there is a reasonable pool of skilled labor. Although investment in infrastructure (particularly in water supply and solid waste management in the coastal areas) may be critical for tourism development, the Republic enjoys a decent infrastructure.

1.46 **Private appropriability of returns to investment in Montenegro seems to be low for several reasons.** Although taxation is among the lowest in the region (especially after the recent tax reforms), the following factors also serve to reduce the private appropriability of the returns to private investment: (i) the high regulatory burden and poor public administration, as well as corruption and lack of transparency; (ii) poor property rights and contract enforcement; and (iii) labor-capital conflicts, including the high burden imposed on capital (employers) by the labor law and the collective bargaining agreements, and the labor unions in wage negotiations.

1.47 *Montenegro's high regulatory burden and poor public administration and institutional capacity* are manifested by the presence of a large informal sector on the one hand, and a high bureaucracy and a considerable presence of discretion and corruption in regulations and the enforcement of rules on the other. Its *poor property rights and contract enforcement* are manifested by the existence of an "implementation gap" for business-related laws such as mortgage law, restitution law, bankruptcy law, and company law, and by the lack of a speedy resolution of commercial disputes by courts. While significant progress has been made with regard to reforming and improving the legal and regulatory framework as it affects the private sector, there has been weak implementation of these laws. The lack of effective land registration and administration in the coastal areas is a clear example of poor property rights. The presence of *labor-capital conflicts* is evident in the still high costs imposed by the labor law and the new collective bargaining agreements, although the recent changes to the labor law were steps in the right direction (see Chapter 2).

1.48 **The cost of finance in Montenegro is high and the economy seems credit-constrained.** The nominal lending rates are very high, in the range of 15-20 percent. With inflation ranging between 3 and 7 percent in recent years, the real interest rate has ranged between 10 and 15 percent. The Republican Development Fund, and the Employment Fund of Montenegro lend funds to SMEs at subsidized interest rates (4-10 percent), but they are relatively marginal in terms of their share in private sector credit. Given Montenegro's limited opportunities in Greenfield investments, most investors would be hard pressed to find a project whose real rate of return would exceed 10-15 percent.

1.49 **Several factors may explain the high cost of finance in the economy.** Montenegro's national savings are low, but household savings with the banking sector have increased in recent years. Several other non-savings factors may be responsible for the high costs of finance and the poor financial intermediation. First, because of relatively high demands for credit by the public sector for deficit financing, the Treasury bills market actively competes for banking sector funds which could otherwise be directed to the private sector. The Treasury bills rate is high, between 8 and 12 percent.²⁰ The

²⁰ The T-bills rate has been significantly reduced in 2005—to less than 5%—as government cleared some of its domestic debt using the large privatization revenue.

Government's fiscal policy, in particular the control of domestic financing, is therefore one key factor in the poor financial sector intermediation and high real interest rates. Second, although Montenegro has made progress in recent years in terms of banking sector reforms, the banking sector is not competitive. Most of the banks are still either majority owned by the Government, or indirectly owned by the social funds (Pensions Fund, Health Fund). The banking services for the Government and for the main state-owned entities such as the KAP, EPCG are concentrated at a handful of banks. Therefore, the competition exists mainly in theory, rather than in practice. Finally, there is a high spread between the deposit and lending rates of commercial banks because of the high risks associated with collaterals, loan recovery and liquidity problems, the high administrative costs of commercial banks, and the very small size of the Montenegrin market.

1.50 The above cursory examination of Montenegro's economy would lead to five hypotheses on the binding constraints to growth in Montenegro:

- *Fiscal policy and the composition of expenditures:* Although significant progress has been made towards macroeconomic stability, the large current account deficit, coupled with euroization and falling aid flows (in particular grants), threatens macroeconomic stability and growth (i.e., low social returns). Furthermore, it is not clear whether the composition of fiscal expenditures is supportive of growth or whether there is a need for reallocation towards capital and infrastructure investments.
- *High regulatory burden and poor administrative and institutional capacity:* Despite reforms, corruption and inefficiency reduce investment and increase the informal economy (i.e., low private appropriability of social returns).
- *Poor property rights and contract enforcement* as manifested by the existence of an "implementation gap" for business-related laws such as mortgage law, restitution law, bankruptcy law, company law, and the lack of speedy resolution of commercial disputes by courts limit private investment and growth (i.e., low private appropriability).
- *The high cost of finance and poor financial intermediation,* as manifested by high real interest rates ranging between 10 and 15 percent and low credit to the private sector, has limited private investment and growth (i.e., low private appropriability).
- *Poor labor market conditions,* including the rapid real wage growth witnessed in recent years, and the high costs imposed by the labor law (despite recent improvements) and the new collective bargaining agreements, and the lack of labor market flexibility, have limited private investment and growth (i.e., low private appropriability).

1.51 How do these growth hypotheses relate to competitiveness? With a sound fiscal policy and continued macroeconomic stability, a further loss in competitiveness could be avoided by moderating wage increases in line with productivity growth. Furthermore, public expenditure reallocation towards infrastructure and capital investment could reduce the costs of doing business for the private sector by supplying public goods which are complementary to private investment. Poor administrative and institutional capacity increases the effective cost of doing business and may, by encouraging informal sector activities, undercut the competitiveness of firms in the formal economy. Conversely, cutting red tape for importers and exporters, and serving their needs through building strong institutions and a competent bureaucracy, can help promote the competitiveness of firms. Similarly, improving access to credit and reducing the cost of capital and labor would be important to increase the competitiveness of companies and businesses.

1.52 **The rest of this report examines these hypotheses with greater scrutiny of the Montenegrin data.** In Chapter 2 we take an in-depth look at Montenegro's labor market and its main characteristics, the extent to which the areas in which the labor law continues to be restrictive (despite recent improvements), and we examine whether the collective bargaining and social dialogue are supportive of growth and private sector employment creation. In Chapter 3 we examine Montenegro's fiscal policy, including whether the fiscal position is sustainable and whether the current level and structure of spending are supportive of growth, and what reallocation may be needed, if any, to support growth and competitiveness. In Chapter 4 we examine the extent to which poor administrative and institutional capacity, poor property rights and contract enforcement, and the high cost of capital and low financial intermediation are holding back growth and competitiveness in Montenegro. These are treated under the theme of constraints to private sector investment, growth and competitiveness. In Chapter 5 we use tourism as a case study to illustrate Montenegro's challenges of competitiveness and growth in practice.

2. LABOR MARKET REFORM FOR GROWTH AND COMPETITIVENESS

2.1 Montenegro has had high unemployment rates throughout the past decade— over 20 percent. This is mainly because to date very few employment opportunities have been created in the emerging private sector. Owing to the low demand for labor, a significant share of the able-bodied population is “forced” to stay out of the labor markets. The lack of demand for labor in turn stems from a business environment which is not conducive to investment and job creation, and from the impact of current labor regulations, which hinder private sector activity and encourage informality (see Chapter 4 on private sector development). Government policies that would send people back to work, including the promotion of private investment as well as further improvement to the labor market regulations, would significantly help the growth and competitiveness of the economy.

2.2 During 2000-2004, Montenegro’s real wage grew by much more than the productivity growth, thereby undermining the growth and competitiveness of the economy. The prime source of productivity growth is technological change, but sources of productivity growth also depend on macroeconomic institutions and regulatory factors. Since 2000, the Montenegrin economy has experienced a cumulative labor productivity growth of 18.2 percent (2000-2004).²¹ That productivity growth has derived largely from a reduction in the degree of underemployment among workers who are primarily within Montenegro’s formal sector, associated with enterprise restructuring and privatization. On the other hand, average net earnings doubled (growing by 103 percent) between 2000 and 2004. The rapid increases in labor costs in the last few years have reduced competitiveness, growth, and employment.²²

2.3 Montenegro’s labor market is characterized by a relatively high level of job protection and rigidity, a high degree of unemployment, and a high share of employment in the informal sector. The legacy of the “self-management” system for enterprises has, to a large extent, shaped the high level of job protection and the overall rigidity present in the economy. Although the 2003 reform of the Labor Law made dismissal procedures less complex and less costly (for example, minimum severance payments were reduced from an extremely high 24 months’ wages to 6 months’ wages), firing procedures are still fairly inflexible and costly. Second, unlike many other socialist countries, the former Yugoslavia had open unemployment as early as in the 1960s which increased even further during the turbulent mid-1980s and 1990s. Finally, during the 1990s, informal employment was tolerated by the Government since it was one of the key survival strategies. About one-third of total employment is estimated to be in the informal economy, which in turn has reduced the Government’s ability to collect various tax and social insurance revenues.

²¹ Labor productivity is calculated using the employment data from annual labor force surveys as a proxy for employment dynamics, and the reported real GDP growth rates.

²² In the short term, productivity and employment stand in inverse relation to one another.

A. KEY CHARACTERISTICS OF THE LABOR MARKET

*Participation and Employment*²³

2.4 **The labor supply in Montenegro is affected by many demographic factors, including the still relatively high fertility rates.** In 2002, the total fertility rate in the Republic equaled 1.66, which is high compared to other transition countries, excluding the Central Asian states. In the coming years the number of new labor market entrants will have a significant impact on the labor supply.

2.5 **Despite the growth in the working age population, the labor force has not increased, which suggests that the more able-bodied population is becoming inactive** (see Table 2.1).²⁴ In the next five years, around 25,000 people will leave the working age bracket but the number of new entrants the reaching working age will be around 44,000. The country also has relatively modest old-age dependency burdens among the Central and Eastern European transition countries: the population share of those 65 years and older is only around 12 percent of the total population. The labor supply is also affected by the recent inflow of refugees from the neighboring countries, although the number of refugees is rapidly declining. At one time (January 1993), over 64,000 refugees were living temporarily in Montenegro. By the latest estimates (September 2004), 8,474 refugees and 18,047 IDPs were still registered in Montenegro.²⁵

Table 2.1. Labor Force Growth and Employment-to-Population Ratios, Transition Economies

	Annual labor force growth rate (%)	Employment-to-population ratio (%)
	1998-2003	2003
Transition economies	0.7	53.5
Central and Eastern Europe	0.4	49.1
Montenegro*	0.0	40.6
Baltic States	-1.1	50.8
Commonwealth of Independent States	0.9	55.6

* - MONSTAT: Labor Force Survey Data.

Source: ILO 2004.

2.6 **Montenegro's labor force participation rate, defined as the share of employed and unemployed in the total working age population, also remains among the lowest in the region** (Table 2.2). According to the 2004 Labor Force Survey, about 52 percent of the population at age 15 years and older are economically active but the relatively high participation rate masks the high unemployment rate among the able-bodied population. By age group, youth (especially young females) have the lowest participation and employment rates, more than four times below the average employment rate for EU-15 countries. More than half of the youth of age 15-24 in the labor force are unemployed.

²³ Montenegro has several sources of labor market data: first, the official data of MONSTAT on employment and unemployment derived from the labor force survey conducted regularly in October each year; second, the registered unemployment data published regularly by the Employment Service; third, the household survey data which are collected, published and analyzed regularly by the ISSP. For analytical purposes, the labor force survey data (ILO methodology) tend to be the most reliable source of labor market information.

²⁴ By the labor force survey data, there were 180,400 employed and 50,700 unemployed individuals in 1998, and 187,300 employed and 71,800 unemployed individuals in 2004.

²⁵ UNDP (2004). Household Survey of Roma, Ashkelia and Egyptians, Refugees and Internally Displaced Persons. Podgorica; Government of Montenegro (2005). Strategy for permanent solution of refugees and IDPs issue in Montenegro. Podgorica.

Table 2.2. Employment/Population Ratios, Participation, and Unemployment Rates in 2003-04

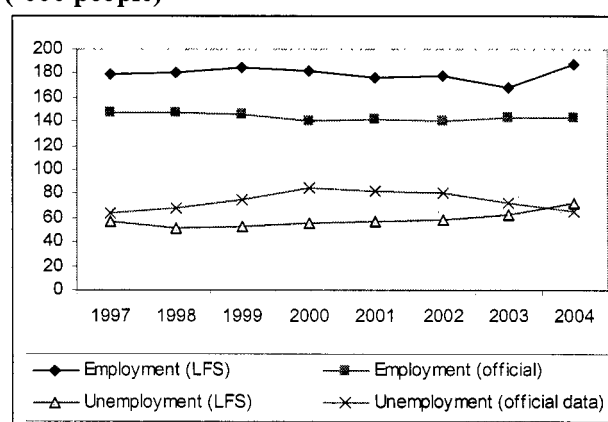
Age	Montenegro	Serbia	Macedonia	Czech			Slovakia	EU-15	OECD
				Hungary	Republic	Poland			
		LFS 2004	2003						
Employment/Population ratios									
15-64	40.6	53.5	38.5	57.0	64.9	51.4	57.7	64.8	65.0
15-24	10.3	18.6	12.1	26.7	31.4	19.6	27.6	42.6	43.6
25-54	56.6	68.2	50.7	73.7	81.7	67.6	76.0	76.9	75.1
55-64	20.6	38.1	28.5	29.0	42.3	28.6	24.6	42.3	50.8
Labor force participation rates									
15-64	65.1	66.6	61.3	60.0	70.4	64.2	70.0	70.3	69.8
15-24	34.1	36.3	35.3	30.8	38.1	34.4	41.2	50.0	50.3
25-54	82.6	82.4	76.4	77.8	87.8	81.7	89.5	82.6	79.9
55-64	40.0	42.0	35.8	29.8	44.2	32.2	28.5	44.9	53.4
Unemployment rates									
15-64	23.0	19.5	37.1	5.9	7.8	20.0	17.6	7.8	6.9
15-24	51.5	48.8	65.7	13.4	17.6	43.0	33.1	14.7	13.3
25-54	20.1	17.2	33.7	5.3	7.0	17.3	15.1	7.0	6.0
55-64	8.1	9.3	20.5	2.8	4.4	11.2	13.6	5.7	4.7

Source: OECD Employment Outlook 2004. Paris, Serbia and Montenegro: MONSTAT. Labor Force Survey data.

2.7 As a result, Montenegro has the lowest overall employment rate in the region, with only about 40.6 percent of Montenegro's working age population being employed. Limited job opportunities in Montenegro have led to discouragement and massive labor force withdrawal, especially among younger and older cohorts as well as women. The combined effect of unemployment and labor force withdrawal was a substantial fall in the employment to population ratio: out of an aged 15-64 working age population of 413,000 (by the 2003 population census data), only 167,700, or around 40.6 percent of the total, are employed. The average employment rate of the able-bodied population for the transition economies is 53.5 percent, (Table 2.1). The existence of high unemployment not only translates into higher poverty and lower economic growth but also indicates the low ability of the Montenegrin economy to create jobs.

2.8 According to the Labor Force Survey data, employment has declined in Montenegro since 1999 (Figure 2.1). This is another indication that for various reasons discussed below, the economy is not generating jobs. In the last four years (2000-2004) the elasticity of employment with respect to output in Montenegro was negative of -1.30, i.e. each percent of output growth resulted in 1.3 percent of employment cut, indicating that the job

Figure 2.1. Trends in Employment and Unemployment in Montenegro, 1997-2004
(‘000 people)



*LFS=Labor Force Survey Data.

Source: MONSTAT; Labor Force Survey data; ISSP 2004.

market has not responded to economic growth and in that fact we have the phenomenon of “job-loss economic growth.”²⁶ GDP growth is thus largely due to a labor productivity growth attributed to enterprise adjustment and restructuring (Table 2.3). Jobless growth is quite widespread in CEE and SEE countries, although there seem to be some exceptions such as Hungary (which experienced only one year of jobless growth), the Czech Republic (which experienced two episodes of more than 3 percent growth with modest job destruction) and the Slovak Republic. According to the preliminary 2004 labor force survey data, employment at age 15 years and over has rebounded to 187,300 individuals.

Table 2.3. GDP Growth and Employment Dynamics, 2000-2004

	Actual			Estimate	
	2000	2001	2002	2003	2004
GDP, million euro	1022.2	1244.8	1301.5	1433.0	1535.0
GDP, real growth rate	3.1	-0.2	1.7	2.3	3.7
Employment LFS (thousands)	181.7	176.6	177.6	168.5	187.3
Employment dynamics (% of previous year)	-1.7	-2.8	0.6	-5.1	11.2
Labor productivity growth rate	8.1	2.2	5.3	6.0	0.3

Source: MONSTAT.

2.9 The public sector continues to be the main employer in the Montenegrin economy. From the 2003 labor force survey data, 59.2 percent of employment took place in the public sector (including in Government-provided public services, such as the civil service, the health and education sector, and social protection), 25.7 percent in the private sector, and 0.8 percent in firms of mixed ownership. By sector, agriculture, trade and tourism related services are the key employers in the economy. More than 64 percent of total employment is in the services sectors. Compared to other transition countries in the region, the share of self-employed in Montenegro is higher – 9.7 percent of total employment. In Hungary and Poland the share of self-employed was above 5 percent of total employment, while in Croatia the ratio was close to three percent (end-1990s; EBRD, 2000). The share of employment in SMEs, in contrast, is a low 20 percent out of the total employment. Therefore, large enterprises still dominate in the formal sector of the economy.

2.10 Flexible forms of employment (part-time and temporary work) are almost entirely absent in the Montenegrin economy (with some exception in the tourism sector). Only 2.0 percent of the employed had part-time jobs, indicating that there are constraints on part-time employment (see Section 2B). In comparison, in Poland 11.5 percent of jobs is part-time work, as are 16.6 percent in the EU-15 countries (Table 2.4).

²⁶ The employment elasticity (which shows the responsiveness of employment to economic growth) can be calculated by dividing the net new-job growth rate by the economic growth rate. The official GDP should be treated with caution. In particular, MONSTAT calculates only 8.8-9.8 percent of GDP as originating from the informal sector while other sources (ISSP, for example) estimate that at least 30 percent of GDP is produced in the informal sector.

Table 2.4. Incidence and Composition of Part-time Employment in 2003 (percent)

	Part-time employment as a proportion of employment			Women's share in part-time employment
	Total	Men	Women	
Montenegro	2.0	1.5	2.7	54.9
FYR Macedonia	5.7	5.2	6.5	45.5
Czech Republic	3.2	1.6	5.3	71.9
Hungary	3.5	2.1	5.1	69.0
Poland	11.5	7.1	16.8	66.2
Slovak Republic	2.3	1.3	3.6	69.1
EU-15	16.6	6.3	30.1	78.5

Source: OECD (2004); Montenegro: Labor Force Survey data. Data on Macedonia refers to age group 15-64 only.

Unemployment

2.11 Perhaps the most important characteristic of the Montenegrin labor market is its high unemployment rate. According to the 2003 Labor Force Survey data, 71,800 unemployed at age of 15 and over were registered, with the unemployment rate of 27.7 percent out of total labor force.²⁷ In April 2005, the Employment Agency had 58,000 registered unemployed on the roster, which is a 23.5 percent decline compared with the same period in 2003. Despite these positive developments in the last year, the unemployment rate in Montenegro remains well above the average for CEE countries, which in 2003 stood at 13.8 percent.

Table 2.5. Duration of Unemployment in Montenegro

Duration of unemployment	Employment Bureau data		Labor force survey data
	2000	2003	2003
Less than 6 months	12.0	26.6	7.6
6-9 months	6.2	5.1	0.9
9-12 months	7.1	3.7	7.0
1-3 years	25.1	18.0	21.4
3-5 years	16.2	12.3	23.0
5-8 years	14.0	12.3	16.8
More than 8 years	19.4	22.0	23.3
Total	100.0	100.0	100.0

Source: MONSTAT; Employment Bureau.

2.12 Montenegro's unemployment is of long-term duration, as more than one-fifth of the registered unemployed is in the roster for more than eight years (Table 2.5). About 85 percent of the registered unemployed are out of job for more than one year, and this is a much higher percentage than that for other regional countries and is almost twice the level for EU-15 countries (Figure 2.2). The skills and work habits of many of the long-term unemployed have eroded and to a large extent their reintegration into the labor market is complicated, at least without an upgrading of their human capital.

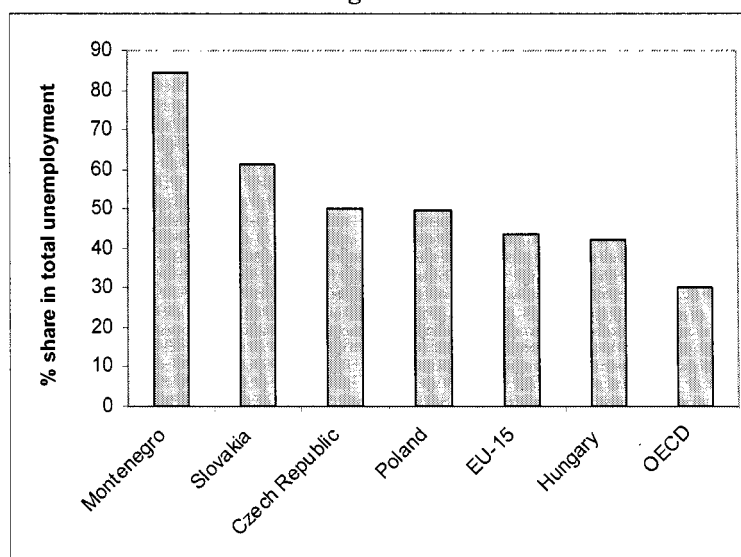
²⁷ In Montenegro, the registered unemployment is rather close to the actual number, due to incentives in the form of health and pension insurance entitlements provided to the registered unemployed. By the 2003 labor force survey data, more than 90 percent of the unemployed had registered themselves at the Employment Agency thus making themselves available to various employment services.

Long-term unemployment constitutes an additional burden on the social funds and the families of the affected. The persistence of high unemployment and growing under-employment even after more than a decade of economic growth is worrisome. For the reality of a rather stagnant unemployment pool with a high incidence of long-term unemployment is at odds with the idea of a rapid reallocation of workers across firms and sectors. Many households have turned to subsistence agriculture and petty trade, to stave off poverty, while jobs in the formal sector have continued to disappear.

2.13 As in other SEE and CEE countries, unemployment mainly affects the young (those below 25 years of age) and females. According to the 2003 Labor Force Survey, about 50 percent of those aged 15-24 years are unemployed (Table 2.2). International experience shows that low levels of youth employment and participation often reflect lengthy schooling and/or the high costs of hiring and firing.²⁸ New entrants in particular face more serious impediments in accessing employment than other groups of workers.

Almost two-thirds of the registered unemployed (66.4 percent) are first time job seekers, and one-quarter (23.4 percent) are youth at age 24 years and less; 52.7 percent of the registered unemployed in 2004 were females (in 2000 the share was 58.4 percent). In contrast, older workers have high recorded employment and participation rates, lower levels of unemployment, but very long durations of unemployment once they lose their jobs.

Figure 2.2. Long-term Unemployment in Montenegro Relative to Other Countries in the Region



Source: OECD 2004; MONSTAT: Labor Force Survey Data.

Wage and Productivity Dynamics

2.14 Despite high unemployment, Montenegro's average net earnings more than doubled between 2000 and 2004 (Table 2.6).²⁹ The average gross wage³⁰ increased from 150.9 euros in 2000 to 302.6 euros in 2004, while average net earnings increased from 96.4 euros to 195.3 euros over the same period. In 2004 alone, real wages increased by 12.3 percent.

²⁸ See Garibaldi and Mauro (1999).

²⁹ There are no officially reported statistics on wages, other than the household survey data. By the household survey data, there are only around 110,000 employed in the country (extrapolating the data from the survey to the whole country) (ISSP 2004). The surge in wages could have in part been due to price and trade liberalization, which occurred in 2000-2002 in Montenegro.

³⁰ Gross wage contains a significant share of non-wage (cash and in-kind) compensation on a non-taxable basis, established according to the General Collective Agreement. The most significant from the fiscal standpoint are food allowance and compensation for transportation, and seniority (age) premium and additional holidays associated with the service length of the employee. This shifts compensation away from wages to non-taxable incomes.

Table 2.6. The Dynamics of Average Wages in Montenegro, 2000-2004 (euros)

	Minimum wage	Average gross wage	Total contributions and taxes	Average net earnings **	Ratio of minimum wage to net earnings	Annual CPI, %	The dynamics of real net earnings, % 2000=100	Labor productivity, 2000=100
2000	37	150.9	55.5	96.4	38.4	36.1	100	100
2001	42	176.2	68.5	108.0	38.9	21.8	92.0	102.2
2002	50*	229.2**	87.1**	142.2**	...	16.8	103.7	107.9
2003	50	271.0	97.2	174.0	28.7	6.8	118.9	114.1
2004	50	302.6	107.5	195.3	25.6	3.2***	129.3	...

Note: Since the new Personal Income Tax Law was applied in July 2002 (the tax base was broadened to cover all payments to employees), MONSTAT has changed the methodology for calculating the average wage.

* Since July 2002. ** An average for 1-6/2002 to 7-12/2002, ISSP data. MONSTAT reported data on gross wage in 2002 was euro 251.3 *** Estimate by the Center for Entrepreneurship and Economic Development.

Source: ISSP 2004; MONSTAT.

2.15 The growth in net wage earnings has been much higher than that of many other countries in the region (Table 2.7) (with the exception of Serbia, where the data suggest that net monthly wages grew fourfold since 2000). Ultimately, wage growth must be compatible with productivity. If the wage increase is not justified by productivity, employment will fall until the resulting increase in unemployment exerts enough downward pressure on wages (see Layard, Nickell and Jackman, 1990; Gilles, 2004).

Table 2.7. Net Monthly Wages in Euros, 2000 and 2004

	2000	2004	Wage growth in 2000-2004, %	Gross National Income per capita, US\$
Albania	99.1	169.3	70.8	1740
Bosnia and Herzegovina	191.2	258.2	35.0	1540
Bulgaria	94.9	122.6	29.2	2130
Croatia	435.4	556.6	27.8	5350
Macedonia, FYR	172.4	201.0	16.6	1980
Montenegro	96.3	195.9	103.4	1910*
Romania	107.2	147.2	37.3	2310
Serbia	45.4	193.0	425.1	1910*

Notes: Albania – public sector wages only; Bosnia and Herzegovina – average in Republika Srpska and Federation of B&H; Bulgaria – data for 2004 are for Q4 only.

* Data for Serbia and Montenegro (excluding Kosovo).

Source: Bank calculations; GNI – World Bank Atlas 2004, Washington, DC.

2.16 Montenegro has one of the highest labor taxes among the transition countries. There are two alternative indicators of the wage tax burden: the non-wage labor cost and the tax wedge on the labor market.³¹ By our calculations, in 2004 the tax wedge—taking into consideration all the social contributions (pensions, health insurance and employment contribution, as well as fees and surtaxes established according to the General Collective Agreement, the Law on Communal Taxes and Compensations and other laws—is estimated at 52 percent of the labor costs.³² Non-wage labor costs

³¹ The non-wage labor cost is defined as the ratio between payroll taxes and gross wages. The tax wedge on labor is the difference between the labor cost to the employer and the take home pay (net wage) expressed as a percentage of total labor cost.

³² In 2005, this legal basis for compensation (tax) for the use of goods of common interests of 3 percent of gross wages was replaced by the Law on Local Self-Government Financing, which allows the municipalities to introduce a surtax of 13-15 percent of the calculated personal income tax.

were estimated in 2004 at 35 percent. In OECD countries, the total burden on the labor market is 51.8 percent among European member countries and 37.3 percent for non-European member countries, (ISSP, Montenegro Economic Trends, 2004).³³ Labor taxes lower the labor demand by raising labor costs. But they also lower labor supply by reducing the real consumption wage. The high wage tax burden has contributed to lower employment, higher informalization, and higher (long-term) unemployment.

2.17 Most recently, the Government of Montenegro has reduced the amount of tax and social contributions payable by employed persons, to stimulate employment creation and formalization. According to the Decree on Tax Relief for New Employees, from April 2003 to December 2004 all newly employed workers were registered under favorable conditions, which means that companies that, within a business year, will hire new employees for a contract of at least two years will be allowed to reduce their tax base by the amount of gross salaries paid to these employees, augmented by the employer's portion of the social contribution. By official estimates, this measure led to a shift of 30,000 jobs currently in the gray economy into the official economy and helped to create more than 5,000 new jobs (see Government of Montenegro, 2005).

2.18 In addition, the decree on Employment of Nonresident Persons, which established a relatively low "tax" of EUR 2.5 per day for employing non-residents, has resulted in the registration of around 50,000 nonresident workers and has made it possible to collect additional revenues of 1.7 million euros.³⁴ Local employers are interested in hiring foreign workers, especially for seasonal employment. For example, on average, the cost of labor for construction workers from Serbia and the Republic of Srpska is 20-30 percent less than that of Montenegrin workers because of lower taxes for non-resident persons and lower bargaining power.

2.19 Still, Montenegro's new General Collective Agreement imposes additional non-wage (cash and in-kind) and non-taxable costs to employers,³⁵ thereby effectively preserving some of the rigidities removed through reforming the labor law in recent years. Compared to the previous 1995 Collective Agreement, the 2003 Agreement expanded the list of supplementary benefits, which has significant fiscal cost implications for all employers including the Government. In particular, the housing allowance and the collective insurance of employees were added to the already extensive list of additional benefits to workers (see Table 2.11). Among other benefits, an employee is entitled to paid absence from work in the course of a calendar year of up to 7 days for various family events, allowances for annual leave, transport and meals, seniority (wage) premiums, and additional annual leave for years of service. In addition, employers have to pay 0.7 percent of gross earnings to the Housing Fund for employees (see Table 2.9). This will significantly increase non-wage labor costs, which are especially burdensome for SMEs.

³³ In addition to personal income tax, PIO contribution and contribution to the Health Fund, the employees have to pay from their wages also unemployment contribution, 0.5 percent of gross wages; the employers, in addition to the PIO contribution and the contribution to the Health Fund, have to pay an unemployment contribution 0.5 percent of gross wages; fee to the Chamber of Commerce - 0.32 percent of gross wages; fee to the Confederation of Independent Trade Unions - 0.20 percent of gross wages; payment to the housing fund for employees - 0.7 percent of gross wages; compensation for use of public goods - 3.0 percent of gross wages (replaced in 2005 by 13-15 percent of personal income tax (PIT); meal allowance 50 percent of the minimum wage (EUR 25), and transport allowance 25 percent of the price of gasoline per km. (See Table 4.15 for details.)

³⁴ The actual result might be slightly lower due to the double-counting of non-residents changing work places and asking for new work permits.

³⁵ The most recent General Collective Agreement was signed by the Chairmen of the Council of Union of Independent Trade Unions of Montenegro and Managing Board of the Chamber of Commerce of Montenegro, and the Prime Minister of the Republic of Montenegro on December 19, 2003.

2.20 The minimum wage is moderate and in late 2004 equaled 50 euros per month, or around 17 percent of the average gross wage (Table 2.6). However, the 2003 General Collective Agreement increased the minimum wage coefficients depending on a person's education and qualifications. For employees with a university or higher education degree, the minimum wage is set at 165 euros, or a high 54 percent of the average wage. This may have an impact on employers' hiring decisions, especially regarding new entrants with a higher education. Empirical evidence indicates that the minimum wage set at a moderate level usually does not have a substantial dis-employment effect, but at the same time it has only a limited and often transitory impact on the earnings of low-wage workers.

B. HOW RESTRICTIVE ARE THE LABOR REGULATIONS?

2.21 A flexible (adaptable) labor market facilitates economic restructuring, promotes productivity growth and competitiveness, and helps the economy adjust to supply and demand shocks. Employment protection legislations (EPLs), especially on hiring and termination, are often hotly debated for good reasons. On the one hand, they define the job security of workers and as such are very important; on the other hand, they typically make it harder for certain groups, including women and displaced older workers, to enter or re-enter the labor market. They also strengthen labor market "insiders," and increase long-term unemployment. In addition, by discouraging hiring and firing, EPLs may slow down adjustment to shocks and impede the reallocation of labor, with potentially significant efficiency losses. Recent studies also indicate that greater flexibility in the host country's labor market relative to that in the investor's home country is associated with larger foreign direct investment flows.³⁶

2.22 In Montenegro, the general framework of labor regulations is determined by the Labor Law of 2003 (as amended in 2004), and the General Collective Agreement of 2003, which applies to employees with an employer headquartered in the Republic of Montenegro, employees sent by an employer to work abroad, public officials and employees in public administration bodies, and local self-government units—i.e., to all hired employees. The social protection of the unemployed and the provision of employment services are regulated by the Law on Terms and Conditions of Employment, approved in 2003.

2.23 Montenegro's current labor regulations, although significantly improved in 2003, still hinder the efficient reallocation of labor and provide incentives for informality. The Government improved the labor regulations significantly through the 2003 key amendments to these regulations, but the Labor Law continues to over-regulate employment relations and discourage hiring. The Law is still highly directive and prescriptive. It reaches into the direct relationship between the employee and the employer – even prescribing the scope and nature of the disciplinary action that an employer may take when an employee transgresses (USAID, 2004). This has contributed to a stagnant formal sector labor market, with high unemployment and limited opportunities for new entrants, and a large informal sector. Thus, it has also hampered the required labor reallocation, thereby wasting a potential for economic growth.

2.24 The share of undeclared work in Montenegro is estimated by the Institute for Strategic Studies and Prognoses (ISSP) as at least at 30 percent of GDP and is among the highest in the region (Table 2.8). The recent EU report shows that former socialist economies with the most protective labor laws and the most rigid labor policies also have the highest level of shadow economy/undeclared work. Conversely, it shows that economies with liberal labor regimes have low levels of undeclared work. When there are fewer job opportunities in the formal sector, inequality often rises as people turn to the informal sector, which offers lower pay and no health insurance or social benefits.

³⁶ See Javorcik, Beata and Mariana Spatareanu. Do Foreign Investors Care About Labor Market Regulations? World Bank Policy Research Working Paper 3275. April 2004.

Table 2.8. Undeclared Work in CEE and Baltic States and in EU Member States (pre- May 1, 2004)*

CEE States and Baltic States	% of GDP	EU Member States (pre-May 2004)	% of GDP
Montenegro**	30	Austria	1.5
Bulgaria	22-30	Belgium	3
Czech Republic	9-10	Denmark	5.5
Estonia	8-9	Finland	4.2
Hungary	18	France	6.5
Latvia	18	Germany	6
Lithuania	15-19	Greece	20+
Poland	14	Italy	17
Romania	21	Netherlands	2
Slovak Republic	13-15	Portugal	5
Slovenia	17	Sweden	3
		UK	2

Source: European Commission 2004. * Undeclared work is defined as “productive activities that are lawful as regards to their nature, but are not declared to the public authorities, taking into account the differences in the regulatory system between Member States.” European Commission 2004. **ISSP 2004.

2.25 Employment protection measures refer to hiring and firing arrangements, and can be thought of as distributed on a continuum of rigidity/flexibility. These measures include the kinds of contracts that are allowed, the conditions under which contracts can be terminated, occupational standards, and rules for mass layoffs (Betcherman et al. 2001). They include hiring procedures, probation, fixed-term employment relationships, the supplying of labor by third parties, so-called atypical employment relationships, and last but certainly not least, termination of employment and protection against unjustified dismissal. A labor market with strict rules to protect job security – for example, with rules that restrict nonstandard forms of employment -- has more stable jobs but also more long-term unemployment and non-participation than labor markets without these protections.

2.26 The present Labor Law places obstacles in the way of employing persons for fixed-term, second or third jobs and places restrictions on the type of work that can be considered “temporary work.” Fixed-term employment contracts, currently limited to a set of pre-determined activities, could be useful for expanding employment in certain sectors, occupations and activities. According to the Law, employers have to involve the Employment Fund when recruiting or selecting employees. If these very strict regulations were enforced they would protect jobs for incumbent employees while limiting opportunities for the unemployed and new entrants (e.g., youth, women re-entering the labor market).

2.27 The Labor Law still imposes a very rigid regime of working hours. Full working hours should amount to 40 hours per working week, and overtime is allowed only in exceptional cases associated with earthquakes, floods, fires, etc., but may not surpass 10 hours per week. Requirements to notify the Labor Inspectorate of overtime working, and to take annual leave in a specific way, are outdated and unnecessary.

Table 2.9. Comparison of Additional Benefits to Workers Provided by the 1995 and 2003 General Collective Agreement (GCA)

Benefits	GCA, 1995	GCA, 2003 (based on current basic minimum wage levels)
Allowance for annual leave	3 minimum wages	3 minimum wages (€150)
Retirement of workers	6 minimum wages	6 minimum wages (€ 300)
Compensation for work stoppage If the worker is not responsible the employer shall pay	50 % of the employee's wage	Not regulated
Transport allowance	Half of the cost	25 % of the price of gasoline per km
Meal allowance (per month)	50 % minimum wage	50 % minimum wage (€ 25)
Contribution to unions	0.20 % of gross wage	0.20 % of gross wage
Awards	Employees are entitled to awards after 10, 20 and 30 years of service, not less than 2 minimum wages. Also annual leave shall be increased according to the length of service: 1-15 years - by 1 working day; 15-30 years - by 2 working days; over 30 years - by 3 working days; disabled person - 3 working days; a parent of a child with physical and mental problems - 3 working days.	No obligation for monetary awards. Annual leave shall be increased according to the length of service: 1-15 years - by 1 working day; 15-30 years - by 2 working days; over 30 years - by 3 working days; disabled person - 3 working days; a parent of a child with physical and mental problems - 3 working days.
Housing allowance	<i>No obligation</i>	<i>Compulsory payment to the housing fund for employees, 0.7 % of gross earnings</i>
Seniority (wage) premium for each year of service	Up to 10 years – 0.5 % of wages; 10-20 years – 0.75 %; Over 20 years – 1.0 %	Up to 10 years – 0.5 % of wages; 10-20 years – 0.75 %; Over 20 years – 1.0 %
Additional annual leave	Marriage – up to 5 business days; birth of child – up to 3 business days; moving – up to 2 business days; severe illness of the immediate family member – up to 7 business days; work examination – up to 3 business days; emergencies due to natural catastrophes – up to 3 business days; participation in competition in work or production – up to 2 business days; personal reasons – up to 2 business days.	Birth of child – up to 3 business days; severe illness of the immediate family member – up to 7 business days; voluntary blood, tissue and organ donation – up to 3 business days; care of child with physical and mental retardation – up to 3 business days; emergencies due to natural catastrophes – up to 3 business days; participation in competition in work or production – up to 2 business days.
Minimum wage coefficients depending on the group of jobs (based on education and qualification)	Between 1.0 and 3.2 of the basic minimum wage	Between 1.0 and 4.0 of the basic minimum wage of €50.
Collective insurance of employees	<i>No obligation</i>	<i>An employer shall provide employees with collective insurance from accidents at work and outside work, and risks of death due to illness.</i>

Note: – in italics – newly introduced benefits and entitlements.

Source: General Collective Agreement 1995 and General Collective Agreement 2003.

2.28 Dismissal costs in Montenegro are still high. Employment may be terminated through notice, owing to economic, technological, structural or similar transformations, but the process is unnecessarily cumbersome and costly to employers. In such an environment firms are not able to easily adjust to market changes. Despite recent significant improvements (compared to pre-2003), mandatory minimum severance payments are still capped at six monthly salaries with no regard for length of service. Moreover, the base wage for severance pay calculation should not be lower than the average wage in the Republic. This adds an undue cost to the dismissal of workers who have short periods of employment.³⁷

³⁷ This is still a step forward compared to the pre-2003 Labor Law, in which severance pay was established at up to 24 monthly wages based on the wage level of the previous month prior to dismissal. Invalids could have stayed until

By making dismissal for economic reasons more difficult or costly, these employment protection rules are intended to increase job security. However, the trade-off again is that employers may be reluctant to hire workers if they face constraints in dismissing them for business reasons down the road.

2.29 Dismissal of disabled workers is still costly.³⁸ The 2003 Labor Law prohibited the dismissal of disabled employees, irrespective of whether there was work for them. In 2004 the Law was amended and now the labor contract with the disabled employee can be terminated on par with other individuals, except that the severance package was established in the amount of not less than 24 average monthly wages in the Republic if the disability was caused by injury out of work or disease, or not less than 36 average wages, if the disability was caused by injury at work or occupational disease. This is a step in the right direction, but nevertheless these provisions, together with the restrictions on female workers with young or disabled children, make it harder for these groups of job seekers and new entrants to find jobs.

2.30 Montenegro has one of the longest maternity leaves in the world of 365 days from the beginning of exercising the right to it. According to the existing Law on Social Protection, the maternity leave benefit should be paid by the employer, and then at the request of the employer it will be reimbursed by the state. Since the state budget does not have sufficient funds for reimbursement, the payment of maternity leave benefits is in arrears. Moreover, such generous entitlements have already had an impact on the labor market. According to the latest available labor force survey data (October 2004), 46.5 percent of males at age 15 years and older were working while among the females, the employment rate was 28.8 percent. The employment rate of females is traditionally lower than for males but this gap to a large extent reflects the rigidities associated with female labor (see also Box 2.1)

Box 2.1. Maternity Leave and Women's Labor Market Participation

Under the 1992 EU Maternity Leave legislation, EU Member States are required to provide at least 14 weeks (98 days) of paid maternity leave. Currently in Europe the duration of paid maternity leave varies from less than 100 days in Germany, Ireland and Portugal to 365 days in Slovenia and Albania, and 270 days in Macedonia. The most typical duration in transition countries is 126 days, and the basis for benefit calculation is average monthly wages for at least the last three months of work. In many countries, only half of the wages is paid in maternity benefits, and wage limits for benefit calculations are also established.

Extended maternity leave can potentially adversely affect women's labor market participation by leading to an actual or perceived erosion of skills. Extended leave entitlement, especially if accompanied by a decline in childcare places, may also enforce the notion of women as second earners, and diminish their economic and social roles in favor of their maternal functions. Thus, it is important to create a flexible and widespread network of childcare options to ensure equal opportunities for women in the market economy, and relieve an unsustainable financial burden from the Government related to maternity leave transfers (UNICEF 1999). Many transition countries have established a partially paid parental (childcare) leave of up to two to three years, a flat rate benefit paid from the state budget. This is much less burdensome to the budget and employers, if they are paying the benefit, and can avoid discrimination against female labor in the formal labor market.

2.31 In sum, the Labor Law should ease the conditions for concluding fixed term contracts, contracts for temporary, casual and seasonal employment, and full-time and part-time labor contracts. Labor market rigidities are especially burdensome for private small and medium enterprises

they retired or were willing to accept any other job offer. If the worker had less than 5 years to retire, the employer had to pay a severance for the period up to 5 years.

³⁸ It is estimated that there are around 12,000 disabled workers in the formal sector, or around 11 percent of the workforce.

(SMEs), which have been a dynamic source of new job creation in many transition countries in the region. Changes in the Labor Law should create a more favorable environment for SMEs.

C. HOW WELL DO THE COLLECTIVE BARGAINING AND SOCIAL DIALOGUE FUNCTION?

2.32 Collective bargaining can play an important role in determining wages and other conditions of work. The representation of the worker's voice through unions and collective bargaining can reduce discrimination. In addition, by instituting dispute resolution mechanisms, it can reduce arbitrary management decisions, increase job tenure and investment in training, and improve work safety conditions. These positive effects of unions would contribute towards greater labor productivity. Another major issue for social dialogue will be the introduction and widespread use of so-called atypical employment relationships, such as part-time and fixed-term contracts, triangular arrangements or probationary contracts, which could serve the interests of both employees and employers. The role of serious and continuous dialogue should be that of striking the right balance between the interests of the two parties in the industry.

2.33 Montenegro's recent trends in wage dynamics may indicate a strong voice on the part of Montenegrin unions in putting pressure on wage levels. It is well known that, *ceteris paribus*, unions can raise wage pressures, and that wages bargained collectively are generally higher than those bargained individually. In Montenegro union membership is very high compared to most other transition countries. On average, 75,000 workers and employees pay their trade union membership fees (depending on the month, between 71,000 and 82,000), which means that the union density rate is around 68 percent of the formal sector employment and 45 percent of the total employment.³⁹ For comparison, the weighted average trade union density of 10 new EU Member States is 22 percent. (USAID, 2004). In addition to high union density, bargaining coverage in the formal sector of the Montenegrin economy is close to 100 percent.⁴⁰ It is estimated that wage coefficients introduced in the 2003 General Collective Agreement were on average increased by 19 percent (Government of Montenegro, 2005), in part owing to the strength of trade unions. The Confederation of Independent Trade Unions of Montenegro is the main representative of workers and employees.

2.34 In contrast, employers are not well represented in collective bargaining and wage negotiations. Until 2004, the Chamber of Commerce was the only authorized body to represent employers in collective bargaining and to sign mandatory agreements binding all employers.⁴¹ The ILO Conventions state that the social partners can only be the voluntary organizations of workers and employers, and not the chambers of commerce that exist on the basis of the legal obligation of the companies to be registered with the chambers and to pay the contribution to them (see ILO Convention No. 144 and Recommendations No. 113 and 152 on tripartite consultations). In Montenegro, membership in the Chamber of Commerce and the payment of relevant fees (0.32 percent of gross wages of their employees) is mandatory for all legal entities. Thus, this practice of representation contradicts the ILO Conventions.

2.35 In 2004 an important amendment was made to the Labor Law to define the criteria for the representativeness of employers' associations. According to this amendment, the authorized association

³⁹ Serbia and Montenegro is an ILO member since 2000 and has so far ratified 68 ILO Conventions (67 of them are in force).

⁴⁰ Union density refers to the proportion of workers who are members of a union. Union coverage refers to the proportion of workers who are covered by collective agreement bargaining.

⁴¹ Since September 2005, a government decree has established that the Union of Employers of Montenegro must be a party to all collective bargaining and other negotiations at all levels of the social dialogue.

of employers shall be the one whose members have a minimum of 25 percent of employees in the economy of the Republic and that participates in the gross domestic product of the Republic with a minimum of 25 percent. Two of the newly emerging associations of employers, such as the Montenegrin Union of Employers (around 2,000 registered members) and the Montenegro Business Alliance (around 400 registered members), may thus qualify for the status of nationally representative employers' organizations.

2.36 The current system of labor agreements takes little account of the individual employer's circumstances or of individual sector circumstances. Currently, according to the Labor Law, the General Collective Agreement shall be negotiated for the territory of the Republic and shall apply to all employees and employers. In this way, it sets the framework for measures on social protection at work, supplementary benefits, and other aspects of labor relations. In most other countries in Europe and elsewhere, the majority of collective agreements is at the sector or company level (or even for the public sector and the private sector). Although the Montenegrin Labor Law provides for collective agreements at national, branch and employer levels, there are very few collective agreements at the firm level in practice. Moreover, while all collective agreements are typically effective for a fixed term, and while negotiations should be carried out in a tripartite manner with representative participation of each party, the General Collective Agreement in Montenegro is concluded for an indefinite period of time. There are almost no articles in the General Collective Agreement indicating the process of labor bargaining on some core labor market issues, such as wage adjustments (except minimum wage), working time, or atypical work arrangements (i.e., on labor issues and situations that may change annually or even seasonally).

2.37 Regular social dialogue at the national level with representative social partners is not functioning. Montenegro's Social and Economic Council, established by the Government Decree of February 1, 2001, consists of 38 members, including 7 representatives of workers appointed by the Union of Independent Trade Unions of Montenegro, 7 representatives of the industry appointed by the Chamber of Commerce, 7 renowned experts and public figures appointed by the Government, and 5 representatives of labor, education and health, nominated by the Ministry of Labor. However, the Council has had only occasional meetings and has not become a player in social dialogue. Moreover, other associations of employers, such as the Montenegrin Union of Employers and the Montenegro Business Alliance, are not represented in the Council.

2.38 Montenegro's Labor Inspectorate has been constructive in resolving individual labor disputes (complaints from over 800 workers were submitted in 2004) and in enforcing the legislation on legalizing the informal activities. The Labor Law and other related laws in Montenegro call for labor arbitration in the resolution of labor disputes, the composition, procedure and method of which shall be defined in the collective agreement. This is in line with international best practices of moving away from court-based procedures and adversarialism and towards alternative non-court approaches that emphasize fact-finding, conciliation, and arbitration.⁴²

D. INSTITUTIONS DEALING WITH HIGH UNEMPLOYMENT

2.39 The Employment Bureau of Montenegro is the main institution providing employment services to job seekers (see Table 2.10). As noted above, there were 58,000 registered unemployed in the

⁴² Effective dispute resolution relies on three key principles. First, prevention is always better than resolution, and adequate enforcement of labor laws goes a long way toward preventing labor disputes. Second, if a dispute is unavoidable, the parties to a dispute ought to attempt to resolve it themselves. Third, if a dispute cannot be resolved, third party intervention ought to involve the disputing parties as much as possible (Heron and Vandenabeele 1999).

roster of the Bureau by April 2005.⁴³ In Montenegro, employers are obliged to report to the Employment Bureau on the available vacancies and the related working conditions. On an exceptional basis, the employer may enter a labor agreement without a previous public announcement of vacancies. The Bureau publishes job vacancies within five days from the day on which the employer submits the application. The requirement for actively seeking employment and accepting adequate employment is applied only to recipients of the unemployment benefit. The right of the unemployed person to financial compensation ceases if, among other reasons, the person, without justification, fails to contact the Bureau for two subsequent months, or refuses to participate in the program of active employment policy, or does not respond to a vacancy announcement, as instructed by the Bureau.

Table 2.10. Main Activities of the Employment Bureau of Montenegro in 2004 (January-October)

Activity/Indicator	No of individuals
Average number of registered job seekers	66242
Newly registered job seekers	29550
Recipients of unemployment compensation	42439
Number of advertised vacancies	27388
Number of job seekers individual employment plans	60127
Number of participants of information and motivation seminars	2980
Participants of training programs	2075
Number of employed interns	852
Employment of non-resident individuals	28062
Provision of information to unemployed youth	20000

Source: Employment Bureau of Montenegro.

2.40 Montenegro's unemployment benefits (UB) are quite modest and therefore not a limiting factor to job creation, but the program is under-funded (see Table 2.11). In the 2004 budget for the Bureau, 4.3 million euros was allocated for the benefits, but by December only 1.2 million euros was received. Currently, the benefit payment is in arrears for one year on average. This erodes the ability of the unemployment benefit system to act as an effective social safety net and drives people into the informal sector. The insured person whose employment was terminated without his/her request, consent or fault, and who has been employed full time for a minimum of 9 months continuously, or 12 months with interruptions, in the past 18 months, has the right to financial compensation if that person registers with the Employment Bureau within 30 days from the day that the employment ceased. The financial compensation (unemployment benefit) is equal to 60 percent of the minimum wage, or currently 30 euros. The duration of the unemployment benefits payment is 3 months if the insured has had unemployment insurance for 9 (12) months, and up to 12 months if the insured person has paid insurance contributions for 20 to 25 years. The unemployed person with over 25 years of insurance contributions has the right to financial compensation until that person finds new employment. The low coverage and generosity of benefits may have reduced the otherwise adverse impact of unemployment benefits on job creation.

2.41 In contrast, Montenegro spends significant resources on active labor market programs (ALMPs), amounting to 0.55 percent of GDP (Table 2.11).⁴⁴ There are two main characteristics of Montenegro's public employment service (PES). First, around half of the budget on ALMPs is spent on activities related to different counseling and job search assistance programs. Second, in recent years Montenegro spent significant resources on micro-credit programs. The structure of expenditures confirms that, compared to some other countries in the region, Montenegro has a much higher level and share of

⁴³ According to the Law on Terms and Conditions of Employment, high school and university students and farmers at age 15-64 who are actively seeking employment cannot be considered as unemployed.

⁴⁴ Calculations are based on the 11 months' actual spending of the Employment Bureau and estimated GDP for 11 months.

public expenditures on ALMPs, spent mainly on in-house services such as counseling and job search assistance as well as on youth and direct job creation measures through a micro credit scheme. The country has a relatively low share of expenditures on unemployment benefits (Table 2.11).

**Table 2.11. Public Expenditure on ALMPs in Some Transition Countries
(percent of GDP)**

	Montenegro, 2004*	Czech Republic, 2002	Hungary, 2002	Slovakia, 2002
1. PES and administration	0.29	0.07	0.12	0.15
2. Training	0.08	0.02	0.06	0.04
3. Youth measures	0.07	0.02	-	0.01
Measures for unemployed and disadvantaged youth	-	0.02	-	0.01
Support of apprenticeship and general youth training	0.07	-	-	-
4. Subsidized employment	0.11	0.06	0.34	0.21
Subsidies to regular employment in the private sector	-	0.02	0.08	0.06
Support to unemployed persons starting enterprises	-	-	0.01	0.06
Direct job creation	0.11	0.03	0.26	0.09
5. Measures for the disabled	0.00	0.01	-	0.04
Vocational rehabilitation	0.00	-	-	-
Work for the disabled	0.00	0.01	-	0.03
6. Unemployment compensation	0.09	0.27	0.37	0.48
7. Early retirement for labor market reasons	-	-	-	0.01
TOTAL	0.74*	0.45	0.90	0.94
Active measures (1-5)	0.55	0.17	0.52	0.46
Passive measures (6-7)	0.09	0.27	0.37	0.48

* - Montenegro: January-November 2004 using an estimated GDP for 11 months; additionally, 0.10 percent of GDP was spent by the Employment Bureau on repayment of credits and on investments.

Source: OECD Employment Outlook 2004. Paris; Employment Bureau of Montenegro.

2.42 The micro-credit scheme is the costliest labor market program offered by the Employment Bureau, but its impact on unemployment is yet to be properly assessed. The Bureau provides micro-credit for new business start-ups for those who are unemployed and who may face major difficulties in trying to secure a loan at the market interest rate. Although the efficiency of the program may have improved in recent years, Montenegro's program remains costly – the program spends on average 3,000 euros per job created and embraces only a limited number of participants (around 1,000 jobs are created through the program annually).⁴⁵ International experience suggests that micro-credit programs are successful if supported by technical services such as training, counseling, and assistance in developing and implementing a business plan. The micro-credit program in Montenegro is yet to be properly evaluated in terms of placement rates, career development of participants, and small business survival rates.

2.43 International experience indicates that, even under the best scenarios, payoffs to most ALMPs are modest (Box 2.2). It is difficult to address the problems of large-scale unemployment through these programs. They may work for specific groups in specific circumstances – hence, the need for careful targeting. On the other hand, labor market interventions have a large potential for improving labor market performance. International experience suggests that counseling and job search assistance are more cost-effective in tackling frictional unemployment. In particular, counseling can be crucial in

⁴⁵ Micro credits provided by the Employment Bureau through the commercial banks are for three years with a one year grace period and an interest rate of 3 percent annually while regular commercial credits are at an interest rate up to 20 percent annually. Around 16 percent of the participants have failed to repay the loan.

helping individual workers obtain information about education, training, and alternative job opportunities. The provision of job search assistance or placement services—which provide information on labor markets and job openings, the registration of job seekers, the selection and referral of job applicants, and follow-up with employers after referral—also helps to enhance labor mobility. In any case, the positive impact of labor market policies cannot be taken for granted, which points to the importance of the need for monitoring and evaluating the effectiveness of ALMPs in Montenegro.

Box 2.2. How and Which ALMPs Are Effective?

A recent World Bank review of ALMPs around the world, based on the 152 scientific (i.e., control-group) evaluations, drew the following general conclusions (Betcherman et al. 2004)*:

- *Job search assistance.* These services generally have positive impacts on the post-program employment and earnings of participants. Costs are relatively low (usually assistance is provided by PES staff) so the cost-benefit ratio is often favorable.
- *Training for the unemployed.* Participants often benefit from these programs in terms of higher employment rates but not in terms of higher earnings. The few evaluations in developing countries paint a less favorable picture. Programs seem to work best with on-the-job training and active employer involvement. Results are more positive for women than men.
- *Retraining for workers in mass layoffs.* These programs most often have no positive impacts, although there are exceptions. The few successful cases typically include a comprehensive package of employment services to accompany the retraining. However, these are generally expensive.
- *Training for youth.* These programs are almost always unsuccessful in improving labor market outcomes, at least in developed countries. It makes much more sense to invest earlier in the education system to reduce drop-outs and other schooling problems. While there are few studies in developing countries, evaluations in Latin America do find positive impacts for programs that integrate training with remedial education, job search assistance, and social services.
- *Wage/employment subsidies.* Most often these do not have a positive impact and have substantial deadweight and substitution costs. Targeting and monitoring may help but at the cost of reducing take-up rates.
- *Public works.* This can be an effective short-term safety net but public works do not improve future labor market prospects for participants.
- *Micro-enterprise development/self-employment assistance.* There is some evidence of positive impacts for older and better-educated workers. However, take-up is very low.

Note: * These reviews were based almost exclusively on the experience of industrialized countries because very few evaluations existed anywhere else.

2.44 Montenegro has not yet established a Labor Fund, despite the need for such a fund to facilitate restructuring and labor redeployment. The Law on Terms and Conditions of Employment anticipates the establishment of a Labor Fund to provide transitional income support, including severance payments and other social contributions, for employers who are unable to secure assets for payments. The Fund is supposed to be established by the Government, the association of employers, and the authorized trade unions. However, the Fund has not become active despite the need for such a fund. It is expected that the reduction in the number of employees in the formal sector of the economy will continue: in accordance with the Economic Reform Agenda, the reduction is estimated at 5,000 persons in 2005. The launching of the Labor Fund would be instrumental in supporting the displaced workers in their search for alternative employment and in preventing these workers and their families from slipping into poverty.

E. CONCLUSIONS AND POLICY RECOMMENDATIONS

2.45 In view of the high unemployment rate in Montenegro, improving labor market performance is critical for the political sustainability of market-oriented reforms, growth, and competitiveness. The

following measures can improve the institutional framework for labor relations and employment creation in Montenegro:

- *Relax some aspects of the labor regulations.* While the new Labor Law, adopted in 2003, has improved the flexibility of the labor market, considerably it has not yet assured full flexibility (Government of Montenegro, 2005). It is still focused on the protection of existing work places in the Government and in the recently privatized companies rather than on opening new work places in the private sector. The reforms in labor relations should focus especially on the following: (i) relaxing the contracting rules for employing “non-standard” workers, including employees on fixed-term and part-time contracts; (ii) reducing the costs for employers to terminate regular (i.e., permanent) employees for economic reasons; (iii) permitting more flexible arrangements in working hours; and (iv) limiting non-wage costs to employers.
- *Reduce the high rates of labor taxation and strengthen the enforcement of labor taxes to encourage formal employment.* Recent reforms have helped reduce the payroll tax and contributions burden, yet the labor taxes (or payroll taxes) are still too high and among the highest in the region. Montenegro’s tax wedge, one of the most important indicators of tax burden, stood at about 52 percent of the labor costs in 2004, while the comparative burden for the regional non-European member countries was 37.3 percent of total labor costs. A further phased and well-planned reduction in payroll taxes—compensated by equivalent increases in other taxes, and with adjustments to compensate the resulting lost income of the social funds—is desirable. The identification of alternative sources of revenue, such as the VAT or other indirect taxes, to make up for reduction in payroll taxes is critical to maintain the overall fiscal balance as well as the fiscal position of the health and pensions funds. Such reduction in payroll taxes should also be accompanied by improved enforcement of taxes, including through more aggressive use of bankruptcy as a means to deal with delinquent tax payers, as well as regular payments of contributions for health insurance by all users of health care. The reductions should be done in a way that does not hamper the financial sustainability of the both the health and pensions funds. In addition, further reforms of the health and pension systems (early retirement, disability, maternity leave and sickness benefit) may need to be pursued in parallel to tighten eligibility criteria and eliminate abuses in the systems. The legal frameworks have already been laid for pension and health sector reforms, but further reforms are necessary both to improve financial sustainability and service delivery to the people.
- *Rein in the rapid wage growth witnessed in recent years.* This can be undertaken by: (i) establishing a more balanced collective bargaining and wage setting process whereby the voices of employers (including Government) are strengthened; (ii) promoting greater decentralization of bargaining to the firm level; and (iii) undertaking a more vigorous implementation of public administration reforms and the reduction in public sector staffs (many of whom earn wages well in excess of the average for the economy).
- *Introduce or expand, through the Employment Bureau, some other active labor market programs which have proven to be cost effective in other countries in the region.* Those would include: (i) *employer contact services*, which match applicants’ skills and refer the best qualified applicants to employers; (ii) *vacancy and job fairs* designed to assist local employment agencies in matching labor supply and demand; (iii) *job clubs* for those with low self-confidence who have been unemployed for extended periods of time; and (iv) *virtual enterprises (or a practice firm)* to develop teaching and training skills for operating a real enterprise. In addition, an assessment of the net impact of ALMPs needs to be undertaken.

- *Improve labor market data and information.* Available data do not allow a detailed analysis of the labor market in Montenegro. Special and more detailed regular labor force data may be needed to monitor the following: employment, underemployment and unemployment; seasonal, occasional and informal employment; earnings and incomes generated; working time involved, by occupational and professional groups and regions, on alternatives to formal sector employment; and work in the informal sector and in households. The absence of regular and reliable information on the labor market limits adjustments in labor market interventions.

3. FISCAL POLICY REFORM FOR GROWTH AND COMPETITIVENESS

3.1 Montenegro's euroization has limited its options for macroeconomic management to fiscal policy. Its high current account deficit (before grants), at about 12 percent of GDP at end-2004, remains unsustainably large. In the past such a large current account deficit was financed through high official grants, loans and privatization revenues. However, official grants have declined in recent years (from 7 percent of GDP in 2002 to about 3 percent in 2004) as have privatization revenues, while net foreign borrowing has increased. With declining grants and rising debt service payments, adjustment to a smaller current account deficit is necessary. With euroization, the main policy tool for such adjustment remains fiscal policy. For that reason, fiscal sustainability remains a serious concern. However, while restraining demand through prudent fiscal policy is necessary, it is equally important for the Government to ensure that the composition of expenditures is supportive of growth, through increasing expenditure allocation to investment in public goods, in particular to infrastructure.

3.2 The chapter is organized as follows. Section A provides a background on the evolution of general government expenditures and revenues in recent years. Section B examines Montenegro's current fiscal situation, in particular whether its fiscal position is sustainable. It provides estimates on the level of a long-term sustainable fiscal deficit for Montenegro and discusses the adjustment needed to regain fiscal sustainability and where that adjustment may come from. Section C considers the allocation of public expenditure across key spending categories, to identify where the spending level may be excessive or inefficient, and also where more spending may be needed. The section looks into both the economic and the functional composition of general government expenditures to draw conclusions on the extent to which the current composition of expenditures is supportive of growth. Section D looks at the legal and institutional processes for budget management and planning, and the improvements that the Government may make to strengthen the link between fiscal policy and growth, while Section E provides conclusions and recommendations.

A. BACKGROUND

3.3 Montenegro's consolidated general government expenditure accounts for about 42 percent of GDP (Figure 3.1).⁴⁶ Of this, Central Government accounted for 22.2 percent of GDP, the extra-budgetary social funds for 15 percent of GDP, and municipalities for about 4.2 percent of GDP. Further decomposition of expenditures by economic and functional classifications is provided later in this chapter.

3.4 Over the last three years, consolidated expenditures have declined from about 43 percent of GDP in 2002 to about 41.5 percent in 2004, which suggests that the role of the Government in the economy declined only marginally. Current expenditures, accounting for over 90 percent of total general government expenditure, declined from over 38 percent of GDP in 2001 to about 34 percent in 2004, while capital expenditures, net lending and general reserves, which together account for less than 10 percent of the total, remained more or less steady. On the revenue side, consolidated general government

⁴⁶ The IMF data on consolidated fiscal operations for Montenegro do not cover local governments/ municipalities. However, Montenegro has local government data available for 2002-2004, although the quality of the data may be weak. To provide a more complete picture of consolidated general government in Montenegro, we supplement IMF data with such data on local governments. Since by law and in practice, local governments cannot generate deficits, their revenues (net of central government transfers) are equal to their expenditures. In that sense, exclusion of local governments does not introduce material difference into the IMF fiscal targets.

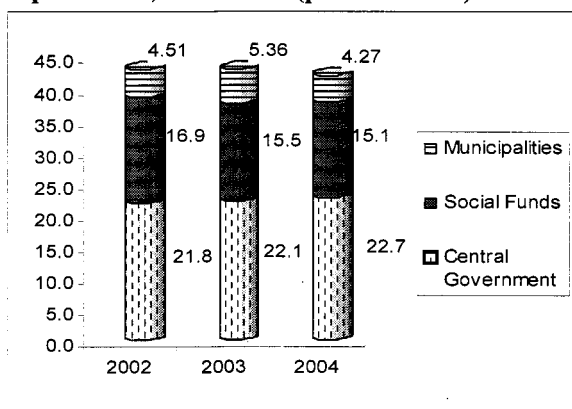
revenue **increased** from about 39 percent of GDP in 2002 to about 41 percent of GDP in 2004 (Figure 3.2), including revenues of local governments. Central government revenue and grants accounted for about 25 percent of GDP, social funds for about 11 percent of GDP; and local governments for about 4 percent of GDP. Consolidated general government in Montenegro is defined in Box 3.1.

Box 3.1. The Concept of Consolidated General Government in Montenegro

The concept of consolidated general government in Montenegro includes consolidated data for the Montenegrin Republican budget (central government), three extra budgetary funds--the Pensions Fund (PIO), the Health Insurance Fund (HIF), and the Employment Fund—and local governments. Local governments in Montenegro are represented by 21 municipalities, and their expenditure and revenue data are not always complete. Own revenues of the social funds and local governments are supplemented by transfers from the Republican budget.

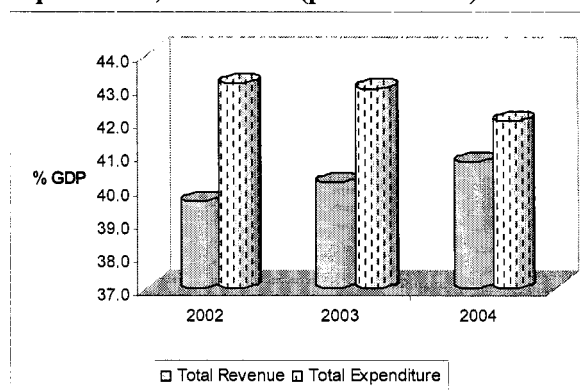
Fiscal data for the central government of Montenegro are based on the new GFS classification. However, data for the extra budgetary funds, reported directly by the funds, are not on a GFS basis and are generally compiled with delays. Montenegro's budget for 2005 already contains tables with consolidated budgets for the central government and the social funds, but the municipalities have not yet adopted a new harmonized chart of accounts that would allow for the consolidation of municipal budgets into general government.

Figure 3.1. Consolidated General Government Expenditure, 2002-2004 (percent GDP)



Source: IMF; Montenegrin Ministry of Finance; USAID Urban Institute for Local Governments data.

Figure 3.2. Consolidated Public Revenue and Expenditure, 2002-2004 (percent GDP)



Source: IMF; Montenegrin Ministry of Finance; USAID Urban Institute for Local Governments data.

3.5 The composition of revenues has shifted significantly over the last three years, owing mainly to the revenue reforms undertaken by the Government. By composition, social security contributions and value-added tax (VAT) account for about 62 percent of the total tax revenue (Figure 3.3). Personal income tax revenue and the excise tax each account for an additional 12 percent of total tax revenue. International trade taxes account for 7 percent and corporate income tax accounts for only 3 percent of total revenue. The Government has introduced several tax reforms over the last three years. The *Personal Income Tax Law*, which came into force on July 1, 2002, replaced a proportional 19 percent income by progressive rates ranging from 0 to 25 percent. The *Value Added Tax Law* came into effect in April 2003. The sales taxes of 12 percent on services and 24 percent on most goods were replaced by the VAT rate of 17 percent. The *Corporate Profit Tax Law*, which also came into effect in July 2002, replaced a flat corporate profit tax rate of 20 percent by progressive rates of 15 percent for profits up to 100,000 euros and 20 percent for profits over 100,000 euros. This Law was further amended in the last quarter of 2004, which decreased the corporate tax rate from the prior progressive rates of 15 and 20 percent to a proportional rate of 9 percent. As a result, Montenegro now has the lowest corporate profit tax rate in

Southeast Europe. In large part because of these reforms, the composition of revenues has changed. Personal income tax revenues and revenues from international trade taxes have declined, while revenues from social contributions and the retail sales tax/ VAT have increased (Figure 2.3). Other revenues, including revenues from excises and corporate income tax, have remained more or less stable.

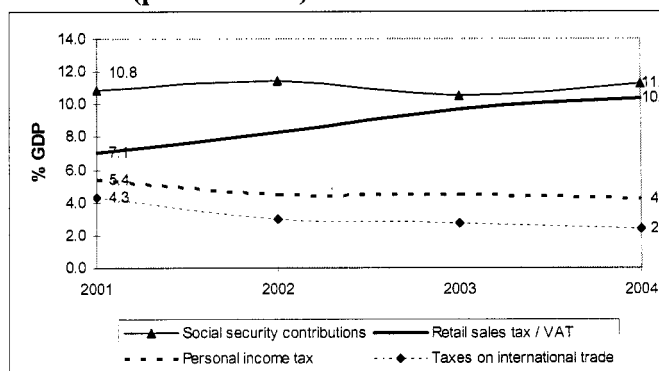
B. IS THE FISCAL POSITION SUSTAINABLE?

3.6 The general government deficit after grants increased from about 1.6 percent of GDP in 2001 to about 3.1 percent in 2004 (Figure 3.4). By type of financing, net foreign financing steadily increased from zero in 2001 to about 2 percent of GDP in 2004 (with program aid increasing from zero to 0.9 percent of GDP and project aid increasing from zero to 1.2 percent of GDP); privatization receipts declined from about 5 percent of GDP in 2002 to about 0.5 percent in 2004.⁴⁷ Domestic borrowing, including the issuance of short-term securities (Treasury bills), fluctuated, in part depending on the Government's privatization revenues. In 2004, domestic financing accounted for about 0.6 percent of GDP. The recent increases in deficits after grants pose a risk to fiscal sustainability and macroeconomic stability.

3.7 Fiscal sustainability requires that the present value of the government's primary balance must equal the current debt-to-GDP ratio. At the end of 2004, Montenegro's estimated debt-to-GDP ratio was 43.8 percent of GDP. Under the simplifying assumptions that the economy grows at a constant real rate of 4 percent per year, and that the real interest rate is constant at 5 percent, a recent analysis by the World Bank finds that a primary budget balance of 0.4 percent is needed for Montenegro to achieve long-run fiscal sustainability.⁴⁸

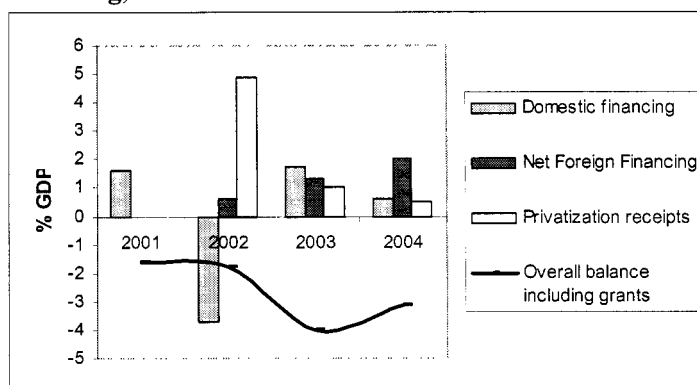
3.8 Montenegro is thus currently very far from achieving a sustainable fiscal balance. In the past two years, estimates of the primary fiscal balance in Montenegro put it at close to a deficit of 2 percent of

Figure 3.3. Trends in the Composition of Revenues, 2001-2004 (percent GDP)



Source: IMF; Montenegrin Ministry of Finance; USAID Urban Institute for Local Governments data.

Figure 3.4. Sources of General Government Deficit Financing, 2001-2004



Source: IMF; Montenegrin Ministry of Finance.

⁴⁷ The government expects to receive a much larger amount—about 10 percent of GDP—in privatization revenues in 2005. Whether the government uses these receipts to reduce deficit spending instead of increasing it will have important implications for fiscal sustainability and macroeconomic stability.

⁴⁸ This is based on an internal World Bank document: "Debt Sustainability in Serbia and Montenegro", June 2005.

GDP. Current projections for the primary balance suggest a deficit of just over 1 percent of GDP in 2005. This is well short of the surplus of 0.4 percent of GDP needed for fiscal sustainability. Currently the effective nominal interest cost of Montenegro's debt is a little below 3 percent of its stock of debt. If one were to assume that real interest rate is 1 percent (rather than 5 percent as assumed above) in the long-run, a primary deficit no greater than 1.3 percent of GDP would be needed to maintain a stable debt-to-GDP ratio. Regardless of the level of interest rate assumed, the analysis suggests that, a substantial fiscal tightening—in the order of 1 percent of GDP-- is needed to achieve fiscal sustainability. While a higher growth rate and access to concessional financing can supplement such effort, fiscal reforms would take center stage. The next section highlights where such adjustment may come from.

C. IS THE COMPOSITION OF EXPENDITURE SUPPORTIVE OF GROWTH?

3.9 While further fiscal tightening is needed to ensure sustainability, it is equally important for the Government to ensure that the composition of expenditures is supportive of growth by ensuring adequate investment in public goods such as infrastructure.

*The Economic Composition of Public Expenditure*⁴⁹

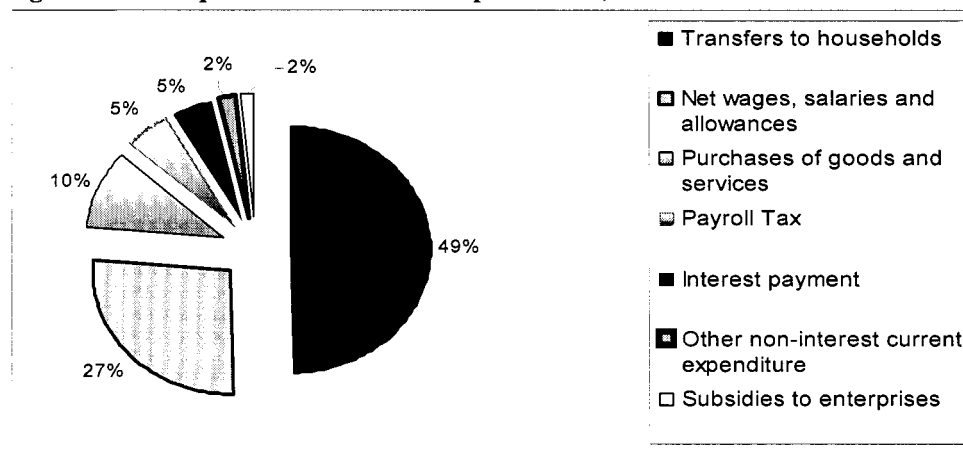
3.10 **Two key conclusions emerge from an analysis of the economic composition of expenditures.** *First*, Montenegro spends about three-fourths of its expenditure on wages, and various social benefits to households. A comparison with regional states shows that Montenegro's wage bill both as a proportion of total government expenditure and as a proportion of GDP is far above the average. On the other hand, capital expenditure is much below the level for other countries in the region (see Figure 3.6). In particular, the high wage growth has crowded out spending on public investment and operations and maintenance—expenditures that are essential for growth. *Second*, subsidies and lending to public enterprises have been progressively reduced over the last three years, but a lot remains to be done to impose a full hard budget constraint on public enterprises. Combined, direct enterprise subsidies and loans to enterprises accounted for about 1.6 percent of GDP in 2004. Despite several years of efforts at privatization and enterprise restructuring, incomplete reforms across the economy feed into the budget via enterprise subsidies and net lending. State-owned enterprises still lack hard budget constraints and budgetary discipline and therefore take resources away from other priority areas of expenditure, such capital investment in infrastructure. The scope for further fiscal tightening, as well as reallocation to public investment, lies in reducing expenditures on the wage bill, transfers to households, lending to public enterprises, and interest payments.

3.11 **Two economic items--social welfare and transfers to households⁵⁰ and the wage bill--account for over 75 percent of total current expenditures** (Figure 3.5). The other expenditures, including expenditures on the purchase of goods and services, the payroll tax, interest payments, subsidies to enterprises, and other non-interest current expenditures, account for only about one-quarter of total expenditure. Transfers to households principally include government-funded social protection benefits for children and families, and for war veterans and maternity benefits, benefits to pensioners through the Pension Fund, benefits to the unemployed through the Employment Fund, and medical protection and health insurance through the Health Fund.

⁴⁹ Analyses of both the economic and functional composition of expenditures do not include data for local governments/ municipalities.

⁵⁰ Transfers to households includes transfers and social benefits, transfers to individuals, transfers to humanitarian organizations and NGOs, transfers to the three social funds, transfers to other units of government at a lower level (i.e. local governments), and social insurance and protection. Transfers to the social funds are netted out in the consolidated general government expenditure.

Figure 3.5. Composition of Current Expenditures, 2004



Source: IMF; Montenegrin Ministry of Finance.

3.12 Montenegro's public sector wage bill is high as a proportion of general government expenditure, although it is less than the average for the EU-15 countries. (Figure 3.7). In 2004 the total public sector wage bill expenditure represented about 9.1 percent of GDP (or 27 percent of total expenditure). However, this substantially underestimates the true level of the wage bill, since it does not include the wage bill in the health sector (financed under contractual arrangements through the Health Fund) and other wage bills concealed under transfers to semi-autonomous institutions, such as higher education. In comparison to other countries in the region,⁵¹ Montenegro's wage bill is substantially higher as a share of GDP (over 9 percent against about 7 percent for most other countries in the region).

3.13 The high level of the wage bill is due mainly to the over-employment in the public sector. Average gross monthly wages in Montenegro increased from about 150 euros in 2000 to 302.6 euros in 2004—a cumulative growth rate of 103 percent in just four years. The public sector continues to be the prime employer in the Montenegrin economy, accounting for about 60 percent of total formal employment (according to the 2003 Labor Force Survey).

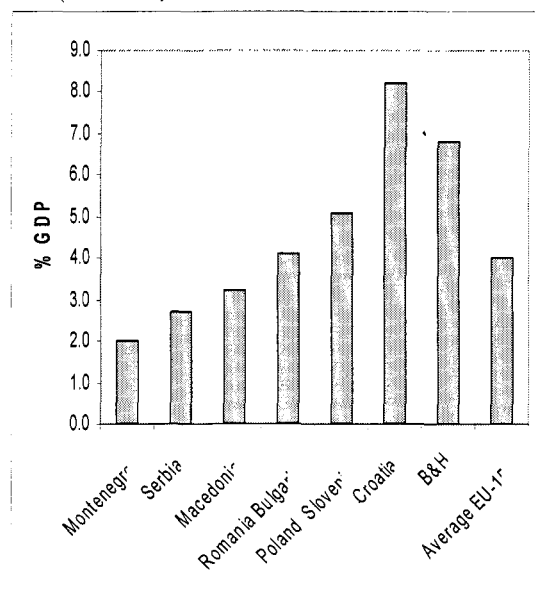
3.14 The high and growing wage bill and transfers to households have crowded out essential public expenditures on operations and maintenance and capital investment. Budgetary spending on operations and maintenance declined from around 6 percent of GDP in 2001 to about 3.5 percent in 2004. Montenegro's *capital expenditure* has remained not only low but also volatile. Capital expenditure decreased from 2 percent of GDP in 2001 to 1.5 percent in 2002, but increased to about 2 percent of GDP again in 2004. The volatility seems to arise from treating capital spending as a residual spending in the event of revenue shortfalls and other budgetary pressures. Montenegro's capital expenditure is also one of the lowest in the region, accounting only for less than one-half of the average regional spending as a share of GDP (2 percent in Montenegro versus 5 percent in most other countries) (Figure 3.6).

3.15 Subsidies and net lending to enterprises stood at about 0.6 percent and 1 percent of GDP, respectively, in 2004. Direct subsidies to public enterprises declined from about 1.2 percent of GDP in 2001 to about 0.6 percent in 2004. Still, this is not only lax but it also understates the real magnitude of subsidies in the economy, since state-owned enterprises also receive subsidies through the local

⁵¹ Wage bill data for countries in the region represents three-year averages covering mostly the period 1999-2001. For Montenegro the figures represent three-year averages covering the period 2002-04.

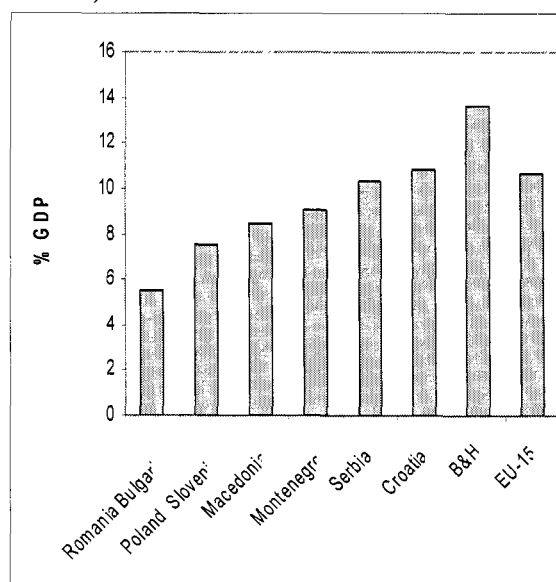
governments (municipalities). *Net lending* by the Government, which includes loans to public enterprises, has fluctuated in recent years but remained significant at about 1 percent of GDP in 2004. There is no adequate transparency surrounding the lending to state-owned enterprises, including the terms and repayment conditions.⁵² Finally, *interest payments* increased from 0.1 percent of GDP in 2001 to 1.6 percent in 2004.⁵³

Figure 3.6. Capital Expenditure, Comparison with Other Countries in the Region, 2003-2004 (% GDP)



Source: IMF; Montenegrin Ministry of Finance; Funck 2002.

Figure 3.7. Wage Bill, Comparison with Other Countries in the Region, 2003-2004 (% GDP)



Source: IMF; Montenegrin Ministry of Finance; Funck 2002.

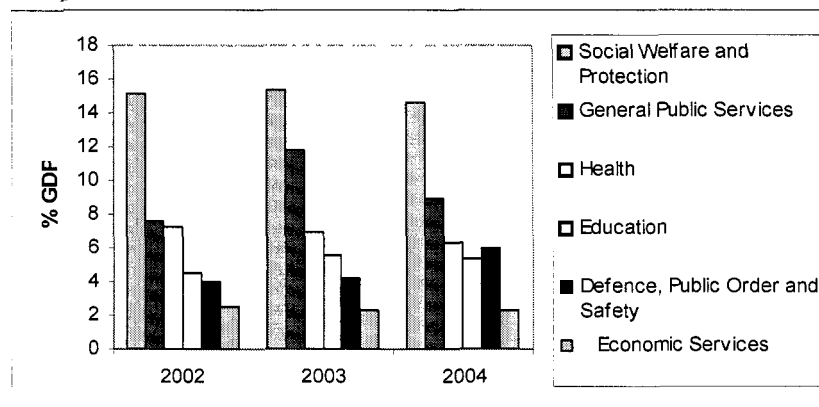
⁵² Loans to public-owned companies have very favorable conditions – 2 percent interest rate, 1 year grace period, and a 3- year repayment period.

⁵³ Besides debt repayment, interest payment has been the only expenditure where budget outturn has been higher than planned.

The Functional Composition of Public Expenditure

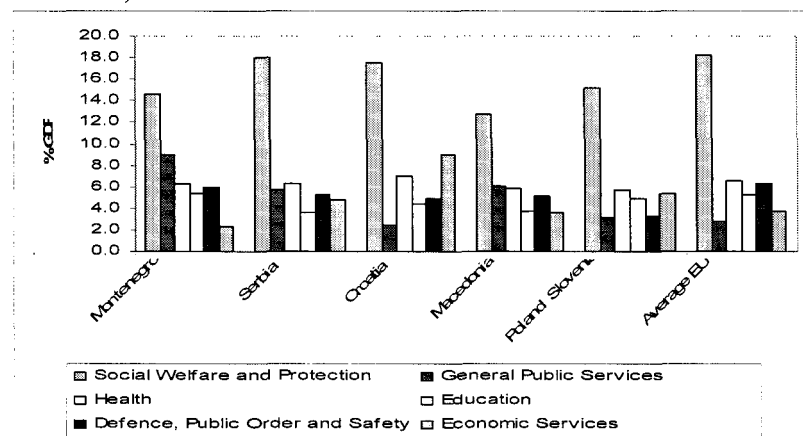
3.16 A look at general government expenditure by functions⁵⁴ suggests where some of the priorities for expenditure reform might lie. Four conclusions emerge from such an analysis. *First*, general government services (public administration, public order and safety, and defense) and social protection each consume about a third (33 percent) of total general government expenditure. Education and health combined account for another 25 percent of the total spending. The rest goes to economic services, and housing, sports and recreation (about 5 percent). *Second*, compared with other countries in the region, Montenegro spends substantially more on almost all of these functions--general public services, defense and public safety, education, and health in that order (Figure 3.8).⁵⁵ *Third*, despite the fact that Montenegro started public sector reforms a couple of years ago, the reforms have not yet resulted in a reduction in the costs of public administration and public order and safety. Instead, the costs of these functions have continued to grow. *Fourth*, although spending on social protection is more in line with other countries in the region, the dominance of spending on pensions and veterans' benefits means that a relatively small proportion of spending is targeted towards poverty related programs.

Figure 3.8. Montenegro's Functional Spending by Major Components, 2002-2004



Source: IMF; Montenegrin Ministry of Finance.

Figure 3.9. Montenegro's Functional Spending Compared to Other Countries, 2003-2004



Source: IMF; Montenegrin Ministry of Finance; Funck (2002).

⁵⁴ Due to lack of data, the table does not include municipal spending by functions. Public and economic services and education are financed primarily through the central government budget; health services are financed through the Health Insurance Fund and pensions through the Pensions Fund. General public services do not include interest payments.

⁵⁵ Montenegro data are average for 2002-2004, and do not include municipal expenditures and part of the externally financed projects, and exclude interest payments. Comparator country data refer to three-year averages for 1999-2001 except for Albania (2000-2002) and Hungary (1999-2000), and exclude interest and amortization charges.

3.17 Montenegro spends substantially higher amounts than other countries in the region-- about 9 percent of its GDP-- on general public services (i.e., public administration) (Figure 3.9). Despite the high spending, the general view is that public administration is poor, as standards within the public administration are not optimal and staff are often poorly trained and equipped for the functions that they are required to perform. In view of this, it remains essential for the process of public administration reform, which has begun recently, to provide budgetary space by not only reducing the very high level of spending on public administration but also by improving standards and service delivery (see Box 3.2).

Box 3.2. Public Administration Reform and Budgetary Space

Public administration reform remains critical to creating budgetary space in Montenegro. So far, some basic steps have been undertaken. A new Civil Service Agency has been established, a new Law on Salaries for public administration employees has been approved, and a new systematization of working posts is expected to lead to the rightsizing of the public sector.

The basic reason why the wage bill is so high is because of the excess staff in the public sector as well as a generous salary and wage increase in recent years. Public administration reforms are fundamental to addressing this problem. The reforms to date have not effectively addressed the excess staffing and the issues of the different types of allowances (hot meals, transportation, annual leave grants) that continue to burden the wage bill. While the Government has recently taken some steps to bring public sector employment and wage bill spending more into line with European norms (e.g., by reducing excess staffing in the education sector by almost 700 employees thus generating savings in the wage bill of around €3 million), there is a need to extend such steps to other sectors, such as public administration, with its excess staffing and inefficiencies. The Government plans to reduce employment in the public sector by 4,200 by the end of 2005, which is expected to generate an estimated savings of about €10 million⁵⁶, but it remains to be seen whether this reform will be implemented.

In addition, future elements of public administration reform will need to be planned and executed within a realistic budgetary resource framework. Where proposals lead to additional costs, it will be necessary to show how these costs are to be covered from elsewhere within the public service wage bill.

3.18 Defense and public order and safety, at about 6 percent of GDP in 2004, was higher than the average levels in CEE countries, driven primarily by spending on the police service. Reforms are needed to bring staffing progressively in line with norms in the region in order to control spending on this particular component.

Community and Social Services

3.19 Spending on social welfare and protection, by far the largest functional component, accounting for 14.6 percent of GDP, is comparable with the spending levels in other countries in the region (Figure 3.9). As elsewhere in the region, pensions and pension related benefit spending dominates, accounting for 80 percent of this spending. The level of spending on poverty-related social assistance programs has been among the lowest for countries in the region.

3.20 Expenditure on health care services accounts for about 6 percent of GDP. Anecdotal evidence suggests that health spending in Montenegro is not efficient.⁵⁷ In the health care system,

⁵⁶ The government is planning to reduce defense staffing by 3,200; the rest of the redundancy is expected to come from the public administration, which if completed should generate significant budgetary savings.

⁵⁷ See, World Bank, Serbia and Montenegro, Montenegro PEIR, Volume 3.

large inefficiencies, distorted incentives, and a lack of accountability have resulted in substantial resource waste and poor service delivery. Improving the efficiency of health services delivery is therefore essential to containing costs without sacrificing services. This could be achieved through improvements in the management of public health funds, prioritization in resource allocation towards preventive programs and priority treatment programs, and improvements in public procurement procedures in the sector.

3.21 Montenegro's spending on education, at about 5.4 percent of GDP in 2004,⁵⁸ is above that of other countries in the region (Figure 3.9). This is comparable to the OECD standards (5.5 percent for the OECD and 5.4 percent for Montenegro) as well as the standards of other countries.⁵⁹ The structure of education spending may suggest some degree of inefficiency in the sector (Box 3.3). Out of the total recurrent expenditure on general education, 94.6 percent was spent on the wage bill, while only 5.4 percent of total recurrent expenditure was spent on non-staff items. The OECD average for the share of non-staff cost in total recurrent expenditure is 19.7 percent. Furthermore, the match between vocational skills produced by schools and skills demanded by the private sector seems poor in Montenegro. There are a number of vocational profiles currently being offered in schools for which little or no demand exists in the labor market (Montenegro PRSP).⁶⁰ Further efficiency gains can be obtained by reducing the disproportionate staffing costs in education, as well as streamlining the vocational training programs to bring them into line with the skills demanded by the labor market.

Box 3.3. Is Public Expenditure in Education Efficient?

Regional comparisons demonstrate higher levels of public spending in Montenegro on a number of key functions and indicate that there is probably a substantial scope for increasing the efficiency and effectiveness of many programs within existing resource allocations. One such sector appears to be education.

Out of 455 active elementary school units, one-third of the total number (148) have 10 or fewer students; 337 units (including 42 mother schools or a quarter of these units) have fewer than 80 students, which would be 4 classes of 20 students. The student/teacher ratio is very low in many cases. There are 14 satellite (elementary) schools with only 1 student per class and 93 school units (13 mother schools and 80 satellite schools) with fewer than 5 students. In addition, there are many large urban schools with small classes, contributing to the number of employees and directorship or supervisory positions. To address this problem, the MES has recently produced new Norms and Standards, linked to the number of students rather than the number of classes.

Economic Services

3.22 Economic services absorbed only about 2.3 percent of GDP in 2004 (Figure 3.9). This represents less than half of the average level of spending for other countries in the region. Spending on economic services as a share of total expenditures has remained volatile in Montenegro. Within economic services, spending on agriculture has remained constant as a share of total expenditures in the last three years, while spending on tourism-related economic services has been increasing both in nominal terms and as a share of total expenditure.

⁵⁸ This includes spending by social funds as well.

⁵⁹ Only Malaysia, Tunisia and Mexico have similar proportions of education spending.

⁶⁰ According to Montenegro PRSP, there are about 3,953 different vocations in Montenegro (based on data from the Employment Fund), of which there is demand in the labor market for only 750 of them. On the other hand, there are 262 vocations for which demand exists but the school system does not produce adequate trainees. The MES has recently initiated a »tracking« project that would monitor secondary school graduates until they find a job, which should help to better link education with the needs of the labor market.

Is Montenegro's Fiscal Policy Growth-Enhancing?

3.23 A large body of economic literature is concerned with whether (and what kinds of) public expenditures enhance growth.⁶¹ The recent theoretical literature emphasizes that, in evaluating the impact of fiscal policy on growth, the structure of both taxation (i.e., financing) and expenditures should be taken into account.⁶² One way to do this is to divide the government budget into four categories: distortionary or non-distortionary taxes and productive or non-productive expenditures (see, for example, Kneller, Bleaney and Gemmell, 1999). Shifting the revenue stance away from distortionary to non-distortionary taxation has a growth-enhancing effect, whereas switching expenditure from productive to non-productive forms is growth retarding. In this framework, income and corporate taxes are treated as distortionary,⁶³ while taxes on domestic goods and services are treated as non-distortionary. On the expenditure side, those expenditures with a substantial physical or human capital component are treated as productive,⁶⁴ while expenditures on social security and welfare, recreation, and economic services are regarded as unproductive (see Table 3.1).

Table 3.1. Theoretical and Empirical Aggregation of the Government Budget into Distortionary and Non-distortionary taxation Productive and Non-Productive Expenditures, 2002-2004 (percent GDP)

Theoretical classification	Functional classification	2002	2003	2004
Distortionary taxation	Taxation on income	4.4	4.4	4.2
	Corporate income tax	1.0	0.9	1.1
	Social security contributions	11.5	10.6	11.2
	Taxation on payroll and manpower			
	Taxation on property			
Non-distortionary taxation	Taxation on domestic goods and services	12.6	13.7	14.3
Other revenues	Taxation on international trade	3.0	2.7	2.4
	Non-tax revenues	2.3	2.2	1.7
	Other tax revenues	0.4	0.3	1.5
Productive expenditures	General public services expenditure	7.5	11.8	9.0
	Defense, public order and safety	4.0	4.3	6.0
	Educational expenditure	4.5	5.6	5.4
	Health expenditure	7.3	7.0	6.3
	Housing expenditure	0.1	0.1	0.1
	Transport and communication expenditure	0.8	0.4	0.8
Unproductive expenditures	Social security and welfare expenditure	15.1	15.3	14.6
	Expenditure on recreation	1.2	1.0	0.7
	Expenditure on economic services	1.7	1.9	1.5
Other expenditures	Other expenditure (unclassified)	0.1	0.1	0.0

Source: Kneller, Bleaney and Gemmell (1999) for the framework; IMF and the Montenegrin Ministry of Finance for the data.

3.24 We apply this framework to the case of Montenegro for the period 2002-2004⁶⁵ to see whether the composition of fiscal policy has shifted in favor of or against growth. We will use the framework to answer two basic questions. First, on the financing side, have distortionary taxes increased

⁶¹ See, for example, Barro (1990), Barro and Sala-i-Martin (1992), Barro and Sala-i-Martin (1995), Devarajan et al. (1996), Easterly and Rebelo (1993), Glomm and Ravikumar (1997), Kneller et al. (1998).

⁶² Levine and Renelt (1992) convincingly demonstrate that a framework that does not specify the full government budget constraint will lead to biased estimates of the impact of public expenditures on growth.

⁶³ See Barro (1990).

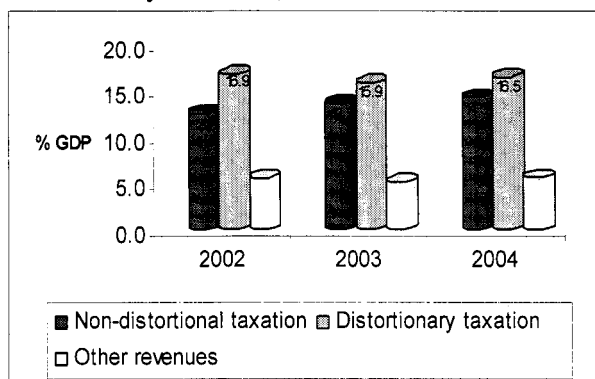
⁶⁴ See Barro and Sala-i-Martin (1995); and Devarajan et al., (1996).

⁶⁵ This framework is more suitable for a long-term analysis, but Montenegro's public expenditure by functional composition is available only for the period 2002-2004.

or decreased over the last three years? Second, on the expenditure side, have productive expenditures increased or decreased over the last three years?

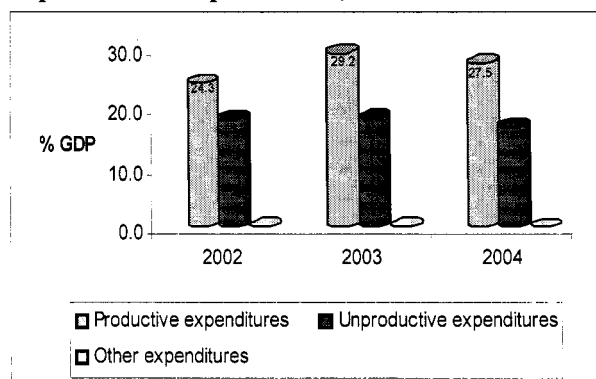
3.25 On the financing side, Montenegro has slightly increased its non-distortionary taxation (from 12.6 percent in 2002 to 14.3 percent in 2004), while distortionary taxation has remained at about the same level (Figure 3.10). Owing to the revenue reforms undertaken by the Government since 2001, the personal income tax and the corporate tax (both distortionary) have declined, while the retail sales tax and VAT (non-distortionary) have increased (see Figure 3.3). Social security contributions (distortionary) have increased but have been more or less off-set by the decline in personal and corporate income taxes so that distortionary taxation has remained more or less constant.

Figure 3.10. Trends in Distortionary and Non-distortionary Taxation, 2002-2004



Source: Kneller, Bleaney and Gemmell (1999); Montenegrin Ministry of Finance for the data.

Figure 3.11. Trends in Productive and Unproductive Expenditures, 2002-2004



Source: Kneller, Bleaney and Gemmell (1999); Montenegrin Ministry of Finance for the data.

3.26 On the expenditure side, productive expenditures have increased while unproductive expenditures have declined slightly (Figure 3.11). Productive expenditures—defined as the sum total of expenditures on general public services, defense, public order and safety, educational expenditures, health expenditures, housing expenditures, and expenditures on transportation and communications—rose from about 24 percent of GDP in 2002 to 27.5 percent in 2004. On the other hand, unproductive expenditures—consisting of social security and welfare expenditures and expenditures on recreation and economic services—declined from 18 percent in 2002 to 16.8 percent in 2004.

3.27 On the whole, it appears that Montenegro's fiscal policy over the last three years has shifted slightly in favor of growth. Still, it has a long way to go. On the one hand, distortionary taxation and unproductive expenditures were reduced; on the other, non-distortionary taxation and productive expenditures were increased. These changes should generally bode well for growth. However, two points should be emphasized. First, the aggregation of the functional classifications into distortionary/ non-distortionary and non-productive/productive expenditures in Table 3.1 is not uncontroversial. In particular, productive expenditures in Montenegro rose in large part because the framework classifies general public administration and defense and public order and safety expenditures as productive expenditures. However, while a reasonable level of spending on basic law and order, police, and administration can rightly count as productive, it could be argued that these expenditures are not wholly productive in Montenegro in view of the excess staffing prevalent in public administration and in the police and public order sector. Second, even if there were no issues with aggregation, the conclusion would mean that, while progress has been made over the last three years, Montenegro still needs to reorient its fiscal policy towards growth by increasing productive expenditures and reducing distortional sources of financing.

Montenegro's Public Investment Program

3.28 **Montenegro's domestically financed capital expenditure in 2004 accounted for about 2 percent of GDP** (Table 3.2). Capital expenditures financed through program and project loans are not integrated into the Government data on capital expenditures, but are estimated to constitute slightly over 50 percent of total capital expenditures in Montenegro (Ministry of Finance). Data on donor-financed capital expenditure are neither regularly reported by donors nor collected by the Government. Similarly, although local governments/municipalities are involved in the provision of basic utilities, their capital investment is not tracked by the Ministry of Finance, in part because local governments are not yet integrated into general government reporting (charts of accounts for local governments are being finalized).

Table 3.2. Montenegro's Capital Expenditure by Function, 2004* (euros)

Functional classification	Capital expenditures	% of Total
Other economic affairs	6,335,000.0	22.68
General public services	6,016,972.0	21.54
Transportation	6,010,703.4	21.52
Health service	3,218,794.7	11.52
Public order and safety	3,086,264.8	11.05
Education	1,347,280.0	4.82
Military and civil defense with administration	1,000,000.0	3.58
Social welfare and social protection	502,000.0	1.80
Sports, cultural and religious activities	326,000.0	1.17
Housing and utility affairs and services	64,100.0	0.23
Agriculture, forestry, hunting and fishing	20,000.0	0.07
Other expenditures	5,000.0	0.02
Energy	0.0	0.00
Mining	0.0	0.00
TOTAL	27,932,114.9	100.00

Table does not include externally financed capital expenditure.

Source: Montenegrin Ministry of Finance.

3.29 **In 2004, over 85 percent of domestically financed capital expenditures went to five major functions**—economic affairs, general public services, transportation, health services, and public order and safety, in that order. Within economic affairs, by far the largest share—nearly 90 percent—of the capital investment went to development projects. Tourism received only 30,000 euros, or about 0.5 percent of the capital investment on economic affairs. Within general public services, capital investment was made in general services (about 67 percent) and executive and legislative bodies (about 32 percent). There was virtually no investment in research and development (only 2,000 euros). The bulk of capital investment in public order and safety went to police and firefighter protection (over 85 percent). Capital investment in health and in education accounted for about 11 and 5 percent, respectively, of total capital investment.

3.30 **Capital investment in infrastructure accounted for only about 20 percent of total capital investment, or about 0.4 percent of GDP.** Within infrastructure, most of the capital investment was made in land transportation, namely, construction and maintenance of roads (slightly over 50 percent), and railroad transportation (about 33 percent). The rest went to water transportation and communication (about 10 percent). Air transportation, pipelines and other transportation systems, and communications affairs received no capital investment. Montenegro would need to create budgetary space for capital investment in general, and, in particular, for well targeted infrastructure investment that would effectively support the development of its tourism industry – the main potential for growth.

D. BUDGET PROCESSES, MEDIUM-TERM PLANNING, AND GROWTH

3.31 Apart from tackling sustainability and allocation issues, Montenegro would need to strengthen its budgetary processes and institutions to ensure a more efficient and transparent utilization of existing public expenditures. Effective budget management, including medium-term sectoral plans effectively tied to the budget, is central to maximizing the impact of current public expenditure on growth and service delivery. While Montenegro has made progress in recent years, there are still challenges with respect to addressing the arrears problem (a symptom of both budget preparation and execution problems) as well as establishing a medium-term expenditure plan that effectively links sectoral development plans with the budget.

The Budget Formulation Process

3.32 **Montenegro's Organic Budget Law, adopted in 2001, provides a framework for budget formulation and execution.** The Law assigns responsibilities to the Ministry of Finance (MoF) to issue detailed subordinate regulations to guide the processes. The MoF is responsible for managing the budget preparation process for the central government. The budgets of municipalities and social funds are prepared by their respective bodies. Montenegro's budget for 2005 already contains tables with the consolidated budgets of the central government and social funds, but a new harmonized chart of accounts is being adopted that would allow for the consolidation of municipal budgets into the general government budget as well. The budget, however, is still not fully comprehensive as it does not include municipalities and, in some cases foreign-financed programs and projects.

3.33 **Montenegro's budget preparation process begins in June with the preparation of the macroeconomic and fiscal policy framework for the next fiscal year, which in turn defines the overall budget resource envelope.** The MoF then issues circular instructions, with expenditure ceilings for each spending agency and the formats for budget submission. Requests for funding would also include planned spending from the so-called "own revenues" of budget users. While the MoF is not responsible for funding those programs and activities planned to be financed from own revenues, all own revenues realized at the level above the planned figure become public revenues and cannot be used by budget users.

3.34 **The spending agencies then prepare their budgets according to the format provided by the MoF and submit their budgets to the MoF in September.** Budget planning at the spending agencies is based mainly on historical costs. Although the Government has recently developed a medium-term fiscal framework covering three years (2005-2007), very few budget users have started preparing programmatic budgets. The final budget allocation outcome would involve negotiations. After negotiations, budget analysts from the MoF work with the budget officer of the respective spending agency to fit demands within the approved level of spending. The consolidated draft budget is then approved by the Government and forwarded to the Parliament in November for voting. The voted budget is published in the official Gazette to inform budget users and citizens of budget allocations.

Budget Execution and the Arrears Problem

3.35 **All budget users, except for higher education and institutions of culture, pass through a central Treasury system.** The Treasury approves and sends a *monthly* spending schedule to each budget user. Also, it closely monitors revenue collection each month and pays the invoices sent by budget beneficiaries, according to available funds. A quarterly analysis of the compliance of execution with plans

is conducted. At year-end, the MoF prepares final accounts, which are then audited by an independent auditor.⁶⁶

3.36 Montenegro's overall budget execution has improved in recent years, but execution varies considerably across categories (Table 3.3). The overall index of budget execution—expressed as a ratio of the actual budget outturn to the planned budget—improved from about 90 percent in 2002 to 97.7 percent in 2004.⁶⁷ Yet there have been significant variations by economic and functional composition. By economic composition, debt servicing (with a persistent execution several hundred times higher than plan) and interest payments, and the wage bill, had the highest index of execution. The items with the lowest index of execution were capital investment (57 percent) and maintenance and operational costs (77 percent). By functional composition, actual spending on general public services has consistently exceeded plan, with an index of execution of over 100 percent. The lowest ratio of budget outturn to plan has been with regard to economic services, with only 52.2 percent of the planned budget actually realized in 2003.

Table 3.3. Budget Execution by Economic Items, 2002 - 2004

Economic classification	2002	2003	2004
Gross salaries	75.7	89.7	94.9
Allowances	88.4	77.6	95.4
Goods and services	78.5	84.6	77.1
Interest	72.2	55.7	135.3
Rent	72.2	84.1	91.8
Subsidies	74.1	87.2	92.2
Grants and social benefits	84.1	85.8	78.1
Other expenditures	71.9	80.9	88.7
Capital expenditures	69.0	59.4	57.1
Loans and credits	64.5	55.9	84.6
Reserves	99.3	85.6	123.8
Total	89.5	94.5	97.7

Source: Montenegrin Ministry of Finance.

3.37 Montenegro's large arrears, defined as the difference between accrued and paid expenditures, are symptomatic of continued budget formulation/execution problems. As at end-2004, total arrears of the central government⁶⁸ stood at 1.3 percent of GDP (€19.7 million). By functions, the largest arrears have been generated toward defense and police (31 percent) and the Health Fund (27 percent), followed by economic services (18 percent) and education (13 percent) (Figure 3.12). Within economic services, most arrears have been generated in the transportation and infrastructure sector. By economic items, the bulk of the arrears constituted unpaid social benefits and transfers (32 percent), unpaid maintenance and operational costs (26.6 percent) and unpaid health insurance contributions to the Health Fund (16.4 percent).

⁶⁶ Until 2005, Deloitte & Touche, a private auditing firm, has audited government accounts in Montenegro. For the first time in 2005, government accounts are expected to be audited by the new Supreme Audit Institution of Montenegro (which has just been established).

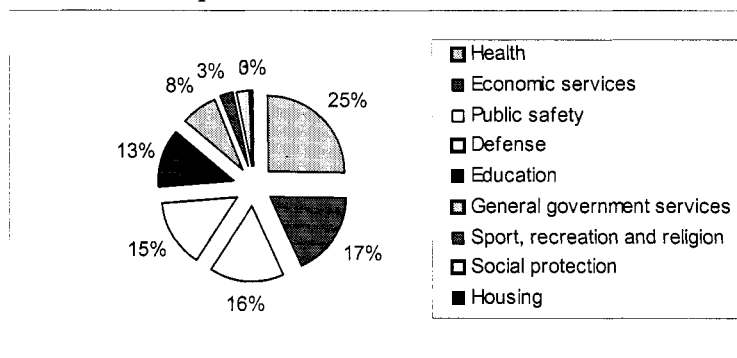
⁶⁷ This is a simple average of the ratio of actual budget to planned budget across all economic classification items.

⁶⁸ General government arrears, inclusive of arrears generated by social funds and municipalities, are probably much larger but no complete data are available.

3.38 **Arrears seem to arise for several reasons in Montenegro. They arise first of all because revenue projections by the MoF often turn out to be more optimistic than actual revenues.** In the recent years there have been consistent shortfalls in revenue collection of 3 percent to 5 percent each year, in part because of recent tax cut measures by the Government. With revenue shortfalls, the Treasury takes expenditure measures to bring expenditures in line with resources, and advises spending agencies to adjust their spending accordingly.⁶⁹ However, this notification comes each time with several months' delay, thereby creating the conditions for the arrears to be generated by the spending agencies or budget users. The time gap between the points at which revenue shortfalls are identified and expenditure measures are adopted by the MoF and the spending agencies leaves a gap of months for budget users to create arrears. The following year, budget users have to first pay off the arrears before making any new commitments. However, while budget users are paying last year's arrears, new arrears in the current year would be generated that roll over to the next year, thereby perpetuating the cycle.

3.39 **However, not all of these arrears are due to poorly planned revenues. The problem arises in part because of lack of good commitment control at the spending agencies.** The Department of Internal Auditing was formed within the MoF only about a year ago. With the establishment of the Department, several internal controllers have been trained to review transactions related to the inflows, commitments and outflows of budget users in 2004. By the end of 2004, the Internal Control conducted budget reviews for seven minor budget beneficiaries. The preliminary findings of this assessment are: (i) all budget users do not properly plan their needs and often are forced to spend funds budgeted for one item on something else; (ii) there is a lack of budget officers and accountants in some institutions; (iii) the even existing budget officers are not well enough trained to perform all of the expected tasks; and (iv) there is a need to improve the quality of financial statements as well as transparency.

Figure 3.12. Central Government Arrears as at end-2004, by Functional Composition



Source: IMF; Montenegrin Ministry of Finance.

3.40 **Arrears undermine budget efficiency, effectiveness and growth for two main reasons.** First, arrears weaken the predictability of budget and planning by spending agencies/budget users. Budget users cannot plan in advance or focus on program effectiveness, efficiency, and improved productivity if they must spend most of their time fighting arrears or battling for funds to operate their program. Second, arrears may be costly, especially when they are owed to suppliers of goods and services and especially if interest has accrued on them. For these reasons, the Government of Montenegro would need to take two key steps to address the arrears problem. First, the Government would need to prevent arrears from arising by providing better and more realistic revenue projections as well as speedy expenditure decisions to be implemented by budget users in the event of revenue shortfalls and by strengthening the commitment control systems at the spending agencies through the upgrading of staffing, accounting standards, and transparency. Second, the Government would have to develop a serious plan to clear the current stock of arrears. Unfortunately, the Government has not yet initiated a systematic plan to audit and clear the arrears. Such a plan should identify the most costly arrears, and attempt to retire those first.

⁶⁹ In 2004 the MoF issued so-called "Saving measures" where it announced budget cuts of €14.9 million (proportionally across beneficiaries). Most of the cuts came from capital spending, maintenance and operational costs and subsidies to enterprises.

Medium-Term Planning and Growth

3.41 The MoF has already taken the initial steps toward providing a Medium-Term Expenditure Framework. In its current form, the framework consists of projections of revenues, expenditures by economic item and financing for the central government for the next three years. While this is a step forward, it is far from being a full MTEF. The framework lacks the consolidation of total public expenditures, in particular the budgets of municipalities, as well as bottom-up medium-term sectoral budgeting and analysis. Bottom-up costing and multi-year budget planning by budget users is critical to achieving an effective link between sector policies and budgets at the micro level, and between broad national policy and development priorities and the budget at the macro level.

3.42 The link between policy priorities and the budget is weak in Montenegro. Many sectors and spending agencies lack medium-term planning and budgeting, which weakens not only the link between policies programs and the budget but the link between public expenditures and growth. A good example is provided by the tourism sector. Tourism is indicated as a priority sector for development in virtually all Government papers, including the Economic Reform Agenda. The Ministry of Tourism has a very detailed strategy (called Tourism Master Plan) for tourism development, which indicates programs and activities that would need to be undertaken in the medium term to long term. However, the strategy has not been translated into a programmatic budget, and the Government remains uncommitted to any medium-term budget for tourism development even though the sector is regarded as the main source of growth. This lack of an effective link between the medium-term tourism development strategy and the budget in turn undermines medium-term growth in Montenegro.⁷⁰ Similarly, Montenegro's PRSP remains unimplemented to date in part because it has not been well linked with the budget.

3.43 Finally, a functioning MTEF could be an effective way to capture the various sources of funding for public investment, including investments by municipalities. Municipal spending is very important in infrastructure, as many of the investments are undertaken at this level of government. Again, to take tourism development as an example, most of the programs are likely to be multi-year and multi-sectoral (involving different institutions at the same or different levels of government). Short-term budgeting is not an optimal arrangement for ensuring the financial commitments of various implementing agencies in guaranteeing program sustainability and growth.

E. CONCLUSIONS AND POLICY RECOMMENDATIONS

3.44 Montenegro's current fiscal position is not sustainable. At the end of 2004, Montenegro's estimated debt-to-GDP ratio was 43.8 percent of GDP. Under the simplifying assumptions that the economy grows at a constant real rate of 4 percent per year, and that the real interest rate is constant at 5 percent, a recent analysis by the World Bank finds that a primary budget balance of 0.4 percent is needed for Montenegro to achieve long-run fiscal sustainability. Yet, Montenegro's primary fiscal balance over the past two years was close to a deficit of 2 percent of GDP, and current projections for the primary balance suggest a deficit of just over 1 percent of GDP in 2005. This is well short of the surplus of 0.4 percent of GDP needed for fiscal sustainability. A substantial fiscal tightening—in the order of 1 percent of GDP-- is needed to achieve fiscal sustainability. While a higher growth rate and access to concessional financing can supplement such effort, fiscal reforms would take center stage.

3.45 The scope for further fiscal tightening as well as reallocation to public investment lies in reducing expenditures on the wage bill, transfers to households, lending to public enterprises, and interest payments. Montenegro spends about three-fourths of its expenditure on wages and various social

⁷⁰ This of course assumes that money allocated to tourism development would be used effectively.

benefits to households. A comparison with regional states shows that Montenegro's wage bill as a proportion of total government expenditure and of GDP is far above average. On the other hand, capital expenditure is much below the level for other countries in the region. In particular, the high wage growth has crowded out spending on public investment and operations and maintenance—expenditures that are essential for growth. Subsidies and lending to public enterprises have been progressively reduced over the last three years, but much remains to be done to impose a full hard budget constraint on public enterprises. Combined, direct enterprise subsidies and loans to enterprises accounted for about 1.6 percent of GDP in 2004. The large, yet-to-be-privatized state-owned enterprises (e.g., KAP, EPCG) still lack hard budget constraints and budgetary discipline and therefore take resources away from other priority areas of expenditure such as capital investment in infrastructure.

3.46 A more vigorous public sector reform is fundamental to creating a budgetary space for capital investment and rationalizing the state's functions, and also reducing the role of the state in the economy. The following measures deserve priority consideration in order to ensure fiscal sustainability and macroeconomic stability, create a budgetary space for capital investment, and improve the delivery of social services.

- *Reduce/control expenditures on the wage bill, transfers to households, and interest payments*, which have risen significantly over the last three years. In particular, the high wage growth has crowded out spending on public investment and operations and maintenance—expenditures that are essential for growth. The high wage growth should be controlled through public administration reforms that would eliminate employment redundancies as well as through the controlling of wage and salary increases (see chapter 2 for other measures).
- *Eliminate/reduce subsidies and lending to public enterprises by imposing a complete hard budget constraint.* Government subsidies and net lending now account for about 1.6 percent of GDP. State-owned enterprises still lack hard budget constraints and budgetary discipline. This problem could be overcome through (i) increasing the transparency around which state-owned enterprises receive subsidies and transfers from the Government; (ii) completing the privatization of these enterprises where privatization is an option; and (iii) where privatization is not feasible, by improving the management of such enterprises and defining strict financial performance criteria that would phase-out subsidies and budget transfers.
- *Develop a sound public investment program that will support tourism development and growth.* At 2 percent of GDP, Montenegro's domestically financed capital expenditure is much below the level of other countries in the region. Capital investment in infrastructure in 2004 accounted for only about 0.4 percent of GDP. While the low numbers may indicate the need for more capital investment, in particular infrastructure investment, such a decision is best guided by two prior conditions: (i) that there is a trade-off between a public infrastructure investment program and macro stability/fiscal sustainability, and whatever investment in public infrastructure needs to be made within the broader macroeconomic and fiscal constraints; (ii) that a rigorous public investment project appraisal and screening system is put in place to rank public investment projects, and fund only those which are strongly growth-oriented and whose economic and social returns are high enough. In Montenegro, there is a need to do both a strategic assessment of what infrastructure investment may be needed, and which of the many potential infrastructure projects warrant investment based on their economic and social returns. There is no doubt that increasing capital investment, in particular in infrastructure, is necessary. The challenge would be to do this in a way that does not compromise fiscal and macroeconomic sustainability (i.e., create budgetary space), and to carefully evaluate and fund only those infrastructure investments that are strongly linked to tourism development and growth (i.e. well-targeted investments).

- *Increase the productivity of current expenditures on education and health care services.* Compared with other countries in the region, Montenegro spends more on education and health. In the health sector it is important to improve the management of public health funds, continue the reform of primary health care, including preventive programs and priority treatment programs, and improve public procurement procedures by passing new regulations. In education the disproportionate staffing costs should be reduced through school consolidation, and vocational training programs should be realigned to suit those demanded by the labor market.

3.47 Furthermore, the Government would need to strengthen institutional and budgetary processes, in terms of both controlling arrears and strengthening the link between budgets, plans and programs. The following specific steps are necessary to increase the effectiveness of the Government budget and its link with growth:

- *Prevent arrears from arising through the following:* (i) providing better and more realistic revenue projections as well as speedy expenditure decisions to be implemented by budget users in the event of revenue shortfalls; (ii) strengthening the commitment control systems at spending agencies through better staffing, the upgrading of accounting standards, and transparency.
- *Develop a serious plan to clear the current stock of arrears.* Unfortunately, the Government has not yet initiated a systematic plan to audit and clear the arrears. This plan should identify the most costly arrears and attempt to retire those first.
- *Strengthen the link between policy priorities and the budget, especially in tourism development and PRSP implementation.* There is a need to develop a comprehensive medium term expenditure framework as a basis for public expenditure planning. This should comprise the central government, the social funds, and local governments, and should reflect fully the policy commitments of the Government. The Government budget generally, and public investment particularly, should support the realization of the growth potential of tourism. The Ministry of Tourism should move toward multi-year budgeting and program implementation, with specific milestones and monitorable targets.

4. PRIVATE AND FINANCIAL SECTOR REFORMS FOR GROWTH AND COMPETITIVENESS

4.1 The development of a competitive private sector, including a vibrant SME component, is essential for generating sustainable economic growth and employment. This chapter addresses three questions. First, in view of Montenegro's large informal private sector, it seeks to answer the question of why the informal sector is large and what the Government can do to expand the formal economy. The emphasis will be on the incentives and disincentives for operating in the informal economy, including the high burdens and the poor administrative and institutional capacity of the Government to enforce rules and operate in a transparent way. Second, the chapter will look into other key constraints that hold back private investment and growth, in both the formal and informal sectors of the economy. Consistent with the hypotheses laid out in Chapter 1, we will examine closely the extent to which enterprise restructuring, property rights and contract enforcement, bankruptcy and exit, and the cost of finance and financial intermediation constrain private sector investment and growth. Third, the chapter will identify policy priorities and suggest recommendations for private sector growth and competitiveness in Montenegro.

A. CHARACTERISTICS OF THE PRIVATE SECTOR IN MONTENEGRO

4.2 **Under the socialist system of the former Yugoslavia, socially owned industries and services generated most of the income (GDP) in the Republic.** During the socialist period, the Government made large investments in state-owned enterprises (SOEs)—notably aluminum production, steel production, ship-building and repairs and tourism—that served the captive former Yugoslav markets. With Montenegro's transition reforms, many of these socially owned enterprises have been privatized. According to the Montenegrin Privatization Council, more than 60 percent of the former socially owned or state-owned capital has been privatized. However, as of the start of 2005, controlling shares in the 17 or so largest companies still remain in the hands of the Government and social funds. Among these companies are the Aluminum Combine Podgorica (KAP) and the Power Company of Montenegro (Elektroprivreda Crne Gore), which continue to play an important role in terms of production and employment.

Table 4.1. Registered Businesses by Type, 2005

Businesses	Number
Joint Stock Companies	377
Limited Liability Companies	10,319
Limited Partnerships	627
General Partnerships	68
Entrepreneurs	13,090
Branches/affiliates of foreign companies	265
NGOs	226
Institutions	704
Other	99
Total	25,775

Source: Commercial Court Podgorica, January 2005.

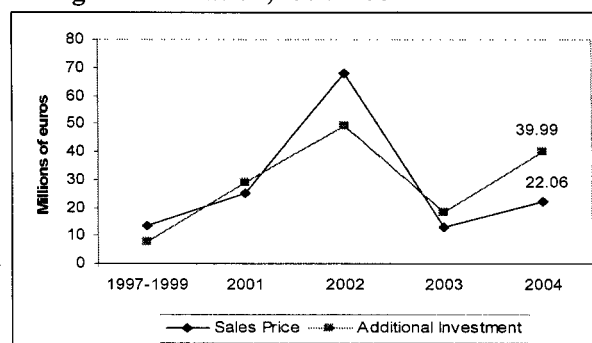
4.3 **In terms of employment, the public sector continues to dominate the Montenegrin economy.** According to the 2003 Labor Force Survey data, 59.2 percent of employment took place in the public sector (including the Government-provided public services, such as the civil service, the health and education sector, and social protection), *25.7 percent took place in private sector*, and the rest was in mixed ownership. More than 64 percent of total employment is in the services sectors, and by the number

of employees, agriculture, trade and tourism-related services are the key branches in the economy (see Chapter 2).

4.4 The private sector's contributions to GDP and employment remain modest. Business registration data show that there are over 10,000 limited liability companies, over 300 joint stock companies, and over 13,000 entrepreneurs (Table 4.1). While it is very difficult to extrapolate from such data the extent of the contribution of the private sector to income and employment, most of the limited liability companies are likely to be SMEs in the private sector. In terms of employment, the emerging private sector, comprised of small firms, has not yet developed the critical mass to generate enough jobs to offset job losses in the public sector. The result has been a rise in unemployment over the last several years (see Chapter 2 for more details). Facilitating the entry of new firms and the growth of small enterprises is hence necessary to create more jobs and reduce unemployment.

4.5 Over the years, the Government's privatization program has clearly helped encourage private investment, including foreign direct investment (FDI), in Montenegro. During 1997-2004, total FDI in Montenegro amounted to 382 million euros. Of this, the largest amount was achieved through the privatization process. Over the same period, the total price of assets sold through privatization amounted to 141.4 million euros, while the new owners made a total additional investment in the amount of 144.09 million euros (see Figure 4.1). While Montenegro had the lowest total inflow of foreign investments in the region in absolute terms, FDI per capita (71 euros) remained close to the regional average.

Figure 4.1. Total FDI Achieved in Montenegro through Privatization, 1997-2004



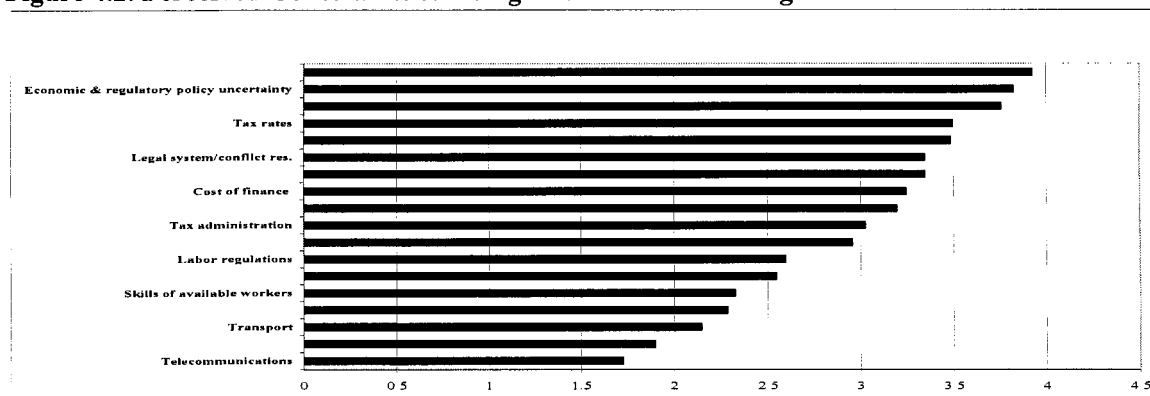
Source: Agency for Restructuring and Foreign Investments.

4.6 The privatization of Telecom Montenegro and KAP, completed as of early 2005, and the expected privatization of the remaining large strategic SOEs, mainly in the area of infrastructure and public utilities in 2006, are expected to bring further FDI inflows. Thus, in the short run the FDI inflow will depend predominantly on progress in privatization. However, in the medium to long-term, Greenfield investments in Montenegro will depend upon broader investment climate factors such as political stability, the protection of property rights, and contract enforcement (in particular, land property rights, regulations and governance) and financial intermediation and the availability of credit. These issues are discussed at length throughout the rest of this chapter.

4.7 The most highly visible feature of Montenegro's economy, however, is the large and persistent informal sector. It is estimated that the informal economy contributes about 30 percent of GDP and employs about 27 percent of the workforce (ISSP, 2004). A large number of firms (or entrepreneurs) do not participate in the formal sector because they seek to avoid taxes, and regulation and other administrative processes. Apart from purely gray economy firms, a significant number of registered enterprises under-report their business activities to avoid taxes and administrative hassles. Even formal sector enterprises try to keep their activities "blended" with informality in order to avoid the administrative and financial burdens of regulation. According to the Productivity and Investment Climate Survey of 2003 (PICS, 2003), firms in Montenegro perceived that their competitors reported on average only 70 percent of their business activities. Whether a firm is unregistered and entirely in the informal sector or is only partly outside the formal economy, it poses a threat to those firms that operate legally.

4.8 A large informal economy limits growth and competitiveness in a number of ways. First, by definition, the sector is beyond the realm of government control, and as such, does not contribute to government revenue. In turn, the sector does not receive property right protection and other services that formal sector businesses enjoy. Second, informal businesses pose an undue competition to those in the formal sector as they are not subject to tax and other government obligations. Indeed, in Montenegro a recent PICS survey shows that the uneven playing field posed by informal businesses is a major barrier to doing business (Figure 4.2). For these reasons, conversion of informal businesses into formal businesses through reforming the underlying policy, regulatory and administrative barriers affecting the former would be essential for growth.

Figure 4.2. Perceived Constraints to Doing Business in Montenegro



Source: PICS, 2003.

B. WHY IS THE INFORMAL SECTOR LARGE?

4.9 **Businesses compare the costs and benefits of operating in the formal sector against those of the informal sector to make decisions about whether to operate formally or informally.** On the one (incentives) hand, there are often regulatory and administrative costs involved in complying with formal sector government rules, including registration and licensing, level of taxes and other contributions required of formal sector businesses, and other operational costs associated with being in the formal sector. On the other hand, businesses also take into account the extent to which they can continue to operate in the informal sector without facing negative consequences for failing to comply with Government rules, and the question of whether they would face legal actions by the Government.

4.10 **According to the EBRD's Transition Report 2000, incentives for participation in the informal sector differ depending on the country's stage of reform.** In economies at a mature stage of reform (e.g., Central and Eastern European countries), the motives tend to be more "market-related" and guided by a desire to evade taxes and avoid other bureaucratic constraints. In economies at an initial stage of reform, informal activity may be driven by poor opportunities in the formal sector and could be providing a "coping strategy" for survival. In Montenegro, the key reasons for the large informal economy seem to be the high regulatory and administrative burdens on businesses on the one hand, and the poor administrative and institutional capacity and the relatively poor opportunities in the formal sector on the other.

The Regulatory and Administrative Burden

4.11 **Montenegro has recently simplified its business registration system.** Heavier regulation of

entry is generally associated with greater corruption and a larger informal economy.⁷¹ Since end-2002, Montenegro has had a much reformed new business registration system in place. A burdensome registration procedure which had involved 38 steps and 45 days was streamlined to 4 steps and 3 days.⁷² The new Company Law has lowered the minimum capital requirement for limited liability companies to 1 euro. Table 4.2 compares the indicators for starting a business in Montenegro with the region and the OECD countries. The outcome has been a reported doubling of business registrations over a period of one year, most of which have been drawn from previously unregistered businesses engaged in the gray economy. Notwithstanding other remaining regulatory and administrative deficiencies, business registration reform clearly demonstrates how the removal of the regulatory burden could help enterprises move from the informal to the formal economy.

Table 4.2. Starting a Business

Indicator	Montenegro	Regional Average	OECD Average
Number of procedures	9	9	6
Time (days)	11	42	25
Cost (% of income per capita)	NA	15.5	8.0
Min. capital (% of income per capita)	0.1	52.8	44.1

Source: World Bank, *Doing Business in 2005: Removing Obstacles to Growth*, Washington, DC, 2004; CEED using the Doing Business methodology.

4.12 Despite the simplified registration process, licensing and inspection problems remain cumbersome and slow, and deter formality and private investment. Recognizing this problem, the Government prepared the draft Law on Licensing, prescribing a faster and more efficient registration at the municipality level and listing the business activities that do not need a license. However, the simplified procedure has not yet been implemented. According to the Law on Local Self-Government, the 21 municipalities in Montenegro are responsible for urban planning, including zoning and building permits, general licensing of businesses and related permits, the provision of utility services (waste collection, water, sewerage and electricity distribution), and also various inspections. However, as a recent FIAS study shows (FIAS, Montenegro Investment Environment Diagnostics, 2004), business operating licenses take a long time to be issued, if they are issued at all. Licensing and inspection activities are not conducted in a fair, professional way. While visible and legal businesses are extensively inspected, there is no noticeable effort to crack down on illegal businesses that operate without a license, avoid tax and social security payments, and/or establish the business premises without building permits. Local land use plans are not adjusted to accommodate the needs of business expansion. These factors are regarded as key impediments to doing business in the regulatory jurisdiction of local governments.

4.13 Payroll taxes and social contributions are still high in Montenegro, discouraging formal sector operation. Several taxes apply to formal sector businesses in Montenegro. The most important of these are the value-added tax (at 17 percent), the corporate tax (at 9 percent)⁷³ and the personal income tax (ranging from 0 to 23 percent, with the maximum rate applied to personal income over €4,572). While these taxes are not out of line with the regional rates, and, indeed, the corporate tax rate is one of the lowest, the high payroll taxes raise the cost of labor, thereby creating incentives for hiring workers informally.

⁷¹ See Djankov S., R. La Porta, F. Lopez de Silanes and A. Schleifer. "The Regulation of Entry", *Quarterly Journal of Economics*, 117, 1-37, (2002)

⁷² CEED, 2003, "Montenegro business registration process analysis"; and, CEED "Starting a business".

⁷³ Amendments to Montenegro's Corporate Tax Law in the third quarter of 2004 decreased the corporate tax rate from the prior progressive rates of 15 and 20 percent to a proportional rate of 9 percent, one of the lowest corporate taxes in the region.

4.14 **Recent reforms have helped reduce the payroll tax and contributions burden.** Table 4.3 shows the total labor cost as a percentage of gross salary for employees and employers in recent years. In April 2003, in response to widespread avoidance and non-compliance, the Government of Montenegro reduced the overall income tax, and social contributions (pensions, health and unemployment insurance) by the employer for newly registered labor, effective for one year until May 2004. The effective rate tax wedge on labor, which takes account of tax deductions, different social contribution levels by sectors, and non-compliance, was thus reduced to about 48 percent in 2003. At the same time, fines were increased for employing unregistered labor and inspections were strengthened as part of the 2003 reforms. According to Ministry of Labor officials interviewed, the policy resulted in 14,300 new registrations by the end of June and a claimed 26,000 by the end of September.

Table 4.3. Income Taxes, Social Contributions and Other Fees and Surtaxes on Wages in Montenegro (percent of gross salary)

Contribution	Employed before April 2003	Newly employed between April 2003 and December 2004	Employed in 2004 and hired before April 2003	Employed since January 2005
1. Employees' share of contributions				
Pension-invalid insurance – PIO Fund	12.00%	12.00%	12.00%	12.00%
Health Fund	7.50%	7.50%	7.50%	7.50%
Unemployment	0.50%	0.50%	0.50%	0.50%
2. Employers' share of contributions				
Pension-invalid insurance	12.00%	0%	10.8%	9.6%
Health care	7.50%	0%	6.5%	6.0%
Unemployment	0.50%	0%	0.5%	0.5%
Compensation for use of public goods	3.00%	-	13-15% of PIT	13-15% of PIT
Housing allowance	-	-	0.7%	0.7%
Allowance for annual leave	€150.0	€150.0	€150	€150
Meal allowance	€25.0	€25.0	€25	€25
Montenegrin Chamber of Commerce	0.32%	0.32%	0.32%	0.32%
Yugoslav Chamber of Commerce	0.125%	0%	0%	0%
Alliance of Independent Trade Unions	0.20%	0.20%	0.20%	0.20%
3. Total taxes and contributions	43.6-68.6%	20.5-44.5%	39-63% plus	37 -60% plus

Source: ISSP, 2003, 2005.

4.15 **Despite the recent reforms, the labor taxes (or payroll taxes) are still perceived as too high and as one of the major factors discouraging operation in the formal sector.** There are two alternative indicators of the wage tax burden: the non-wage labor cost and the tax wedge on the labor market.⁷⁴ By our calculations, in 2004 the tax wedge—taking into consideration all the social contributions (pension, health insurance and employment contributions) as well as fees and surtaxes established according to the General Collective Agreement, the Law on Communal Taxes and Compensations and other laws—is estimated at 52 percent of the labor costs.⁷⁵ Non-wage labor costs were estimated in 2004 at 35 percent. In OECD countries, the total burden on the labor market is 51.8 percent among European member countries

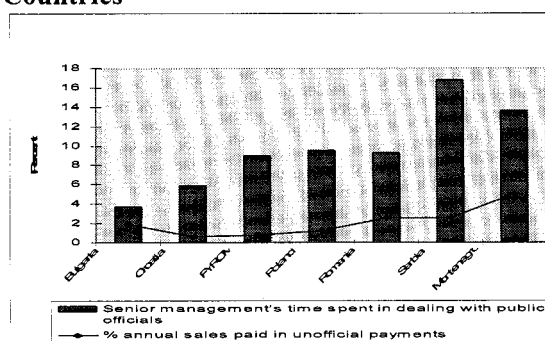
⁷⁴ Non-wage labor cost is defined as the ratio between payroll taxes and gross wages. The tax wedge on labor is a difference between the labor cost to the employer and the take home pay (net wage) expressed as a percentage of total labor cost.

⁷⁵ In 2005, this legal basis for compensation (tax) for use of goods of common interests of 3 percent of gross wages was replaced by the Law on Local Self-Government Financing which allows the municipalities to introduce a surtax of 13-15 percent of the calculated personal income tax.

and 37.3 percent for non-European member countries. (ISSP Montenegro Economic Trends, 2004).⁷⁶ Labor taxes lower labor demand by raising labor costs. But they also lower labor supply by reducing the real consumption wage. The high wage tax burden has contributed to lower employment, higher informalization, and higher (long-term) unemployment.

4.16 Administrative and bureaucratic costs are also high (Figure 4.3). The cost and time tax⁷⁷ of administrative processes and bureaucracy is high in Montenegro. According to PICS 2003, senior management spends an average of 13.6 percent of its time in dealing with requirements imposed by government regulations such as taxes, customs, labor regulations, licensing and registration. The PICs data also shows that the procedures for obtaining licenses, permits and certificates required for business operation in Montenegro are not sufficiently transparent, which results in corruption. Together with Serbia, Montenegro appears higher on the bribe tax. Among surveyed firms, over 5 percent of total annual sales were paid in unofficial payments in Montenegro, more than twice the regional average, excluding Serbia. Yet Montenegrin firms perceive corruption to be a less severe obstacle to their business relative to other impediments, such as the cost of finance, regulatory uncertainty, and contract enforcement and the judicial system.

Figure 4.3. Montenegro's Costs of Administrative Barriers Compared to Regional Countries



Source: PICS 2003 for Montenegro and Serbia, BEEPs II for other countries.

Governance and the Institutional Capacity to Enforce Rules

4.17 Governance and the institutional capacity to enforce rules are weak. Administrative and regulatory burdens, while providing incentives to being in the formal economy, are not the only reason for the thriving informal sector. The lack of effective and consistent application of rules by the public sector contributes equally to the problem.

4.18 The regulatory process is characterized by inconsistency in the application of rules. According to the law, public servants shall effect the issuance of permits, licenses and certificates in compliance with the law on General Administrative procedure, and a complainant is secured the right to take his case before the Administrative Court. In practice, public servants use wide discretionary powers in making decisions that affect, for example, the issuance of permits, licenses and certificates, and tax collection (FIAS, 2004). Visible and legal businesses are extensively inspected, but no noticeable effort is made to crack down on illegal businesses that operate without a license, avoid taxes and social security

⁷⁶ In addition to personal income tax, PIO contribution and contribution to the Health Fund, the employees also have to pay from their wages an unemployment contribution of 0.5 percent of gross wages, the employers, in addition to PIO contribution and contribution to the Health Fund, have to pay an unemployment contribution of 0.5 percent of gross wages, a fee to the Chamber of Commerce - 0.32 percent of gross wages; fee to the Confederation of Independent Trade Unions - 0.20 percent of gross wages; payment to the housing fund for employees - 0.7 percent of gross wages; compensation for use of public goods - 3.0 percent of gross wage (replaced in 2005 by 13-15 percent of personal income tax (PIT); meal allowance of 50 percent of the minimum wage (EUR 25), and transport allowance 25 percent of the price of gasoline per km. (See Table 4.15 for details).

⁷⁷ The time that senior managers have to spend dealing with government officials and regulatory activities provides a measure of the burden (so called "time tax") that regulation places on firms.

payments or establish a business premises without building permits. Such inconsistency provides opportunities for bribe taxes and corruption. Improvements in the quality of regulation through greater transparency and a more consistent application of rules, and an improved tax administration capacity to support rule-based tax collection, are needed.

4.19 The enforcement of rules is weak because of lack of skills and poor institutional capacity in the public sector. Although an adequate legal framework has been put in place for public administration reforms, the Government has yet to fully implement the reforms. In March 2003 the Government approved a Public Administration Reform Strategy, which sets out the key objectives of public administration reform and puts forward an ambitious structural and legislative reform agenda for the reorganization and re-orientation of the state administration. The Strategy seeks to introduce new forms of administrative accountability based on more flexible, result-oriented contractual models, including competition mechanisms in the provision of public services. It also emphasizes the principles of client-orientation and the importance of a modern information system for enhancing the efficiency and quality of public services. The Strategy divides the process of administrative reform into three main stages: the first stage, from 2003 to 2004, concentrates on the development of a legal framework; the second and third stages, from 2004 to 2006 and 2007 to 2009, are devoted to the implementation of the Strategy and the adoption of new rules and procedures. In accordance with the reform phases, a set of key public administration laws—such as the Law on the State Administration, the Law on the Ombudsman and Law on Inspection Control, the Law on Administrative Procedure and the Law on Administrative Dispute — were approved by Parliament in 2003. A further set of laws, including the Law on Civil Service and the Law on Salaries, was adopted in 2004.

4.20 Yet Montenegro is only in the beginning stages of the more difficult phase of implementing the public administration reforms. Agency heads are typically political appointees, which undermines effective administrative coordination and the continuity of skills and knowledge. The public sector is overstaffed and under-productive. Low rates of public sector pay contribute to the problem of attracting and retaining competent professionals. Whatever the underlying factors, a modern public administration system, characterized by transparent, non-discretionary processes, and efficiency--although within reach in the medium term-- is yet to be created in Montenegro. This would require the putting in place of appropriate incentive and accountability systems and significant institutional capacity building through education, training, and the application of information technology, as well as a coordinated action from a number of key players to avoid the risk of administrative fragmentation.

4.21 Further, implementation of the new laws and regulations governing the private sector requires stronger institutional and administrative capacity. In the past three or four years, Montenegro has overhauled much of its legal and regulatory framework regarding the private sector but implementation is lagging behind (see Table 4.4). It was only in 2003 and 2004 that the Parliament of Montenegro adopted 45 laws and 67 laws, respectively, out of which roughly 35 are related to the business environment or the financial sector. It is hard to find an area that is not covered by a new law or by a law being drafted, particularly in regard to the activities of business and commerce (Table 4.4). While the new laws provide an adequate legislative framework for the development of a well-functioning market economy, significant implementation gaps are emerging. Many of the new laws have not yet been fully applied by the administration, the judiciary and the municipalities. In most cases, implementation of legislation aimed at improving the business environment (contract enforcement, access to finance, corporate governance, and business exit) has not yet begun. Because of the country's history, most of the professionals do not have the experience, skills and motivation required for this kind of work. One consequence has been that new legislation is not broadly understood and is not implemented with any effectiveness.

Table 4.4. Recent Business Law Reforms in Montenegro and their Status of Implementation

Group	Business law	Legislative Status	Legislation Date	Implementation Status
Fiscal/Tax laws	Tax Administration Law	5	Enacted Dec 2001	improved
	Personal Income Tax Law	5	Enacted Dec 2001	improved
	Corporate Profit Tax Law	5	Enacted Dec 2001	improved
	Excise Tax Law	5	Enacted Dec 2001	improved
	VAT Law	5	Enacted Dec 2001	improved
Budget/Treasury	Budget Law	5	Enacted Aug 2001	improved
	Law on Assumption of Debt	5	Enacted Oct 2003	improved
	Public Debt Law	5	Enacted Feb 2004	improved
	Law on State Auditing Institution		Enacted early 2004	started
Anti-Corruption Initiative Laws	Public Procurement Law	5	Enacted Aug 2001	improved
	Anti-Corruption Practice Law	4		
	Anti-Money Laundering Law	5	Enacted Oct 2003	improved
	Law on Participation of Private Sector in Delivery Public Services	5	Enacted Jun 2002	weak
	Digital Signature Law	5	Enacted Oct 2003	not implemented
	E-commerce Law	5	Enacted Dec 2004	not implemented
Privatization	E-communications Law	0		
	Telecommunications Law	5	Enacted Dec 2000	complete
	Energy Law	5	Enacted Jun 2003	improved
	Tourism Law	5	Enacted Jun 2002	improved
	Restitution Law	5	Enacted Mar 2002	replaced (new)
Business Law	Restitution Law, New	5	Enacted Mar 2004	ongoing
	Business Organization Law	5	Enacted Jan 2002	weak
	Secured Transactions Law	5	Enacted Jul 2002	improved
	Accounting Law	5	Enacted Jan 2002	(new draft)
	Mortgage Law	5	Enacted Jul 2004	started
	Revision – Real Property Law	0		
	Anti-Monopoly Law	3		
	Unfair Competition Law	3		
	Law on Licensing	2		
	Consumers Protection Law	3		
Contract Enforcement	Law on Foreign Trade	5	Enacted Apr 2004	ongoing
	Law on Enforcement Procedure	5	Enacted May 2004	weak
	Litigation Law	5	Enacted May 2004	weak
	Law on Expert Witnesses	5	Enacted Dec 2004	weak
	Bankruptcy + Cross Border Insolvency Law	5	Enacted Jan 2002	weak
Banking Sector	Central Bank Law	5	Enacted Nov 2000	complete
	Law on Banks	5	Enacted Nov 2000	complete
	Bank Bankruptcy and Liquidation Law	5	Enacted Oct 2001	complete
	Insurance Law	3		
Pension/Social Sector Capital Markets	Pension Law	5	Enacted Sep 2003	ongoing
	Securities Law	5	Enacted Dec 2000	weak
	Securities Law Amendments	1		
	Investment Funds Law	5	Enacted Jul 2004	weak

Status: 0 in preparation; 1 draft – working group; 2 draft – general review; 3 final draft submitted to GRM; 4 in Parliament; 5 enacted.

Source: USAID; <http://www.skupstina.cg.yu/>; World Bank staff assessment.

4.22 There is lack of administrative and institutional capacity at the municipal level as well. Important decisions at the municipal level are often perceived by businesses as driven by narrowly determined special political interests. Businesses feel that municipal decisions, taken or not taken, are ad hoc and non-transparent and do not reflect an appreciation of commercial realities (FIAS, 2004).

C. WHAT OTHER CONSTRAINTS LIMIT PRIVATE SECTOR INVESTMENT AND GROWTH?

4.23 Conversion of the large informal economy to the formal economy—although a major challenge for the Government of Montenegro—is not the only factor, nor perhaps even the most important constraint, affecting private sector investment and growth. Several other constraints that cut across the formal and informal sectors would need to be alleviated.

Privatization and Enterprise Restructuring

4.24 **Enterprise privatization and restructuring are far from complete.** Though significant privatization of socially owned enterprises has been accomplished over the years (see Chapter 1 for a summary), enterprise restructuring remains far from complete, and many companies privatized through the MVP continue to face significant economic and social problems. Although 12 foreign banks and investment funds took part in the establishment of six privatization (investment) funds, the privatization funds could not function well (e.g., as mutual funds operate in the West), in part because most of the shares owned by the voucher funds had no real market. The Montenegrin MVP program corporatized medium to large SOEs of almost any quality and issued their shares in return for vouchers. Thus, the funds ended up with a portfolio full of shares that were essentially illiquid at any significant price ("junk shares"). In addition, the trade in shares of so many diffused owners has been slow at consolidation, making it difficult to find majority owners quickly. Restructuring has progressed more slowly than expected, partly because of the much diversified ownership structure, which would require time to be concentrated in the process of free trade in shares. In the meantime, the transition costs to the shareholders of the companies and to the Government have been considerable.

4.25 **Most companies privatized through the MVP lack the capital injection necessary to re-equip them with new technology, equipment and practices, and thus improve their profitability and competitiveness.** By the nature of their privatization, these companies did not have a strategic foreign investor that could bring the necessary capital and technology. Furthermore, even if with a strategic investor, under the Business Organization Law a two-thirds majority is required to effect re-capitalization, and it appears that this is creating an obstacle. Citizens, workers and investment fund shareholders appear reluctant to see their positions diluted, even if that would lead to higher profitability. There have been cases where potentially interested foreign investors have walked away in the face of this obstacle (e.g., regarding investment in a shoe factory).

4.26 **There is a lack of management and restructuring skills, even in cases where the privatized companies have been placed under new management.** With diffused ownership and lack of majority ownership, the MVP has been fairly ineffective in inducing changes in management and corporate governance. Even where the MVP has led to management changes, the new management has continued to lack expertise in restructuring and developing viable business plans. In the absence of restructuring expertise the companies have continued to perform poorly, which further undermines profitability, shareholders' values, and the private sector's ability to generate employment and growth.

4.27 **Many of the "privatized" companies continue to be saddled with the high costs of excess labor and employment.** Restructuring plans to shed excess labor remain unimplemented to date for two main reasons. The first reason is that because the "privatization funds" lacked staff and resources, which rendered them ineffective in supporting company restructuring, including the shedding of excess labor. The second reason is that, the Government agreed to fund the (social) costs of restructuring in many companies but in many cases has not yet provided the funding or severance payments needed to complete the restructuring. Anecdotal evidence suggests that only 15 out of 32 companies for which the Government promised to meet the social costs have been restructured. A relatively small number of

significantly large companies continue to face the problem of severance payments expected from the Government which have not been made available to date.⁷⁸

4.28 Lack of restructuring in many of these companies has severely curtailed the growth of the formal private sector. In the absence of new investment and technology, and faced with the problem of excess labor, and lack of good corporate governance and management skills, many enterprise managers have performed poorly. The large unstructured companies not only maintain a large excess capacity but also continue to tie labor and capital. The rates of excess capacity among Montenegrin companies, as reported by the PICS 2003 data, average a high of about 55 percent. While producing under capacity, these plants continue to occupy buildings and land located next to infrastructure (electricity, water and sewage connections) that could be better used in other productive activities. A more vigorous implementation of restructuring and of the Bankruptcy Law (see below) would permit, among other things, a faster reallocation of assets and labor toward more productive activities.

4.29 However, there is hope that this is changing, if only very slowly. Currently, shares of companies and investment units privatized through the MVP are slowly being consolidated through trades in two stock exchanges, NEX Montenegro and the Montenegro Stock Exchange. This consolidation of shares into majority ownership may lead to management changes, the completion of the restructuring plans, the introduction of new capital and technology, and better profitability and shareholders' value of these companies.

Bankruptcy and Enterprise Exit

4.30 An effective bankruptcy regime promotes efficiency and productivity in two ways. First, it supports creditors' rights and facilitates lending to firms that are going concerns. Second, the bankruptcy/liquidation regime promotes efficiency by enabling bankrupt firms to be financially or organizationally restructured, or by shutting them down and disposing of their assets if they are not viable as going concerns. An efficient insolvency regime may also allow loan prices to remain low and facilitate access to credit.

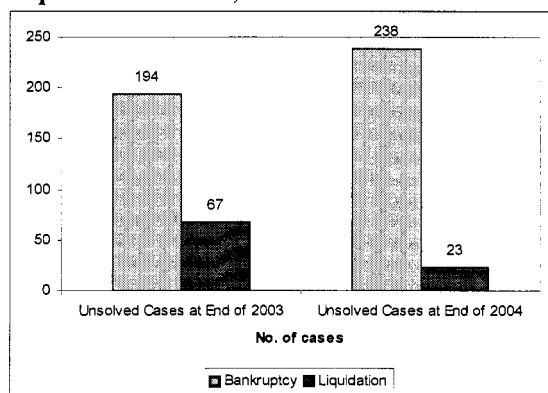
4.31 Montenegro's new Bankruptcy Law, enacted in January 2002 and effective since July 1, 2003, is not yet fully implemented. By the end of 2004, a bankruptcy procedure was initiated for 145 small enterprises, of which 85 have been completed and 60 are ongoing. The procedure therefore seems expeditious for small private companies, and lasts from 3 to 6 months.

4.32 While the new bankruptcy law⁷⁹ seems to function reasonably well for small private companies in financial distress, it has worked less well for large companies privatized through vouchers that continue to accumulate losses. Most of the unsolved bankruptcy cases as of the end of 2004 (238 cases)(Figure 4.4) are for medium and large enterprises. Of 194 bankruptcy cases started for medium and large enterprises before 2004, there are 134 still to be resolved (most of which are linked to former MVP companies). A strict interpretation of the Bankruptcy Law (Law on the Insolvency of Business Organizations), which mandates that a corporation that has been illiquid for 60 days shall enter the bankruptcy procedure, would have implied a larger number of bankruptcy cases, as there are many more illiquid companies. Furthermore, the duration of cases is much longer for medium and large enterprises, with the latter accounting for the bulk of cases lasting over one year (21 percent) (Figure 4.5).

⁷⁸ The 2005 republican budget contains no allocation for such restructuring and severance payments.

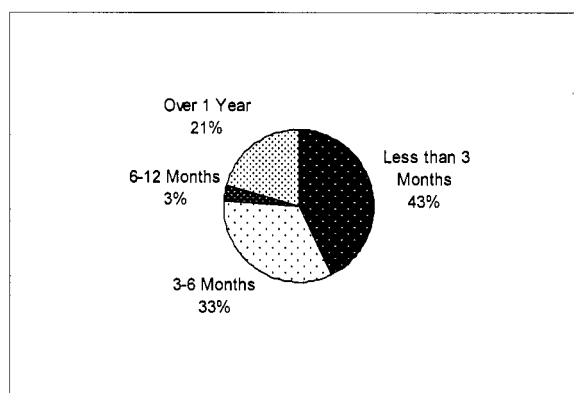
⁷⁹ A new Bankruptcy Law was enacted in January 2002 and took effect from 1 July 2003.

Figure 4.4. Unsolved Bankruptcy and Liquidation Cases , 2003–2004



Source: Commercial Court of Podgorica.

Figure 4.5. Duration of Bankruptcy Cases, 2004



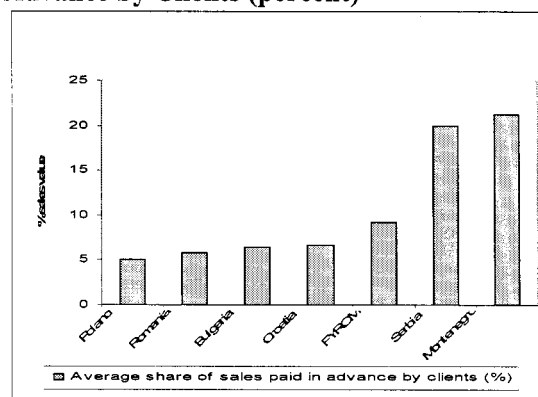
Source: Commercial Court of Podgorica.

Contract Enforcement and Property Rights

4.33 Most businesses in Montenegro do not rely on the courts to resolve commercial disputes. Evidence shows that firms depend extensively on informal practices and other institutions to enforce contracts and reduce uncertainty in transactions. In particular, they rely heavily on pre-payments and on building long-lasting relationships with suppliers and customers (Figure 4.6). In Montenegro, the average share of sales paid in advance by business clients is about 20 percent of the total sales value. This is not only high but is more than double the regional average, excluding Serbia.

4.34 The pro-debtor bias in the system stems partly from the lack of capacity to enforce contracts in courts and from debtor provisions in key legislation. Recently passed laws relating to contract enforcement⁸⁰ provide an improved legal framework for contract enforcement, through, among other things, shifting the burden of proof from courts to parties in dispute, setting deadlines for submitting evidence, introducing the obligation of the second instance court to reach a verdict and not to give a case back to the first instance court, etc. Nevertheless, the implementation of the new laws has been weak to date (Table 4.5).

Figure 4.6. Average Share of Sales Paid in Advance by Clients (percent)



Source: PICS and BEEPS.

⁸⁰ These laws include: Law on Civil Procedure or Litigation Law, Law on Enforcement Procedure, Law on Civil Lawsuit, Law on Criminal Procedure, Law on Courts, Law on Enforcement of Criminal Sanctions, Law on Executive Proceedings, Law on Assessors, and Law on Mortgage.

Table 4.5. Key Recent Contract Enforcement Legislation and Implementation Status

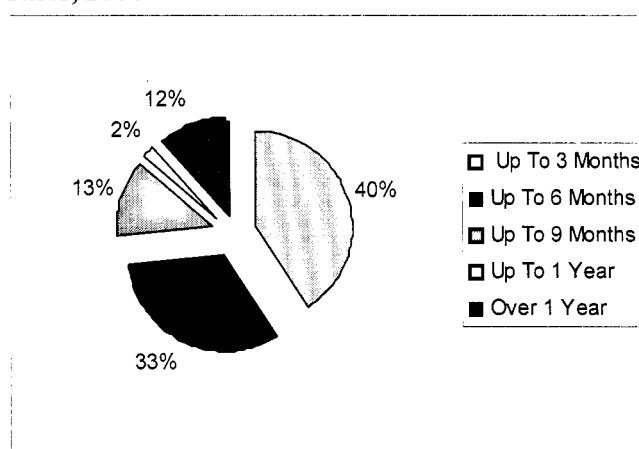
Law	Legislation Date	Implementation Status*
Law on Enforcement Procedure	Enacted May 2004	weak
Litigation Law	Enacted May 2004	weak
Law on Expert Witnesses	Enacted Dec 2004	weak
Bankruptcy + Cross Border Insolvency Law	Enacted Jan 2002	weak

* Bank staff assessment.

Source: USAID and <http://www.skupstina.cg.yu/>

4.35 **In Montenegro, domestic and foreign investors see the poor functioning of the court system as a major impediment to doing business** (FIAS, 2004). Business people's confidence in the independence of judges is low despite the judiciary's formal independence. Corruption in the courts is a serious concern. Foreign investors perceive that preferential treatment is generally given to domestic investors in the courts. Investors hope that the new Law on Courts, which provides new procedures for judicial appointment, will create a pool of more independent judges capable of acting with greater independence and integrity. Also, many judges, particularly at the lower court level, appear to have difficulties in keeping abreast of the rapid rate of legislative changes and the associated new concepts being introduced in the transition to a market economy.

4.36 **The courts are too slow: it can take a year from the submission of a claim to the handing down of a judgment.** Enforcement of a title can take another 6 to 12 months (FIAS, 2004). Resorting to an appeals court could take a further 12 months. Overall, about 40 percent of the commercial court cases are resolved within less than 3 months; 33 percent take up to 6 months; and about 28 percent of the cases take longer than 6 months (Figure 4.7). The average duration is too long, with about 60 percent of cases taking longer than six months to resolve.

Figure 4.7. Estimated Duration of Commercial Cases, 2004

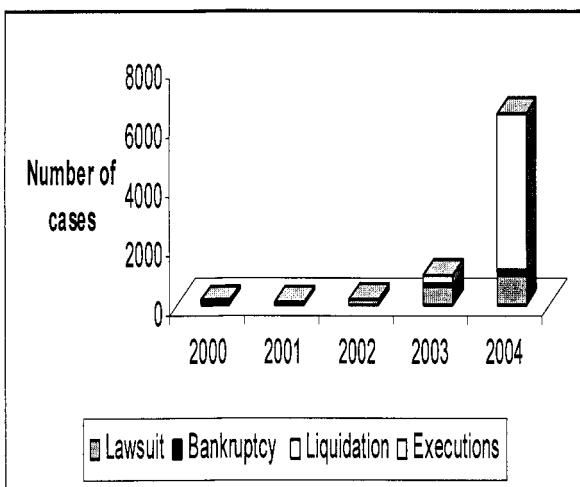
Source: Commercial Court of Podgorica.

4.37 **Yet, the courts' performance has recently improved, in particular during 2004** (Figure 4.8). The introduction of new legislation coupled with accelerated enforcement procedures, has helped to reduce somewhat the backlog, especially of lawsuit and execution cases in 2004. While this reduction in the backlog of commercial cases is encouraging, commercial courts as well as courts in general are still overloaded with inactive or abandoned cases (Figure 4.9).

4.38 **To further reduce the backlog of commercial cases and to speed up contract enforcement, several institutional bottlenecks would need to be removed.** First, the Montenegrin judiciary has been under resources and personnel pressure for an extensive period of time, and this would need to be reversed. Second, the system lacks qualified judges, partly because the pay is low. Without qualified and independent judges it is difficult to win public confidence in the courts. Finally, there is a strong need for court personnel to be trained, evaluated and compensated adequately, and for the court system's infrastructure to be upgraded, including the implementation of a strong Judicial Information System.

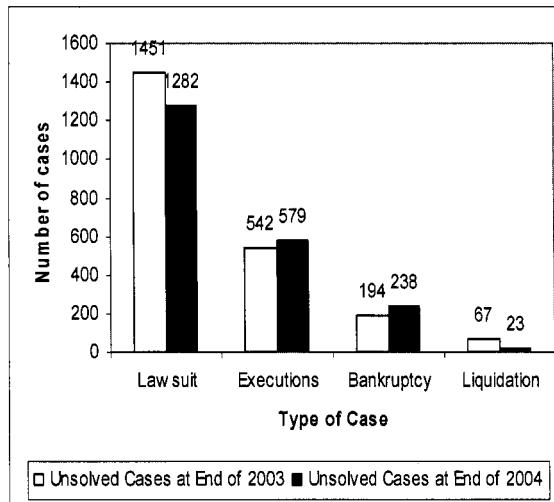
4.39 With regard to property rights, land seems to be a key area in which further improvements are needed. The lack of secure land property ownership is regarded as a significant problem for investors in Montenegro (FIAS, 2004). Montenegro's lack of good property rights over land arises from absence of good and readily available land titles information. Although land titles registration is computerized and not overly time consuming or costly, the Cadastral Office does not have adequate, reliable land information. This lack of transparency and discretionary public access to information makes land title transfers risky for investors, and complicates the planning and approval activities of municipalities.

Figure 4.8. Commercial Court Cases Solved, 2000-2004



Source: Commercial Court of Podgorica.

Figure 4.9. Unsolved Court Cases, End of 2003 and 2004



Source: Commercial Court of Podgorica.

4.40 Uncertain property rights in Montenegro would be reduced considerably if the land title information was made available by the Cadastral Office, and if it was required that land titles be accompanied by a certified site survey and pegging. In most developed countries, every parcel of land and every building is represented in a property document that can be used as collateral for credit. The single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur's house. In this way, life is injected into assets and they generate capital.

Financial Intermediation and the Cost of Finance

4.41 Empirical evidence shows that the private sector obtains less external financing, especially less term financing, in countries with weak legal and financial systems.⁸¹ The ability to finance activities through the sale of equity on the capital markets will not become available to firms until the institutions supporting such a system are adequately developed. In the absence of such finance, firms are forced to rely mostly on internal funds and retained earnings. This also means that financial sector reforms must extend beyond legislative reforms or bank restructuring and privatization, to the building of institutions that underlie firm transparency and accountability. In addition, the small size of the Montenegrin market poses a significant obstacle for the development of a well-functioning financial and banking sector.

⁸¹ Laporta, R., et al, (1998); Demirgüç-Kunt, A. and V. Maksimovic, (1999), Demirgüç-Kunt, A. and V. Maksimovic, (1998), Pagano, M (1993).

4.42 In the past four years the Montenegrin authorities have taken steps to improve the functioning of the financial sector, including privatizing state-owned banks and permitting the entry of foreign banks.⁸² While these measures have helped improve the performance of the financial sector, privatization and restructuring alone will have limited effects on the competitiveness of the banking sector because of the small size of the market. A process of further financial integration, in addition to having a positive effect on the development of the national financial market, could help attract intermediaries from the more developed markets and enhance the access of Montenegrin firms to financial markets, cross-border loans, and other financial services to the Montenegrin firms.

Table 4.6. Structure of the Banking System, End-2004

	State-owned Banks	Foreign-owned Banks	Local Private	Total
Number of banks	2	3	5	10
Total Assets (million euros)	72.8	137.8	233.8	444.4
<i>Share in Total</i>	<i>16%</i>	<i>31%</i>	<i>53%</i>	
Total Capital (million euros)	21.5	29.2	40.0	90.8
<i>Share in Total</i>	<i>24%</i>	<i>32%</i>	<i>44%</i>	
Total Funds-mobilized (million euros)	44.5	63.6	165.1	273.2
<i>Share in Total</i>	<i>16%</i>	<i>23%</i>	<i>60%</i>	

Source: Central Bank of Montenegro (2005).

4.43 As of end-2004 Montenegro's banking system was comprised of ten banks, with 444 million euros in total assets (about 29.1 percent of GDP)(Table 4.6). The total banking system assets increased by 95 million euros or about 27 percent in 2004. Similar to that of other transition countries, the financial system is centered on banks with the share of bank assets over total assets held by financial institutions (banks, insurance companies, pension funds, securities firms, investment funds, etc.) of over 90 percent.⁸³ The Government holds a majority interest in two banks and a direct or indirect minority ownership in five additional banks (about one-quarter of the capital is state owned). There is no apparent shortage of banks (compared to the other countries in the region, Montenegro leads in terms of banks per 100,000 inhabitants – 1.6), but the cautious entry of foreign banks into the Montenegrin market has thus far produced only limited gains: competition has increased slightly and some new products and services have been introduced.

4.44 Nevertheless, confidence has begun to return to the Montenegrin banking system recently. Progress in bank restructuring and the expansion in the market share of foreign-owned banks have provided confidence in the banking sector. In 2004, loan-loss provisioning grew by 43 percent. Montenegro's overall ratio of loan-loss provisions to non-performing loans (NPLs) now stands at 65 percent, in line with some better performing neighboring countries.⁸⁴ Reflecting the increasing confidence in the banking sector, total deposits increased by 29.5 percent in 2004 (reaching 273 million euros as of end-2004). The growth in deposits helped to produce the rapid increase in lending by commercial banks to private companies and natural persons (Figures 4.10 and 4.11). The credit growth appears to be linked

⁸² Other reforms in the financial sector included the establishment of the Central Bank and introduction of the euro as a legal tender, transfer of the clearing house functions to commercial banks and several legislative changes.

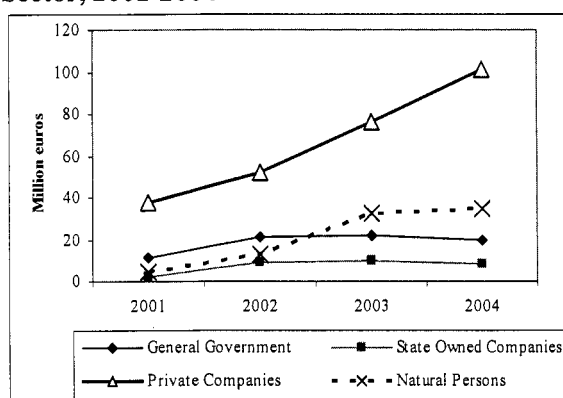
⁸³ In most CEE and SEE countries the share of bank assets over total assets held by financial institutions (banks, insurance companies, pension funds, securities firms, investment funds, leasing companies) exceeds 85 percent.

⁸⁴ However, as witnessed by the recent problems with Hipotekarna Banka, where significant roll-over of non-performing loans almost led to a bank run, further loan provisions are likely to be necessary as these new loans to private sector mature and some portion becomes delinquent.

to firms that generate high profits or to enterprises that have high revenue from partly informal operations.

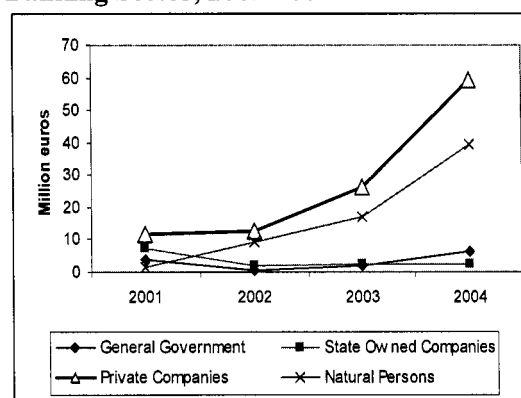
4.45 **However, total credits from banks to the private sector amount to only 11 percent of GDP.** This is quite low compared to the regional countries (42.3 percent in Bosnia and Herzegovina, 26.6 percent in Bulgaria, 57.3 percent in Croatia, and 42.7 percent in Hungary),⁸⁵ although credits to the private sector started to rise from fairly low levels in 2004. The ratio of domestic credit to GDP, however, is only a rough indicator of financial intermediation, not least because credit may include non-performing loans from the past. Directed loans to state and socially owned enterprises or firms that were privatized through voucher privatization may not be declared fully as non-performing even though many of these are overdue and are being rolled over.

Figure 4.10. Short-term Loans by the Banking Sector, 2001-2004



Source: Central Bank of Montenegro.

Figure 4.11. Long-term Loans by the Banking Sector, 2001-2004



Source: Central Bank of Montenegro.

4.46 **Interest rates remain high though spreads vary widely among banks in the Montenegrin banking system.** High interest rates, ranging between 11 and 20 percent, decrease the number of bankable projects with a suitable risk-return profile. Because of the high cost of capital, there is a high degree of dependence on internally generated cash flows among firms. Lack of access to credit limits businesses to using only their own funds, retained earnings, or money borrowed from friends and family and removes an important motive for businesses to formalize—thus contributing to the persistence of the informal economy.⁸⁶ The aggregate interest spread was about 7.6 percent in 2004 (down from 9.6 percent in 2003). The wide variability of interest rates within the system relates to the weak framework for creditor protection and contract enforcement, the high country risk, and low competition in the banking sector. It also partly reflects the different features and strategies of individual banks and their credit assessment skills and operational (in)efficiencies. The variability of interest rates does suggest that some competition exists and that interest rates are likely to be driven further downwards through greater competition.

⁸⁵ The data as of end-2002.

⁸⁶ The PICS survey indicates that dependence on retained earnings was well over 80 percent. While it is not unusual – even in developed economies -- for retained earnings to constitute a major source of enterprise finance, the absolute level in Montenegro was substantially higher than the corresponding figures in Croatia (52 percent), Hungary (63 percent), Bulgaria (66 percent), Poland (68 percent), the Slovak Republic (69 percent) and Romania (70 percent) and slightly higher than Serbia (85 percent).

Why Is the Cost of Capital High?

4.47 Among the main reasons for the high cost of capital are the following: the relatively large Treasury bills market, caused by the large domestic financing needs of the Government; the high risks and low creditor protection; the high overhead costs associated with small-scale operations; and the small size of the market and low competition among the banks.

4.48 **First, the Treasury bills market is relatively large and crowds out private sector credit.** The size and structure of the Treasury bills market is shown in Table 4.7. This market, measured by the amount of Treasury bills issued and sold, grew significantly in 2004. Indeed, only 2004, the Treasury bills market grew by 117.8 million euros. The reasons for such large growth are increased budget expenditure in July and August of 2004 owing to the payment of the old foreign currency savings, and poorer collection of revenues. Only a slight reduction of interest rates was observed on all types of governmental bills.

4.49 **The demand for Treasury bills by banks significantly exceeds the level that the banks allocate to Treasury bills as part of the mandatory reserve funds with the Central Bank of Montenegro.** During 2004, the banks of Montenegro allocated on average some 6.5 million euros in obligatory reserve funds in the form of Treasury bills (both 28-day and 56-day bills), while the amount purchased of Treasury bills alone ranged between 10 and 15 million euros per auction. The demand by banks for Treasury bills is high because of the high interest rates and relatively low risk, although their liquidity is exceptionally poor (i.e., there is no possibility of converting Treasury bills into cash before the maturity date). The high demand by banks for these bills also continued because of the lack of quality alternative opportunities for the marketing of free financial resources. As a result, the amounts due from the previous issuances were mainly reinvested (that is, interests were capitalized).

4.50 **Second, banks face high risks in Montenegro as the institutional arrangements for collateral and creditors' rights are underdeveloped.** In deciding whether to extend credit and at what interest rates, lenders need to know what share of debt they can recover if the borrower defaults. The value of collateral depends largely on the ease of creating and enforcing security agreements, and in Montenegro this appears to be somewhat problematic. The reasons include weak institutional arrangements for valuing and enforcing collateral (especially mortgages) and lack of information on the credit history of the client. Since practically all lending to enterprises in Montenegro is backed by collateral, legislation that would facilitate the use of collateral is particularly important. However, the amount of collateral requested by banks varies widely, depending on the risk assessment of the client. It sometimes exceeds 200 percent of the loan principal.⁸⁷ While the Government has recognized the existing weaknesses and has made efforts to reform the legal framework and create the necessary institutions (e.g., the Secured Transactions Registry),⁸⁸ the risks that creditors face are high for a variety of reasons.

⁸⁷ The PICS survey reports that in almost all cases creditors required collateral or deposits for the credits (PICS average for 2003 was 135 percent). However, due to the very high number of missing values, this could be used just as a rough indicator.

⁸⁸ The Registry is situated at the Commercial Court in Podgorica. Registration takes place either directly on-line for registered users (currently limited to lawyers who are members of the Montenegrin Bar Association and commercial banks) or by submitting an application form in person or by fax to the registrar in Podgorica.

Table 4.7. The Size and Structure of the Treasury Bills Market, 2003-2004 ('000 euros)

	2003				2004			
	Issued	Sold	% sold	Interest rate (annual %)	Issued	Sold	% sold	Interest rate (annual %)
28-Day T Bill	108,500.0	100,709.5	92.8	10.0	179,800.0	174,633.5	97.1	10.1
56-Day T Bill	48,500.0	37,512.5	77.6	10.1	60,200.0	53,827.0	89.5	10.0
91-Day T Bill	--	--	--	--	43,100.0	20,100.0	46.6	9.1
182-Day T Bill	--	--	--	--	9,500.0	7,500.0	78.9	10.0
Total	157,000.0	138,222.0	85.2	10.1	292,600.0	256,060.5	78.0	9.8

Source: Central Bank of Montenegro.

4.51 There is no central system or register for credit records in Montenegro. Credit information registries and credit bureaus can serve as key institutions in improving access to finance and reducing creditor risk, but Montenegro has no such institutions (Table 4.7). Businesses are not able to obtain reliable data on the creditworthiness of a potential customer and depend therefore on their own judgment and on information obtained through other informal channels. An effective, broad-based credit information registry, with a full scope of credit information, is critically important for developing the means to control and price credit risk, thus making possible reduced screening costs of loan applicants, lowered risk, and increased repayment rates.

4.52 Until recently, mortgages or real estate could not be effectively used as instruments for creditor protection in Montenegro. There were many practical difficulties involved in the realization of mortgage rights in the banking sector under the old mortgage regulations. The main problem was that the creditor could realize the mortgage only after the credit term had passed. However, this was too risky for creditors and generally led to lower credit and higher interest rates. In view of these problems, the Government of Montenegro adopted the *Law on Mortgage* in July 2004. Under the new Law, creditors are granted more legal protection through mortgage.⁸⁹ However, as its implementation has just begun, the full impact of this Law remains to be seen. Given the size of the market and, the potentially low demand, the impact of the improved mortgage system may still be limited.

Table 4.8. Credit Information Sharing and the Cost of Creating Collateral

Indicator	Montenegro	Regional Average	OECD Average
Cost of creating collateral (% of income per capita)	2.47-5.75	7.7	5.2
Credit Information Index	0	2.0	5.0
Public credit registry coverage (borrowers per 1,000 adults)	0	6.3	76.2
Private bureau coverage (borrowers per 1,000 adults)	0	46.7	577.2

Source: Doing Business World Bank and CEED for Montenegro.

4.53 Informal operations limit the ability of banks to assess real income and to lend. Enterprises generate significant revenues from partly informal operations (e.g., cash payments on top of official salaries are common). In many cases tax evasion is the main source of financing investments. Although

⁸⁹ A list of all subscribed mortgages is to be collected and published on the website of the Agency for Real Estate within one year of the passage of the Law, which should facilitate notification of third persons on subscribed mortgages.

banks in Montenegro use various strategies to deal with customers in the informal sector operations,⁹⁰ the formalization of firms and the growth of the formal economy would improve the ability of the bank to provide good quality credit risk.

4.54 Third, banks' operational costs are high and competition is low because of the small size of the market. Operating expenses at the aggregate level are high and amounted to 25.5 million euros in 2003. In 2004 overhead expenses increased to 32.7 million euros, a growth of 28.4 percent in just one year. Operating expenses represent between 5 and 8 percent of average assets and increased in 2004. Overhead expenses to core earnings (net interest and fee income) amounted to 75.5 percent in 2004, up from 73.4 percent in 2003.

4.55 Finally, the small size of the economy limits economies of scale and competition. One way of increasing the competition is to have foreign banks establish their affiliates. According to the Law on Banking the affiliates of foreign banks are required to have a minimum capital of 5 million euros. Given the small size of the market, it is questionable whether such a high level of capitalization should be required. Nevertheless, this issue should be considered once the current bank privatization and restructuring plans are completed. More important, the development of leasing industries may be better suited to the small market of Montenegro. Leasing may be a superior option to secured lending in a system with weak creditors' rights and a small size. The passage of the Leasing Law laid the foundation for more rapid development of the leasing industry in Montenegro. At the moment there are four leasing institutions operating in Montenegro, three of which are banks. The potential demand for leasing services is large, and all of the leasing companies planned to expand their businesses in 2004. Through this system, many SMEs should benefit from the increasing competition and the availability of new leasing products.

D. CONCLUSIONS AND POLICY RECOMMENDATIONS

4.56 Montenegro's high unemployment and low growth are in large measure a reflection of a business environment which is not conducive to investment and job creation. Montenegro's emerging private sector, comprised of small firms, has not yet developed the critical mass to generate enough jobs to offset job losses in the public sector. Facilitating the entry of new firms and the growth of small enterprises is, hence, necessary to create more jobs and increase growth and competitiveness. Government policies that would help increase private investment and the growth of small enterprises hold the key to higher employment, growth and competitiveness in the medium term.

4.57 The most highly visible feature of the Montenegrin economy is the large and persistent informal sector, which contributes about 30 percent of GDP and employs about 27 percent of the workforce (ISSP, 2003). The presence of a large informal sector is a symptom of a high regulatory burden and a poor public administration as well as poor opportunities in the formal sector. While Montenegro has simplified its business registration system considerable since end-2002 (a burdensome registration procedure which had involved 38 steps and 45 days was streamlined to 4 steps and 3 days, and a minimum capital requirement of 1 euro) other regulatory and institutional barriers continue to hinder the formalization of small businesses. The following measures deserve priority consideration to increase the formalization of small businesses:

- *Simplify and speed up the issuance of business licenses and inspections.* The 21 municipalities in Montenegro are responsible for the licensing of businesses and related permits, and zoning and

⁹⁰ One bank even indicated that they take into account the unreported income, as otherwise they would not be able to lend.

building permits, and in general the provision of utility services (waste collection, water, sewerage and electricity distribution), as well as various inspections. However, business operating licenses take a long time to issue, and licensing and inspection activities are not conducted in a fair and transparent way (FIAS, 2004). While visible and legal businesses are extensively inspected, there is no noticeable effort to crack down on illegal businesses that operate without a license, avoid tax and social security payments, or establish business premises without building permits. A draft Law on Licensing, prescribing a faster and more efficient registration and listing of business activities, should be implemented as quickly as possible.

- *Reduce the high rates of labor taxation to encourage formal employment.* Recent reforms have helped reduce the payroll tax and contributions burden. Yet the labor taxes (or payroll taxes) are still perceived as too high and as among the highest in the region. Montenegro's tax wedge, one of the most important indicators of tax burden (defined as the difference between the labor cost to the employer and the take home pay [net wage] expressed as a percentage of total labor cost) stood at about 52 percent of the labor costs in 2004, while the comparative burden for the regional non-European member countries was 37.3 percent of total labor cost. A further phased and well-planned reduction in payroll taxes (compensated by equivalent increases in other taxes, and with adjustments to compensate for the resulting lost income of the social funds) could be considered as soon as offsetting fiscal measures have been identified. To decrease such high rates in a fiscally responsible way, reforms of in the health and pension systems need to be pursued to make the systems more efficient and sustainable. In particular, a review of early retirement, disability, maternity leave and sickness benefit policies should be part of the reform agenda with the aim of tightening the eligibility criteria and eliminating the widespread abuse of the system.
- *Improve governance and consistency in the application of rules.* A modern public administration system, characterized by transparent, non-discretionary processes, and efficiency is yet to be created in Montenegro. This would require the putting in place of appropriate incentive and accountability systems and significant institutional capacity building through education, training, and the application of information technology. The presence of high discretionary power often creates an opportunity for corruption. Improvements in the quality of regulation through greater transparency, and a more consistent application of rules, including an improved tax administration capacity to support rule-based tax collection, are essential.

13. **Enterprise privatization and restructuring are not complete.** Many companies that were privatized through the mass voucher privatization (MVP) program still lack strategic investors to re-equip them with new technology and improve their profitability and competitiveness. They also continue to be saddled by the high costs of excess labor and employment. There is thus an urgent need to:

- *Speed up the restructuring of the mass-voucher- privatized companies* by: (i) making budgetary allocations toward covering the social costs of restructuring—including severance payments for shedding off excess labor— for those companies in respect of which the Government agreed to fund such costs; (ii) strictly enforcing the new bankruptcy law for medium and large enterprises privatized through vouchers, that have continued to accumulate losses; and, (iii) strengthening the capacity of courts to deal with such bankruptcy cases.
- *Speed up the consolidation into majority shares of the companies' shares being traded on stock exchanges.* With diffused ownership and lack of majority ownership, the MVP has been fairly ineffective in inducing changes in management and corporate governance. Even where the MVP has led to management changes, the new management has continued to lack expertise in restructuring and developing viable business plans. Currently, shares of companies and investment units privatized through the MVP are slowly being consolidated through trades in

stock exchanges. However, the speeding up of the consolidation of shares into majority ownership is needed to bring about management changes, good corporate governance, completion of the restructuring plans, and the introduction of new capital and technology to generate better profitability and shareholders' value, and employment.

4.58 The implementation of recently enacted business laws and regulations is lagging. In the past three or four years Montenegro has overhauled much of its legal and regulatory framework as regards the private sector, but implementation is lagging. It was only in 2003 and 2004 that the Parliament adopted 45 laws and 67 laws, respectively, out of which roughly 35 are business environment or financial sector laws. While the new laws provide an adequate legislative framework for the development of a well-functioning market economy, significant implementation gaps are emerging. The implementation of legislation aimed at improving the business environment—contract enforcement, access to finance, corporate governance, and business exit—has not yet begun in most cases. Speeding up the implementation of these laws will be critical to private sector investment and growth.

4.59 Contract enforcement and property rights are weak. Investors see the poor functioning of the court system as a major impediment to doing business (FIAS, 2004). The courts are too slow: it can take a year from the submission of a claim to the handing down of a judgment. Enforcement of a title can take another 6 to 12 months. Resorting to an appeals court could take a further 12 months. Overall, about 40 percent of the commercial court cases are resolved within less than 3 months; 33 percent take up to 6 months; and about 28 percent take longer than 6 months. Speeding up the resolution of cases that take longer than six months (which frequently include bankruptcy and liquidation cases) is urgent. As for property rights, land title registration is computerized and not overly time consuming or costly, the Cadastral Office does not have adequate, reliable land information. The lack of transparency and discretionary public access to land information makes land title transfers risky for investors, and complicates the planning and approval activities of municipalities. The specific measures that the Government can undertake to improve contract enforcement and property rights are the following:

- *Reduce the backlog of commercial court cases and speed up contract enforcement* through: (i) easing the resources and personnel constraints in the Montenegrin judiciary; (ii) ensuring that qualified judges are put in place, with better compensation; (iii) training court personnel; and (iv) upgrading the court system's infrastructure, including the computerization of case management.
- *Improve land title transparency and control illegal construction.* Lack of transparency on land titles and registration represents one of the greatest threats to the future prospects of Montenegro's tourism industry, particularly in the few remaining high-potential tourism sites (e.g., Ulcinj, and inland areas close to national parks and other natural attractions). The Government needs to vigorously enforce land property rights and control illegal construction.

4.60 The cost of capital is high and financial intermediation is low. Total credits from banks to the private sector amount to only 11 percent of GDP in Montenegro. This is quite low compared to the regional countries (42.3 percent in Bosnia and Herzegovina, 26.6 percent in Bulgaria, 57.3 percent in Croatia, and 42.7 percent in Hungary), though credits to the private sector have started to rise from fairly low levels in 2004. Interest rates as well as spreads remain high: the real interest rate has ranged between 11 and 20 percent in recent years. The aggregate interest spread was about 7.6 percent in 2004 (down from 9.6 percent in 2003). Given Montenegro's limited opportunities in Greenfield investments, most investors would be hard pressed to find a project whose real rate of return would exceed 11-20 percent. The high cost of capital and the wide variability of interest rates within the system relate to the weak framework for creditor protection and contract enforcement, the high country risk, and the low competition in the banking sector. Specific measures that the Government can undertake to reduce the cost of borrowing and improve financial intermediation are the following:

- *Reduce the need for Treasury bill financing through a tight fiscal policy.* This would help reduce the budgetary burden of interest payments on Treasury bills and would create the conditions for the lower cost of capital in the economy by reducing the crowding-out of Government.
- *Establish an effective, broad-based institution, with full credit information* on all borrowers, to address the problem of asymmetric information in credit markets.
- *Introduce more competition into the banking sector* through the completion of the privatization of government-owned banks (in particular Podgoricka Banka), and by promoting leasing operations in view of the small size of the Montenegrin market.

5. THE CHALLENGES OF GROWTH AND COMPETITIVENESS IN PRACTICE: THE CASE OF TOURISM

A. INTRODUCTION

5.1 Tourism has always been an important part of Montenegro's economy, and has focused mainly on the local and regional market. After almost ten years of steep decline during the 1990s, tourism has shown a strong recovery over the past four to five years. Tourism is widely regarded as Montenegro's main prospect for export-oriented economic growth in the coming years, based on a strategy aimed at greatly increasing the number of foreign visitors. Both the Government of the Republic of Montenegro (GRM) and the World Travel and Tourism Council (WTTC) have made optimistic projections for growth in tourism numbers, revenues and contributions to the economy over the next ten years (GRM Tourism Master Plan, 2001; WTTC, 2004, 2005). If these goals are achieved, Montenegro could have the fastest growing tourism economy in the world by 2014.

5.2 However, the Government's own Tourism Master Plan (2001) offers a frank assessment of the challenge:

Montenegro's position is weak: the country lacks financial resources, a commercial product and adequately qualified specialist personnel. The number of overnight stays has declined from just about 11 million in the 80's to 5 million today. All the foreign markets have broken away; remaining demand is confined to Serbia and Montenegro for six weeks in midsummer and the cheapest accommodation facilities. The hotel sector is a low earner, underutilized and standards are far too low for the demanding guest....

Although tourism in Montenegro has recovered since 2001, and significant progress has been achieved in upgrading infrastructure and hotel facilities, there are a number of challenges still to be overcome, including ensuring the environmental sustainability of the coastal tourism and achieving greater diversification of tourism products.

5.3 **Montenegro has the potential to regain a substantial share of the burgeoning regional and international tourism market.** Development of a diversified tourism offering is the key to capturing such market, with particular emphasis on nautical tourism at the coast and on nature-oriented tourism in the interior. Greater support for tourism development in the interior of the country is also important for its potential to stimulate economic development and reduce poverty in these areas. In both coastal and inland areas, careful planning of tourism growth and management of its environmental and social impacts are necessary to ensure sustainability. Montenegro's limited comparative advantage against regional and international competitors and the need to balance coastal tourism growth with environmental sustainability means that, in the long-term, the prospects for growth in the beach/bathing sub-sector are limited. Sustainable long term tourism growth will depend on Montenegro's ability to attract tourists to destinations other than the coast.

5.4 **Montenegro faces stiff competition from neighboring countries and other destinations worldwide, many of which currently offer a more competitive combination of quality and price to the same target markets.** Success in increasing its market share will depend upon addressing both quality and cost aspects. A large stock of old-fashioned, homogeneous and run-down tourism accommodation is one of the country's weaknesses. The Government's strategy to encourage private

sector investment is generally sound, and to date significant modernization and reconstruction of privatized hotels have taken place. However, physical upgrading of existing facilities through privatization will not be sufficient to capture the high-end tourism market that the country rightly targets. Investment in new and diversified facilities will be needed, including the entry of some recognized international investors and operators. Greater clarity and security of land rights will be fundamental to attracting such investment. The regulatory environment also needs to be supportive of serious investment by experienced operators. While it is important for government to establish and ensure basic health and quality standards consistent with international practice, beyond this the private sector needs flexibility to adapt to market demands.

5.5 While progress has been made in recent years⁹¹, further improvements in public infrastructure are needed for continued tourism recovery and development. Despite the stated focus on tourism as a major source of future economic growth, Montenegro presently invests comparatively little in public infrastructure and services to support the tourism sector. Success will require well-targeted infrastructure investment planning, clear priorities and interim targets in accordance with the available resources. The Government needs to play a coordinating role in areas where infrastructure investments are ongoing with donor assistance, and a complementary role of filling the investment gap in the context of its comprehensive public investment program that rigorously screens public infrastructure investment for their economic and social returns, including in tourism. Equally important is a strong commitment to enforcement of laws and regulations that have a large impact on tourism, such as land use and waste disposal. This is essential both for attracting tourism investors and clients, and for ensuring that tourism development is environmentally sustainable and results in improvement, rather than decline, in the quality of life for Montenegrins.

5.6 While traditionally a labor-intensive sector, the potential employment benefits of tourism are not being fully captured in Montenegro. Contributing factors which need to be addressed include the narrow emphasis on bathing/beach tourism (with its very short season), labor market regulations that create incentives to draw upon the large regional pool of expatriate seasonal workers under flexible contractual arrangements rather than employing Montenegrins in full time positions under standard full time contracts, and a lack of skilled personnel and of tourism training facilities and opportunities. At the same time, growth in the tourism sector, while highly desirable, must be managed properly to achieve environmental sustainability and to make a strong and lasting contribution to the economy as a whole.

B. THE CONTRIBUTION OF TOURISM TO MONTENEGRO'S ECONOMY

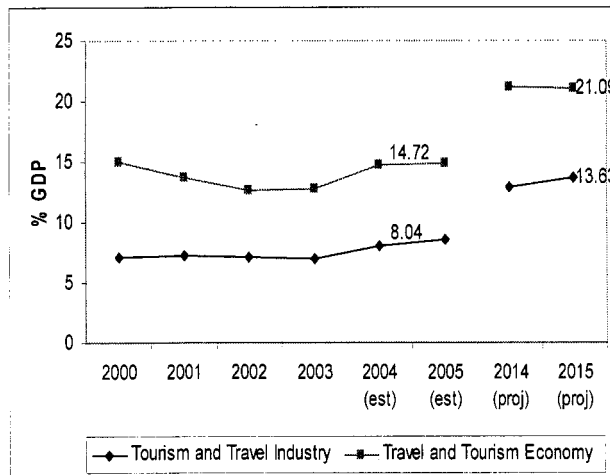
5.7 Tourism in Montenegro has recently shown strong growth, in absolute terms and relative to the economy as a whole, and even more rapid growth is projected for the future. The WTTC Tourism Satellite Account (TSA) included Montenegro for the first time in 2004 (OEF/WTTC, 2004). It indicated that Montenegro's tourism sector is on its way to regaining the economic importance it enjoyed during its peak in the 1980's, when total tourist overnights reached almost 11 million, including a substantial proportion of international visitors. The 2005 TSA (OEF/WTTC, 2005) estimated the contribution of the travel and tourism industry (TTI) at 8.5 percent of total GDP⁹² (over €132.61 million) in 2005, and 9.1 percent of total employment. The

⁹¹ Recent improvements to tourism infrastructure include construction of the Sozina tunnel, and improvements in roads, solid waste, and wastewater management.

⁹² Direct Gross Domestic Product (value-added) associated with "Travel and Tourism Consumption," i.e., the supply-side industry contribution of T&T that can be compared one-for-one with the GDP contribution of other

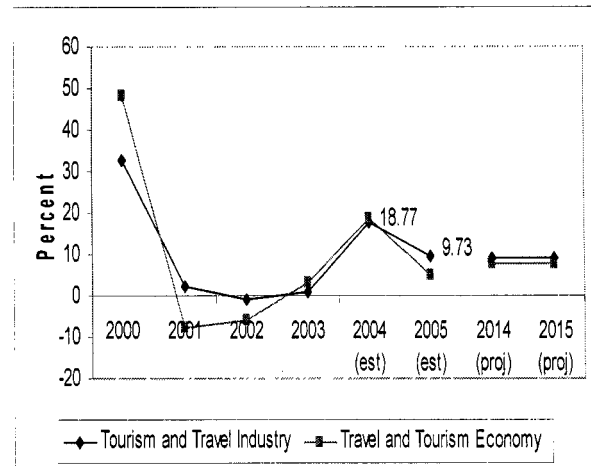
contribution of the greater travel and tourism economy (TTE) which captures broader “economy-wide” linkages associated with tourism,⁹³ was estimated at 14.8 percent of GDP (over €231.9 million) and 15.8 percent of employment. Real growth was estimated at about 9.7 percent for the tourism industry and 4.9 percent for the broader tourism economy. With a projected average rate of increase of over 10 percent per year over the next decade, by 2015 the tourism industry should account for about 13.6 percent of GDP and 14.5 percent of employment, and the broader tourism economy should account for about 21.1 percent of GDP and 22.5 percent employment (see Figures 5.1 – 5.4).

Figure 5.1. Travel and Tourism, Contributions to GDP, 2000-2015 (percent)



Source: Oxford Economic Forecasting, for World Tourism and Travel Council, 2005 (Satellite Account Tables).

Figure 5.2. Travel and Tourism, Real Growth Per Year, 2000-2015 (percent)



Source: Oxford Economic Forecasting, for World Tourism and Travel Council, 2005 (Satellite Account Tables).

5.8 This projected economic growth rate is significantly above the projections for the Montenegrin economy as a whole, and well above the projected average (among 174 countries ranked in the TSA reports) of about 3.8 percent for global tourism economy growth over the same period. However, these projections into the next decade must be treated with some degree of caution as even the Government’s tourism Master Plan (TMP) considers the OEF/WTTC revenue projections overly optimistic. Furthermore, the projected growth in tourism-related employment is modest, in both absolute terms and as a percentage of total employment. In fact, formal employment in the tourism sector increased by only 400 jobs between 1993 and 2003, with an average salary of about €120, which is significantly below the national average of about €195 (without taxes and contributions).⁹⁴ Montenegro currently ranks seventeenth among 174 countries worldwide with respect to the contribution of the tourism industry to total employment, but ranks only in the middle when compared to its neighboring and major competing countries. Clearly, Montenegro’s tourism

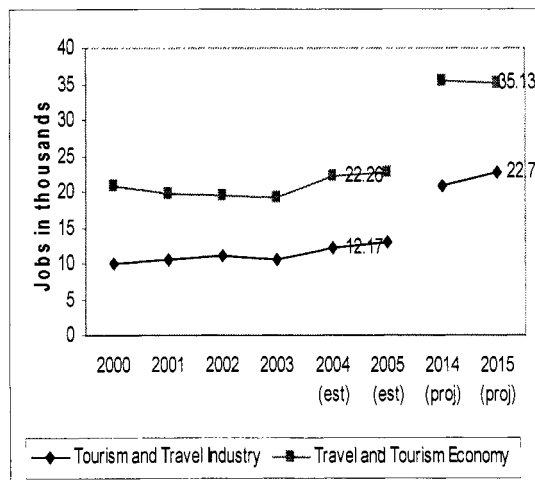
industries in the economy. Includes traditional T&T providers such as airlines, hotels, car rental companies, restaurants, etc.

⁹³ Direct and indirect GDP (value-added) associated with “Travel and Tourism Demand,” representing the broadest measure of T&T’s contribution to the resident economy. Includes establishments included in TTI as well as manufacturing, construction government, etc., that are associated with capital investment and government services that directly or indirectly support tourism.

⁹⁴ The Employment Fund statistics indicate that 3,000 jobs were added in the tourism sector in 2004; however, this figure arises from the legalization of jobs that already existed prior to the Government’s legislation exercise.

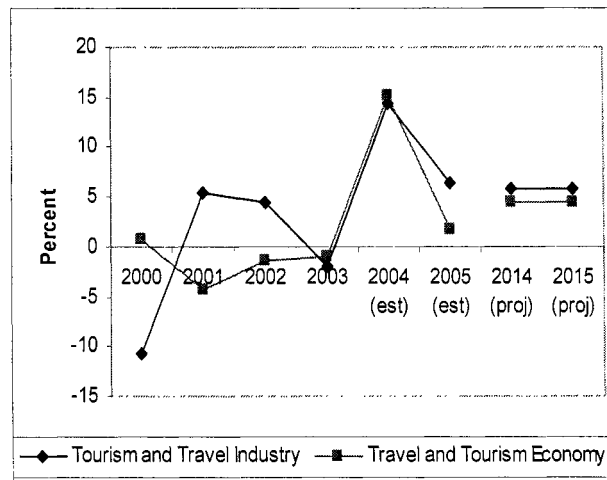
development model is not generating the local employment that could be expected: an important issue, considering the high unemployment rate in the Republic.

Figure 5.3. Travel and Tourism, Contributions to Employment, 2000-2015



Source: Oxford Economic Forecasting, for World Tourism and Travel Council, 2005 (Satellite Account Tables).

Figure 5.4. Travel and Tourism, Employment Growth, 2000-2015



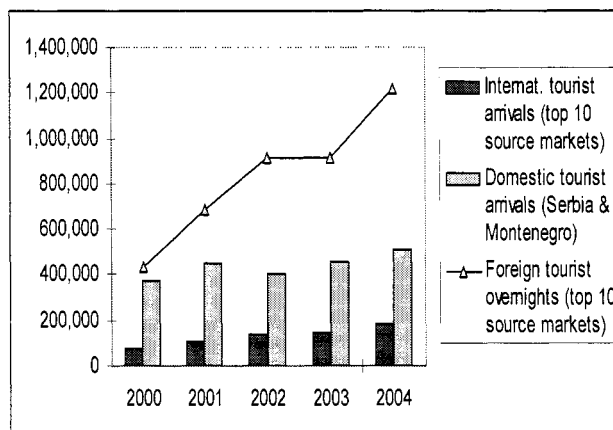
Source: Oxford Economic Forecasting, for World Tourism and Travel Council, 2005 (Satellite Account Tables).

C. VISITOR TRENDS AND TARGETS

5.9 Tourism growth results from increasing the number of visitors, the average length of stay, and the amount of money that they spend in the country. The Government's Tourism Master Plan aims at all three factors, with specific targets for increasing the number and proportion of international standard (more expensive) beds and the average length of stay for foreign visitors. Actual tourist numbers have shown respectable, though variable, growth since 2000 (See Figure 5.5), but the 2004 figure of 4.5 million total overnights remains well below the 1989 peak of 11 million.

5.10 Still, the Government's target of 15.68 million overnights by 2010 and 25.8 million by 2020 seems overly ambitious, given the country's small area and limited environmental carrying capacity. The TMP includes some measures for distributing the burden, such as extending the main summer tourism season to 165 days and increasing visitation to destinations other than the coast. (In 2004 87 percent of all overnights fell

Figure 5.5. Tourist Arrivals and Overnights, 2000-2004



Source: 2000-2003 data: WTTC, 2004; 2004 data on overnights: *Ibid* (covers first 9 months of 2004); 2004 data on arrivals: Ministry of Tourism/National Tourism Organization Bulletin, January 2005 (covers first 11 months of 2004).

between June and September, with 56 percent in July and August, and 96.7 percent of all tourist overnights were spent within the six coastal municipalities). However, to increase overnights by some 11 million would mean accommodating an additional 30,630 people per day, assuming equal distribution throughout the year. More likely, a large proportion of the increase would occur during the summer, and much of it at the coast. Montenegro has made a constitutional commitment to be an “Ecological State,” and it is encouraging that planning for the proposed 25,000 bed new coastal resort complex at Ulcinj includes an environmental assessment, which presumably addresses carrying capacity in some manner.⁹⁵

5.11 Montenegro’s tourism strategy strongly emphasizes increasing international, rather than domestic, tourism. This represents a major change from the historical situation, in which the market has been very heavily domestic (from Serbia and Montenegro). The Government strategy aims to increase the number and proportion of international visitors, particularly from Western and Central Europe, by upgrading accommodation to international standards, improving environment management (wastewater and solid waste disposal), and through marketing and promotion. International arrivals did increase by almost 32 percent in 2004 (compared with a 12.6 percent increase in domestic arrivals), and expenditures by foreign visitors increased by 33 percent, to an estimated €173 million (€199.4 million if the broader tourism economy is considered). Even so, in 2004 domestic tourists still accounted for almost 75 percent of the total. The TSA estimates reflect an impressive 130 percent growth in foreign tourist expenditures between 1995 and 2002 (albeit from a low base) and projects an equally impressive growth of 12.1 percent per year, compared with 5.5 percent per year within the EU, and 5.8 percent per year globally. However, airport arrivals have not increased significantly since 2000, indicating that the increase in foreign tourists to date is mainly from regional (car-accessible), not international, markets.

D. TOURISM ASSETS, PRODUCTS AND COMPETITIVENESS

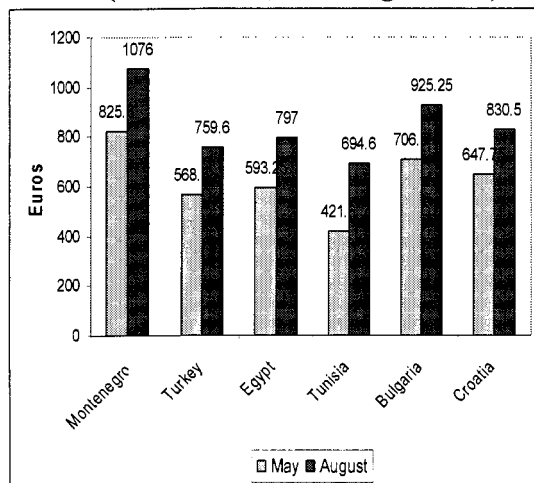
5.12 Montenegro has significant tourism assets and attractions, which have not been used or developed to the best advantage and which need rehabilitation, protection and careful development. The coast is, and will likely continue to be, the major element of Montenegro’s tourism industry, but its beach product alone is not highly competitive and is unlikely to lift the country out of its current status as a mainly low-end to mid-end local and package charter destination. The main prospect for significant transformation lies in combining the coastal element with the beautiful inland mountain landscape and the appeal of a high level of natural and cultural diversity within a small area. The country has a few unique attractions, such as Boka Kotorska (Europe’s most southern, and the Mediterranean’s only, fjord), Skhadar Lake (Europe’s second largest lake and largest bird preserve), the Tara River Canyon (one of the deepest canyons in the world), and Ulcinj (one of the few remaining large, relatively pristine, sandy beach on the Adriatic). Other strong features include a few relatively well-known destinations and facilities (Sveti Stefan, Ialo health spa), some attractive historical sites such as the old capital of Cetinje, and easy access to transborder attractions (Dubrovnik, sites in Bosnia-Herzegovina). There is a considerable prospect for a well-planned tourism development centering on these few limited high-value assets, but there is also a great risk that, in the absence of strong Government commitment to capture this value, they could be ruined in the near future through unplanned, poorly executed tourism development and other impacts (e.g., pollution and hunting in Lake Skhadar).

5.13 Montenegro needs to increase its competitiveness as a tourism destination through attention to both quality and price. A recent bench-marking study (Yanofsky, 2004) found that

⁹⁵ An environmental assessment is required for all new Greenfield projects under the Montenegrin law.

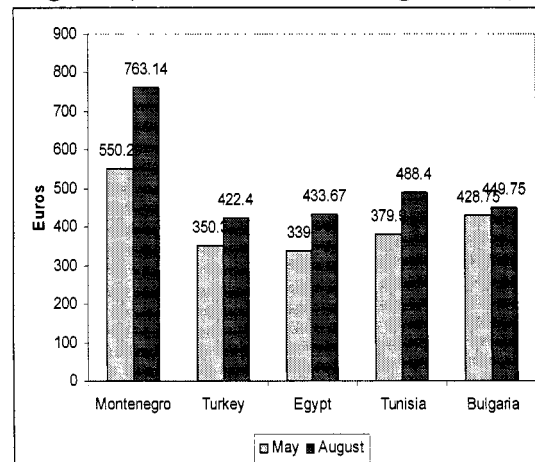
Montenegro offers an inferior quality of facilities and services at higher prices, compared to its main regional competitors, for both foreign and Serbian visitors, particularly during the peak summer season (see Figures 5.6–5.7).⁹⁶

Figure 5.6. Cost of 7 Night Vacation from London (4-Star Hotel, including Airfare)



Source: Yanofsky, 2004.

Figure 5.7. Cost of 7 Night Vacation from Belgrade (4-Star Hotel, including Airfare)



Source: Yanofsky, 2004.

5.14 The authors attributed this “competitiveness gap” to complacency on the part of coastal tourism operators, who until recently enjoyed a largely captive domestic market. They reported that the coastal owners and operators interviewed generally showed little inclination to change pricing practices or improve services, since they continue to enjoy full occupancy during the short summer season, just as they had done in the past. However, this attitude runs counter to the Government’s strategy of attracting the value-conscious international market. Furthermore, even the historically reliable local market is likely to slip, as the younger generation of Serbs is not bound to the Montenegro coast by tradition and habit, and is increasingly pursuing better value for money in Turkey, Egypt, Tunisia, Greece, and other such destinations.

E. POLICY AND STRATEGY: ANALYSIS AND RECOMMENDATIONS

5.15 **The Government’s strategy centers on stimulating private sector investment to renovate and develop high quality tourism facilities, on providing public infrastructure and services, and on using regulation and licensing as a tool for upgrading quality to international standards** (see Box 5.2 for lessons of experience). The division of responsibilities between the private and the public sectors is largely appropriate, but implementing this strategy calls for a clear understanding of the needs, priorities and constraints of the local and international tourism industry. This includes being able to respond to the market in a flexible way without undue bureaucratic obstacles.

Product Diversification

⁹⁶ It should be emphasized that this is a limited sample study—and the only study available benchmarking Montenegro to other destinations. Given that there are no four-star hotels in Montenegro, the applicability of the study to the case of Montenegro is questionable. Further benchmarking studies with large samples and comparisons are needed to get a better understanding of Montenegro’s competitiveness in tourism.

5.16 Investment must be targeted at diversifying the tourism product, based on Montenegro's strengths. Most of the attention for both public and private investment continues to be directed at expanding and upgrading coastal tourism. By contrast, the Government is paying relatively little attention to the considerable potential for diversifying and extending the tourism product through the careful development of inland assets. The Strategic Framework for Sustainable Tourism Development in Northern and Central Montenegro still lacks an economic impact analysis, which needs to be completed. Investment in non-coastal tourism development is presently limited to a few small, donor-funded pilot projects. There have been several initiatives to prepare strategies for developing sustainable tourism in the northern and central regions,⁹⁷ and the TMP makes references to developing year-round and nature-based niche offerings, while the plan for the summer of 2005 mentions mountain tourism, "wellness" tourism, nautical tourism, etc. However, specific plans, programs and incentives need to be developed and implemented to catalyze non-coast tourism investment and development. The emphasis should be on improving the tourism package and restarting winter tourism, with due attention to environmental sustainability and to the expansion of economic opportunities for local communities. The strategy should also take in a broad perspective of tourism-related options. For example, as the TMP points out, the purchase and renovation of vacation homes by prosperous expatriate urbanites has become a substantial segment of rural economic development in a number of countries with attractive landscapes, cultural attractions and proximity to European economic centers.

5.17 Continued attention should be paid to broadening tourism's economic impact. Linked to the diversification objective is the objective of broadening and deepening tourism's contribution to the economy by reducing leakages through increasing the participation of local investors. The importance of tourism's linkages to the broader economy is fully recognized in WTTC's Tourism Satellite Accounts⁹⁸ but it is not addressed in the Government's TMP, which focuses only on the development of the tourism industry per se. Consequently, little attention is paid to strengthening such linkages in the MoT's annual plans and programs, aside from general promotional activities (e.g., "The Year of Good Food" and "Made in Montenegro" campaigns of 2004). The 2005 plan includes an item of "Linking lodging economy and agricultural producers," but it is mainly limited to generalities (such as "Maintenance of regular communication between agricultural producers and tourist economy," and "Program of development of high quality gastronomic offer"). It also vaguely proposes a "guarantee fund" which sounds similar to the subsidies credit for small and medium scale hotel development, and shares its shortcoming of emphasizing the supply side over the demand side. Agriculture sector policies recognize that targeting niche markets represents the main prospect for agricultural development in Montenegro. In-country tourism must be recognized as an important niche market, and the Government can play a facilitative role in helping producers capture it.

Public investment in infrastructure

5.18 Despite the recent progress, expenditure on tourism infrastructure and services in Montenegro is relatively low in comparison with the country's competitors. Montenegro currently ranks at only fifty-eight out of 174 rated countries worldwide in this measure of government and private sector commitment to tourism development. The TSA estimates total capital investment (combining private and public sectors) in tourism infrastructure, plant and equipment at €33.89

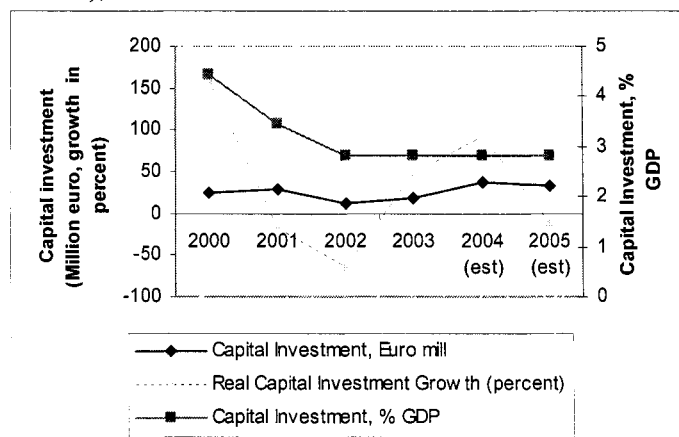
⁹⁷ Including the "Strategic Framework for Development of Sustainable Tourism in Northern and Central Montenegro: Roadmap for Development of Wild Beauty" prepared through UNDP; the Regional Plan for the Mountain Regions prepared by the International Institute of Tourism-Slovenia; and a strategy for the Bjelasica region being developed by the Austrian Office of Technical Cooperation.

⁹⁸ Economic statistics are given for both the "Travel and Tourism Industry" and the broader "Travel and Tourism Economy."

million in 2004, showing a steady increase from €24.6 since 2000. They project that capital investment in the tourism sector as a percentage of total capital investment will grow at 7.4 percent annually through 2014. This compares favorably with the projected rate of 3.2 percent annually across the EU and 4.2 percent worldwide, but the record over the past few years throws some doubt on this projection (see Figure 5.8).

5.19 The Government should focus on addressing the environment-related public infrastructure constraints-- in particular waste water treatment, and waste management-- to ensure sustainability of coastal tourism development. The TMP emphasizes improved infrastructure as a major element in increasing tourism numbers and quality. The Government has numerous initiatives in this area and has shown progress in recent years, mostly in cooperation with international donors, but the scale remains small compared to the need.

Figure 5.8. Capital Investment in Tourism (Public and Private), 2000-2005



Source: OEF for WTTC 2005 (Satellite Accounts).

- Water:** The linkage between water shortages in the coastal municipalities and maintaining and increasing tourism levels has been clearly demonstrated. While there is considerable scope for improving the efficiency and financial viability of existing water distribution and use through rehabilitating the existing infrastructure, stopping illegal connections and improving fee collection, and generally putting water supply on a sound commercial basis, the existing data indicates that there is still the need for a bulk water supply system to supplement local sources. At the request of the Government, the Bank is investigating the feasibility of a regional scheme in the proposed Tourism Development Project. The feasibility assessment will be based on field measurements of all key sources in the system, which are being carried out over the dry summer period. The Government is drafting a new Law on Water, but more attention is needed to enforcing the existing laws.
- Transportation:** Government policy emphasizes road rehabilitation, particularly for access to the coast and between major cities. However, despite recent improvements, actual investment levels remain low and, more substantial longer term commitments will be needed to achieve lasting improvement. The Government should also develop a strategy for using road and other transport infrastructure to steer tourism development to new areas. Air transport is increasingly important as Montenegro targets a wider international market. The two airports are functional but give a poor first impression, as they have received only small investment since 1976. EBRD funds have recently been obtained for airport upgrading. Montenegro has become more open to foreign carriers over the past few years, with about 20 scheduled and charter airlines operating during the peak tourist season. However, Government policy still limits foreign carriers to a few landings a week, presumably as a measure to protect the national airline. This policy is likely to be a barrier to the growth of international tourism in the future, as air travel worldwide is increasingly shifting to the rapidly growing segment of discount air carriers.

- *Solid Waste and Wastewater Management:* Everyone agrees that inadequate solid waste management is a major challenge for maintaining the environmental sustainability coastal tourism and for attracting more international visitors. A waste management master plan at the Republic level was adopted by the Government in January 2005. Also, the Draft Law on Waste Management is soon to be considered for approval at a session of the Assembly of the Republic of Montenegro.. One temporary landfill was constructed with World Bank funding, and a few more are being undertaken.⁹⁹ Similar small investments in wastewater management are being made under other donor-funded projects (e.g., USAID, European Agency for Reconstruction). The 2004 “Keep it Clean Campaign” proposed a wide range of actions, but the implementation was focused mainly on education and media promotion, while little was achieved in relation the elimination of illegal dumpsites or stricter controls on vehicles carrying waste materials. A survey of dumping sites was undertaken, but no other direct measures for roadside clean-up appear to have been implemented. The MoTMA received 35,000 euros from the Government for contracting with municipality service companies for this purpose, but the funds went unclaimed. For 2005, the multi-sectoral Tourism Coordination Commission has proposed a different approach: a public employment program for roadside clean-up of tourism sites. Considering the harm that this problem does to Montenegro’s competitiveness as an international destination, a more intensive effort to combat the problem will be required. As in the case of illegal construction, strict and consistent enforcement of anti-dumping laws is at least as important as capital investment in landfills (people who are in the habit of dumping trash over a nearby cliff will not necessarily take the trash to a landfill several miles away just because it is available). This could be combined with such incentives as national recognition and awards for the cleanest towns. In addition, educational campaigns must be greatly expanded and more effectively targeted (e.g., to schoolchildren).

5.20 The Government needs to play a coordinating role in areas where donor infrastructure investments are ongoing, and a complementary role of filling the investment gap in the context of its comprehensive public investment program that rigorously screens public infrastructure investment for their economic and social returns in tourism.

5.21 **The Government’s Tourism Master Plan (TMP) needs to be provided with concrete budgets and interim implementation targets** (see Box 5.1. for an assessment of the Plan). As noted in Chapter 3, and budget allocations to support the TMP are uncertain from year to year, and have been cut by as much as 20 percent in recent years. Some short-term planning is being carried out, in the form of annual plans for preparation for the forthcoming summer seasons (there are two such plans to date, for 2004 and 2005). However, these annual plans are a mixture of specific and general goals and short-term and long-term undertakings without prioritization, annual targets or costing. Thus, the Action Plan for Preparation for the 2005 Summer Season contains nearly 170 separate items under 32 headings. Some are concrete actions that could conceivably be completed in one year (e.g., works on the third lane from the Mojkovac via Krstac saddle towards Bijelo Bolje). Others will take several years to complete, assuming that the funding is available, and there is no indication of how much is expected to be completed in the coming year (e.g., modernization of the railroad infrastructure—construction of new tracks and reconstruction of tunnels and bridges). Many are simply general statements of intent or policy (e.g., for improving water supply infrastructure:

⁹⁹At present, an ecologically sound closing of illegal dumpsites—including covering the dumps, constructing drainage systems, gas emissions and fencing-- is being undertaken in Kotor, Tivat, Budva, Bar and Ulcinj through World Bank funding (Montenegro Environmental Infrastructure Project, and Montenegro Environmentally Sensitive Tourist Areas Project).

“continuation of activities on realization of sub-projects, internal measures, intervention measures, optimization of existing sources and new ones;” and for privatizing tourism enterprises: “resolve the issues of land ownership between the state, private owners and economy [*sic*]).

Box 5.1. Merits and Limitations of Montenegro’s Tourism Master Plan (TMP)

Montenegro does not have a tourism policy, but a “Tourism Master Plan” (TMP) was prepared in 2001, with technical assistance from the German Investment and Development Company (DEG). The TMP calls for both a large overall increase in tourism arrivals and overnights (up to 15.68 million overnights in all categories in 2010 and 25.85 million in 2020), but also a substantial shift from a mainly lower/medium end domestic market to a mainly mid-to-high end international market. Its two strategic pillars are: (i) upgrading the coastal tourism product (accommodation and services); and (ii) diversifying the tourism product (lengthening the season, developing niche sectors such as adventure/nature tourism). One key element is to gradually eliminate 1- and 2-star accommodations* mainly by upgrading them to 3-star or better through privately financed renovation and stricter regulation. There is also strong emphasis on reducing the “grey economy” in the tourism sector, including, for example, putting in place regulation and flat rate taxation of private apartments that are rented out for tourism purposes.

Some merits of the TMP, and of measures being taken to implement it, are:

- The recognition of the cross-sectoral nature of tourism development. A multi-sectoral Tourism Coordination Commission, established in 2004, is responsible for developing annual plans of action to prepare for the forthcoming summer seasons and then reporting to the Government on their implementation. A “Keep it Clean Campaign” (aimed at reducing and cleaning up solid waste) has been developed and mounted by a working group comprised of the Ministries of Environment, Tourism, Health, Interior, Education and Science, Transport and Maritime Affairs, and Justice.
- The Government’s remarkable openness. Nearly all Ministry of Tourism documents are available on the Internet. The Government is also very open to privatizing state properties and inviting international technical assistance.

Some limitations of the TMP are:

- It fails to recognize the inherent limitations of Montenegro’s coastal tourism product, seeming to work on the assumption that increasing high quality accommodation at the coast is the key to a very substantial increase in market share (in reality, quality accommodation is a necessity but is not in itself an attraction).
- Diversification into other types of tourism is identified as a general objective, but with little detail and no concrete strategies or targets for achieving this.
- While the TMP is itself multi-sectoral and multi-level, it is not clear to what extent it is integrated with other planning instruments (e.g., National Spatial Plan, urban development plans).

Furthermore, some important strategic objectives of the TMP are not reflected in the annual plans. For example, the TMP indicates that Central and Western European countries will be targeted as the key source markets, but in 2005 action plan, the section on “Promotional Activities Nationally and Internationally” is very general and gives no indication of targeting any particular geographic source area or market segment. The plan calls for the opening of Tourism Agencies only in Belgrade, Kosovo, and “abroad.”

Source: Bank Staff assessment. *By 2020, reduce 1- and 2-star hotel beds from 64 percent of total to 25 percent of total; increase 3-star beds from 33 percent to 40 percent.

Private Sector Investment, Regulation, and Finance

5.22 The immediate physical rehabilitation and upgrading of hotels through privatization, while a step in the right direction, should be complemented by the knowledge and experience to create a facility that will attract an upscale, international clientele. The Government would thus need to pay attention not just to the price offered by bidders but also to their knowledge and experience to create high-end value. In the initial round of hotel privatizations some of the properties

were bought by speculators who did not make significant rehabilitation and upgrading of services. Later tenders addressed this problem by stiffening investment requirements. By 2004, 19 hotels had been privatized for a total sale price of about 35 million euros, involving a total investment commitment of about 85 million euros, and a total actual and pending investment of over 200 million euros. A few renovated hotels have reopened (e.g., Maestral, Mediteran). A detailed assessment of hotel privatizations to date, focusing not only on the amount of money invested but on the nature of the buyers and the quality of rehabilitation and the subsequent operation of the property, could provide important insights. In future it may be necessary to give greater consideration to prospective buyers' experience in operating international standard tourism accommodations. In addition, experienced and capable tourism investors are concerned not only with the potential of a particular property but with the overall context, including the Government's commitment to provide essential public infrastructure and services and to control negative influences such as unplanned and illegal development. Finally, because Montenegro is currently relatively unknown in many prospective tourism markets, high priority should be placed on attracting a few high quality "flagship" operators whose presence can help provide the reassurance that many travelers need in order to try out a new destination.

5.23 Legislation and regulation are needed, but must be supportive, not oppressive. In the tourism sector, as in other areas of business, the Government has placed considerable emphasis on enacting new legislation and regulations and creating institutions to implement them. In addition to the Law on Tourism (currently being amended), there is a new Law on Tourism Organizations (February, 2004) which established a Commission for Categorization of Tourism Resorts,¹⁰⁰ and contains various regulations, guidelines and obligatory standards recently enacted or under preparation for the licensing, classification and categorization of accommodations and catering establishments, development of nautical tourism, the development of mountain tourism, etc. The Ministry of Tourism regards such regulations as a main mechanism for stimulating the upgrading of tourism facilities in the country. For example, it has proposed that in the future licenses should be issued only to 3- to 5- star quality accommodations. A classification system is important to give confidence to international travelers, but it must be accurate and reliable in order to serve this purpose. The Commission (which includes an international expert) and the MoT consider that the standards now being applied in Montenegro are equivalent to international standards.¹⁰¹ Furthermore, as noted in Chapter 4, the proliferation of laws and regulations, particularly when combined with a high degree of discretion on the part of inspectors, can lead to confusion and to opportunities for official rent-seeking, and can discourage business owners from joining the formal (regulated) sector. The stated objective of the new wave of regulations is to ensure that accommodation and services are brought up to international standards, but in some cases the level of prescriptive detail seems excessive.¹⁰² One action listed in the 2005 plan is the unification of all laws and by-laws in the tourism sector, but little information is provided regarding how this will be carried out. It is clear, however, that the process should include a thorough review of the body of regulations, to identify

¹⁰⁰ Categorization refers to the type of facility (e.g. hotel, small hotel, apartment hotel, bistro, etc.). Classification refers to quality within that category, such as 1-star (budget) to 5-star (luxury). About 180 enterprises have been categorized and classified to date.

¹⁰¹ However, some experts do not agree. For example, the authors of the MPSDC benchmarking study consider the Government categorizations higher (more generous) than international standards, particularly for the 4- and 5-star categories.

¹⁰² For example, in the *"Obligatory & Qualitative Standards for Private Tourist Rentals – Rooms, Apartments, Houses"* the minimum requirements for all classification levels include (in addition to reasonable items such as clean sheets, curtains and adequate lighting) a requirement that clothes hangers in bedrooms may not be made of wire, an iron and vacuum cleaner be available on request, and there be one reserved parking space for each apartment. For restaurants, it is apparently required that a copy of the price list—stamped by the Minister of Tourism—be displayed on the wall (personal communication with, M. Yanofsky).

those that are required for maintaining basic standards (health, safety, environment, etc.) and protecting consumers' interests, and those to aspects that would be better left to market-based mechanisms.

5.24 Land use planning, the strengthening of property rights and the control of illegal construction are essential and urgent. The TMP recognizes inadequate planning, uncertain property rights and proliferating illegal construction as important constraints to private sector investment, including investment in Ulcinj, which represents a major portion of the projected growth in international tourism at the coast. The Government has taken some important actions, such as preparing the Ulcinj Development Plan (including an environmental assessment), establishing the Coastal Zone Management Agency, embarking on an integrated coastal zone planning program, and preparing a Law on Restitution. However, these institutional instruments will succeed only if there is a strong Government commitment to support and enforce them. The 2005 plan lists intended responses (e.g., defining a list of locations in the Marine Zone of particular importance for the development of tourism and establishing a way of prohibiting their being used for other purposes; defining the legal framework for managing tourist destinations; ensuring more efficient implementation of regulations related to unlicensed construction). However, it lacks concrete mechanisms, commitments and targets. The Government needs to make a genuine commitment to addressing this crucial issue of property rights and associated lack of control of illegal construction, particularly in the few remaining high-potential sites (e.g. Ulcinj, and inland areas close to national parks and other natural attractions). This issue represents one of the greatest threats to the future prospects of Montenegro's tourism. Concrete measures such as improving cadastral data and implementing the Law on Restitution are urgently needed.

5.25 Affordable financing and incentives are key to private sector investment in tourism. The main incentive offered to the private sector is the opportunity to purchase properties for renovation, presumably at attractive prices. In 2004 the Government also put in place a program to subsidize credit for small and medium tourism enterprises. Demand for the loans was fairly high, but the impact has not yet been evaluated. Ad hoc initiatives cannot make up for the overall problem of the lack of affordable, medium-term credit (see Chapter 4). The resulting high degree of dependence on internally generated cash flows means that much of the tourism development that takes place is likely to be in the form of individuals and firms that are in other businesses and are simply "trying their hand" at a tourism enterprise. This contributes to lack of professionalism and inconsistent quality in the sector. The development of a competitive tourism sector will require greater access to medium-term and longer-term credit at feasible rates, provided to investors with the demonstrated professional and financial capacity and commitment to develop and operate high quality tourism enterprises. Other fiscal policies should also be reviewed in relation to their impact on tourism profitability and competitiveness. For example, unlike many countries, Montenegro does not give an exemption on the 17 percent VAT to tourism, as it does to other export goods and services.¹⁰³ It is important for the Government to view tourism as a long-term source of economic growth and employment generation, rather than as a short-term revenue generator.

¹⁰³ Most European countries have one or even two reduced rates for VAT. As of 2004, 10 out of 15 EU Member States and 9 out of 10 Accession countries applied reduced rates on accommodation services; 13 of the 25 are/will apply reduced VAT rate on restaurant services (SCEPP, 2004).

Box 5.2. Sustainable Coastal Tourism Development: Some Lessons of Experience

An extremely difficult challenge in tourism development is to balance four major considerations: (i) profits for developers and other commercial interests; (ii) satisfied visitors who wish to return; (iii) improved quality of life and voice for residents; and, (iv) environmental sustainability for the enjoyment of future generations. Montenegro faces all of these challenges at the moment, including attracting private investment for coastal development. However, achieving sustainable coastal tourism development is probably the biggest challenge over the long-term.

The experiences of Caribbean islands with small population and specializing in sea-based tourism--in particular that of Antigua-- illustrates what not to do. On the other hand, the experience of US Virgin Islands in coastal management practices illustrates good practice of how to achieve coastal management and sustainable tourism development.

Failure to protect coastal capital is often the most important threat for sustainable coastal tourism development. This arises due to environmental neglect, and/ or aggressive promotion low value-added mass tourism. Antigua represents an example where there has been loss of coastal capital and lack of sustainability. Between 1975-1980, total tourist visits doubled, and it doubled again between 1980-1990. During these years more mangrove swamps and offshore reefs were damaged or killed than in all previous island history (Coram, 1993). Subsequent to these asset losses, the number of overnight visitors has dropped and still not recovered (WTO, 2002). This policy failure derived from a legacy of environmental neglect, the poor performance of non-tourist diversification into manufacturing and other economic sectors, marginal citizen participation in decision-making, and the authorities' persistent preference for short-term economic gain over long-term sustainable natural resource planning and management. Montenegro may need to avoid all of these ills.

However, coastal capital depletion can be avoided. The Virgin Islands Coastal Zone Management Program (VICZMP) provides a best practice example of how coastal assets can be protected while realizing tourism development. The program was enacted by the US Virgin Island Legislature in 1978 to protect, maintain and, where feasible, enhance the overall quality of the coastal zone environment for the benefit of residents and visitors alike. A Commission, headed by a cabinet level position and made up of 15 private citizens/ staff, was appointed by the Governor and approved by the Legislature to regulate activity and development in the coastal zone through major and minor permit processes. In the case of a major permit for a large resort, the process involves an Environmental Assessment Report (EAR), review by the Commission staff and appropriate agencies, public notices/hearings for citizen input, and a final decision by the Commission. Public participation--in particular the thorough permit vetting process--institutionalizes expert input from Commission staff and from technicians in related local public agencies. Commission staff is also charged under the law with identifying any illegal coastal zone activities undertaken without valid permits. The lessons are that sustainable coastal tourism development can be achieved through: (i) a basic integrative understanding from public planners, resource users, and managers and developers of how terrestrial and marine ecosystems interact to preserve overall ecological stability; (ii) the establishment of an effective regulatory framework supportive of coastal stability based on such understanding; and, (iii) an institutionalized citizen participation in coastal resource management and conflict resolution. The VICZMP is recognized as a model for other governments and for other island governments in the Caribbean in coastal tourism management.

Source: Based on: Jerome L. McElroy, "Sustainable Tourism Coastal Development: Some Policy Suggestions", Paper presented to the Workshop on Coastal Tourism Policy, Simon Fraser University, Vancouver, British Columbia (December 6-7, 2002)

Labor Market and Skills Development

5.26 Human resources development is key to upgrading tourism and reaping its benefits. Tourism is one of the most labor-intensive export industries, and employment generation is usually an important economic benefit of tourism development. However, the extent and quality of the

employment benefits varies depending on the type of tourism, on labor market policies, and on the level of investment in human resources development. In Montenegro the potential employment benefits are not being captured. Local employment in the tourism sector is relatively low and is projected to grow at only a modest rate (1.7 percent in 2005; average 4.5 percent per year over the next decade:) (OEF/WTTC, 2005). Montenegro currently ranks eighty-sixth among 174 countries worldwide with respect to employment in the tourism and travel economy (TTE) as a percentage of total employment, while it ranks sixteenth in the contribution of TTE to total GDP. This suggests that the rate of tourism sector job creation is below what would be expected (it should be noted, however, that these figures reflect only registered jobs, while a substantial proportion of tourism workers are likely to be unregistered¹⁰⁴).

5.27 The WTTC (2004) identified a severe shortage of skilled labor, and inadequate training facilities (especially at the higher levels), as major constraints to developing a vibrant and competitive industry in Montenegro. Certainly, a better trained workforce will be essential for improving Montenegro's competitiveness in this industry where service is everything, and for making tourism an attractive career for young Montenegrins. However, the TMP barely makes a general reference to this as an area where international assistance is needed (mainly in relation to improving catering and service skills), and includes no comprehensive strategy or targets. The National Employment Agency strategy appears to focus on training and increasing employment at the unskilled and low-skilled levels, with no strategy to absorb or mobilize the substantial population of young, educated, unemployed people. An EU-funded project for providing school leavers with practical job skills is initially targeting the tourism and wood industries, and provides training as waiters and waitresses. While better skills at the service level are urgently needed to improve quality and competitiveness in the existing facilities, the future development of a modern tourism sector will require higher level professional training in a wide range of skills and with an emphasis on modern information technology, management, and flexibility and "multi-tasking." The existing faculty of Tourism and Hotel Management at the University of Montenegro is not in a position to perform this function. The first private faculty of tourism, management and trade, established in 2004 by Atlas Mont Bank in Bar, holds out promise, but is at a very early stage and little information is available on it.

5.28 Finally, Montenegro needs to continue to take a regional perspective on tourism development. The Government's tourism development strategy, as reflected in the TMP, is focused mainly on Montenegro in isolation from its neighbors. In reality, Montenegro is a small part of a region which includes some countries with well-established tourism industries (e.g., Croatia) and several others that are targeting tourism as a major area for investment and economic growth. While these countries represent competition, in today's highly mobile market (thanks to inexpensive long-haul air travel), physical proximity is not a major factor in this regard. The real challenge is to entice international tourists to come to the western Balkans in the first place, rather than to other comparable destinations such as the Mediterranean, the Caribbean, etc. Caribbean and southern African countries have recognized the advantages of cooperating with one another to sell themselves collectively as world class destination with each country identifying its own particular niche and benefiting from the appeal of multi-country circuits. Their strategies include joint marketing and promotion and the facilitation of inter-country movement through measures such as reducing border formalities, building complimentary infrastructure, and using of common signage. Smaller, less known countries benefit from their larger and more advanced neighbors through an "overflow" effect, while the latter have an

¹⁰⁴ The Labor Agency reported 3,000 new jobs filled in the tourism sector in 2004, but the majority of these are jobs that existed previously in the informal sector and moved into the formal sector as a result of a legalization campaign. Estimates are that one-half to one-third of tourism jobs are held by expatriate seasonal workers. (Wieland, pers. comm.)

incentive to assist the former to develop to a high standard in order to raise the overall reputation of the region. By itself, Montenegro has limited drawing power as an international destination, but with the right approach it could benefit from, and contribute significantly to, a competitive regional package.¹⁰⁵

¹⁰⁵ There are already a considerable number of cross-border tourism travels between Croatia and Montenegro, but Montenegro, in cooperation with Croatia, could benefit from further removing constraints to cross border movements.

REFERENCES

- Alesina, Alberto and Romain Wacziarg (1998). "Openness, Country Size and the Government". *Journal of Public Economics*, Vol. 69, Issue 3 (September), 305-321.
- Alesina, Alberto, Enrico Spolaore and Romain Wacziarg (2003). Trade, Growth and the Size of Countries, Harvard Institute of Economic Research, Discussion Paper # 1995, January.
- Barro, R. (1990). "Government Spending in a Simple Model of Endogenous Growth," *Journal of Political Economy*, 98(1) 103-117.
- Barro, R., and X. Sala-i-Martin (1992). "Public Finance in Models of Economic Growth." *Review of Economic Studies* 59, (4) 645-661.
- Betcherman, G., A. Luinstra, and M. Ogawa (2001). "Labor Market Regulation: International Experience in Promoting Employment and Social Protection." SP Discussion Paper No 0128. World Bank. Washington, DC.
- Betcherman, Gordon, Karina Olivas, and Amit Dar (2004). "Impacts of Active Labor Market Programs: New Evidence from Evaluations with Particular Attention to Developing and Transition Countries." World Bank, SP Discussion Paper No. 0402. Washington, DC.
- Bogetic, Z. (2002). "Montenegro's Currency and Foreign Trade Reforms: A Brief Review", Washington, D.C.
- Center for Entrepreneurship and Economic Development (2002). "Montenegro Enterprise Survey," Podgorica.
- Center for Entrepreneurship and Economic Development (CEED), *Montenegro Business Outlook*, various issues, Podgorica.
- Central Bank of Montenegro, Izvještaj glavnog ekonomiste – 2002, 2003, 2004 (Chief Economist Reports for 2002, 2003 and 2004).
- Commission of the European Communities. (2004). "Serbia and Montenegro Stabilization and Association Report 2004," Commission Staff Working Paper, Brussels.
- Coram, R. (1993) *Caribbean Time Bomb*. New York: William Morrow.
- Dar, Amit, and P. Zafiris Tzannatos (1999). "Active Labor Market Programs: A Review of the Evidence from Evaluations." Social Protection Discussion Paper No. 9901, January. World Bank, Washington, DC.
- Demirgüç-Kunt, A. and V. Maksimovic (1998). "Law, Finance, and Firm Growth," *Journal of Finance* 53, 2107-2137.
- Demirgüç-Kunt, A., and V. Maksimovic (1999). "Institutions, Financial Markets and Firm Debt Maturity," *Journal of Financial Economics*, 54, 295-336.
- Devarajan, S., V. Swaroop, and H. Zou (1996). "The Composition of Public Expenditure and Economic Growth." *Journal of Monetary Economics*, 37(3) 313-344.

- Easterly, W., and . Rebelo (1993). "Fiscal Policy and Endogenous Growth". *Journal of Monetary Economics* 32(3) 417-458.
- Easterly, William and Aart Kray (1999). "Small States, Small Problems." Washington DC: World Bank (processed).
- EBRD (2002). Transition report 2000: Employment, skills and transition. London.
- European Central Bank . "Statistics Pocket Book, May 2004," Brussels.
- European Commission (2004). Undeclared Work in an Enlarged Union. An Analysis of Undeclared Work: An In-Depth Study of Specific Items. Brussels.
- Eurostat (2004) "Statistical Annex of European Economy." Brussels.
- Favaro, Edgardo (2003). "Managing Risk in a Small State," Washington, DC, World Bank (draft).
- FIAS (2004). "Montenegro Investment Environment Diagnostics", Washington DC.
- Fretwell, David H., Jacob Benus, and Christopher J. O'Leary (1999). "Evaluating the Impact of Active Labor Market Programs: Results of Cross Country Studies in Europe and Central Asia." Social Protection Discussion Paper No. 9915. World Bank, Washington, DC.
- Funck, Bernard (ed.) (2002). "Expenditure Policies Toward EU Accession", World Bank Technical Working Paper NO. 533, Washington, D.C.
- Garibaldi, P., and P. Mauro (1999). "Deconstructing Job Creation." IMF Working Paper 99/109.
- Gilles, Saint-Paul (2004). "Why Are European Countries Diverging in Their Unemployment Experience?" *Journal of Economic Perspectives*. Vol 18, No 4.
- Glomm, G., and B. Ravikumar (1997). "Productive Government Expenditures and Long-run Growth". *Journal of Economic Dynamics and Contr.,l* 21(1) 183-204.
- Godfrey, Martin (2003). Youth Employment Policy in Developing and Transition Countries – Prevention as well as Cure. SP Discussion Paper No. 0320. World Bank, Washington, DC.
- Government of the Republic of Montenegro (2005). Economic Reform Agenda for Montenegro 2002-2007 – Report and Recommendations. Podgorica.
- Government of the Republic of Montenegro (2005). Strategy for permanent solution of refugees and IDPs issue in Montenegro. Podgorica.
- Government of the Republic of Montenegro (2001). Tourism Master Plan for Montenegro.
- Government of the Republic of Montenegro (2003)"Economic Reform Agenda for Montenegro," Podgorica.
- Government of the Republic of Montenegro, Economic Policy (for 2002, 2003, 2004 and 2005), Podgorica.

Government of the Republic of Montenegro, Ministry of Tourism (2004) (September). Overview of the Summer Tourism Season 2004.

Government of the Republic of Montenegro, Ministry of Tourism (2004) (November). Action Plan for the Preparation of 2005 Season.

Government of the Republic of Montenegro, Ministry of Tourism, and National Tourism Organization of Montenegro (2005) (January). Bulletin: New Year's Issue.

Government of the Virgin Islands (2004). *VICZMP Official Website*. <http://www.viczmp.com>

Heron, R., and C. Vandenabeele (1999). Labour Dispute Resolution: An Introductory Guide. ILO East Asia Multidisciplinary Advisory Team. ILO Regional Office for Asia and the Pacific: Bangkok.

ILO (2000b). "Good Practices in Settlement of Individual Labour Disputes: The Case of Chile." Available at www.ilo.org.

ILO (2004). Global Employment Trends. Geneva.

Institute for Strategic Studies and Prognoses (ISSP), Household Survey, various issues, Podgorica.

Institute for Strategic Studies and Prognoses (ISSP), *Montenegro Economic Trends*, various issues, Podgorica.

ISSP (2004). Montenegro Economic Trends, November.

Javorcik, Beata and Mariana Spatareanu (2004). "Do Foreign Investors Care About Labor Market Regulations?" World Bank Policy Research Working Paper 3275. April.

Kneller, R., M.F. Bleaney, and N. Gemmell (1999). "Fiscal Policy and Growth: Evidence from OECD Countries". *Journal of Public Economics*, 74 171-190.

Laporta, R., F. Lopez-de-Silanes, A. Shleifer, and R. Vishny (1998). "Law and Finance," *Journal of Political Economy* 106, 1113-1155.

Layard, Richard, Steven Nickell and Richard Jackman (1990). *Unemployment*. Oxford: Oxford University Press.

Levine, R., and D. Renelt (1992). "A Sensitivity Analysis of Cross-country Growth Regressions." *American Economic Review*, 82(4) 942-63.

Marc Yanofsky Management Associates (2004). The Montenegro Private Sector Development and Competitiveness (MPSDC) Project Tourism Sector Strategy: Relevant Strategy as a Framework for Meaningful Impact. (Prepared for the U.S. Agency for International Development)

McElroy, Jerome L. "Sustainable Tourism Coastal Development: Some Policy Suggestions", Paper presented to the Workshop on Coastal Tourism Policy, Simon Fraser University, Vancouver, British Columbia (December 6-7, 2002)

Montenegro Statistical Office (MONSTAT), Press Releases on National Accounts for 2000-2002

Montenegro Statistical Office (MONSTAT), *Statistical Yearbook 2004*, Podgorica.

OECD (2004). *Employment Outlook*. Paris.

Oxford Economic Forecasting, for World Travel and Tourism Council (2004). *Montenegro Travel and Tourism: Forging Ahead. The 2004 Tourism and Travel Economic Research*.

Oxford Economic Forecasting, for World Travel and Tourism Council (2005). *Montenegro Travel and Tourism: Sowing the Seeds of Growth. The 2005 Travel and Tourism Economic Research*.

Pagano, M. (1993). "Financial Markets and Growth: An Overview," *European Economic Review*, 37, 613-622.

Rodrik, D., R. Hausmann and A. Velasco (2004). "Growth Diagnostics":
<http://ksghome.harvard.edu/~drodrik/barcelonaoct19.pdf>.

Rodrik, Dani (2004). "Growth Strategies": <http://ksghome.harvard.edu/~drodrik/GrowthStrategies.pdf>.

Rychly, Ludek, and Rainer Pritzer (2003). "Social Dialogue at National Level in the EU Accession Countries." Working Paper No 12. ILO, Geneva.

Savetodavni Centar za Ekonomska I Pravna Pitanja (2004) (March). *Impact of the Value Added Tax (VAT) System in Montenegro and Serbia on the Tourism Sector*.

U.S. Government, Bureau of Labor Statistics: (www.bls.gov).

UNDP (2004). *Household Survey of Roma, Ashkelia and Egyptians, Refugees and Internally Displaced Persons*. Podgorica.

UNICEF (1999). "Women in Transition." Regional Monitoring Report No 6. Florence.

USAID – BearingPoint (2004). *Review of Labour Law – Montenegro*. Podgorica.

World Bank (2003). *Serbia and Montenegro Public Expenditure and Institutional Review*, Volume III: Montenegro, Washington, D.C.

World Bank (2003). "Montenegro Investment Climate Survey," Washington DC.

World Bank (2003). "Serbia and Montenegro Poverty Assessment (in two volumes), Vol I: Executive Summary," Washington, DC.

World Bank (2004a). *Doing Business in 2005*. Washington, DC.

World Bank (2004b). "Serbia and Montenegro – Serbia: An Agenda for Economic Growth and Employment." Washington, DC.

World Bank (2004c). *World Bank Atlas 2004*. Washington, DC.

World Tourism Organization (WTO) (2002). *Compendium of Tourism Statistics 2002*. Madrid, SP: WTO.

World Travel and Tourism Council (2004). Montenegro: The Impact of Travel and Tourism on Jobs and the Economy.

World Travel and Tourism Council (2005). Montenegro: Sowing the Seeds of Growth.

Young, David (2003). "Employment Protection Legislation: Its Economic Impact and the Case for Reform." European Commission. Economic Papers no 186. July. Brussels.

ANNEXES

ANNEX 1. MONTENEGRO--CHRONOLOGY OF MAJOR EVENTS, 2002-2004

Year	Month	Main Event
2002	January	<ul style="list-style-type: none"> - Introduction of euro and replacement of Deutsche Mark as legal tender - A new company law was adopted (minimal capital requirement significantly reduced for LLC – to one euro. - Several important laws adopted: Customs Law and Law on customs administration, Employment Law, Enterprise Insolvency Law, Law on Courts and Accounting Law.
	February	<ul style="list-style-type: none"> - The Central Bank decided to introduce compulsory management in Jugobanka - The Agreement on the Redefinition of the Relations between the two Yugoslav republics was signed.
	March	<ul style="list-style-type: none"> - The Government of Montenegro makes decision to freeze the debt and the old foreign reserves on balance sheet of Montenegro Banka. This decision was made to rehabilitate and re-capitalize the bank. - EIB approved loan for railways sector of 15 million euros.
	April	<ul style="list-style-type: none"> - Euro becomes the only official currency, 115 thousands persons in MN converted currencies of counties from euro zone to euros (approximately 920 million DM) - The government adopted Economic policy, - Parliament of Montenegro adopts Agreement on Redefinition of Relations between Montenegro and Serbia. - License for work granted for Montenegro Banka, - Bankruptcy process started in Jugobanka.
	May	<ul style="list-style-type: none"> - The new three-year arrangement with IMF started, - No confidence for the republican government voted in the Parliament.
	June	<ul style="list-style-type: none"> - Initial tender for privatization of Telecom of Montenegro, - Minimum capital requirement for commercial banks raised to 5 million euros - Central Bank's initiative for the process for closing the offshore banks started.
	July	<ul style="list-style-type: none"> - Signed agreement with Greece on bilateral assistance to Serbia and Montenegro
	August	<ul style="list-style-type: none"> - WB emergency energy project started, - privatization of Jugopetrol started by issuing tender
	September	<ul style="list-style-type: none"> - A USAID sponsored commercial bank -- Opportunity Bank-- started operations.
	October	<ul style="list-style-type: none"> - Elections for the Republican Parliament, 39 out of total 75 mandates, won "Democratic list for European Montenegro – Milo Djukanovic". "Coalition for changes" won 30 mandates, "Liberal Committee" 4, and "Albanians Together" 2 mandates. - Jugopetrol, largest oil retailer, privatized. The new owner is Greek oil retailer Hellenic Petroleum. - Signed contract on concession of largest Montenegrin port – Port of Bar container terminal (concessionaire is Panama's company Eberhard International Distributors).
	November	<ul style="list-style-type: none"> - Repayment of frozen foreign exchange savings started, - Set of laws on education and breeding passed. The Parliament of Montenegro passed General Law on Education and Breeding, Law of Pre-school Education, Primary Education, Law on Gymnasium and Law on Professional Education of adults.
	December	<ul style="list-style-type: none"> - Parliament approved budget for 2003 (expenditures will be 431millions euros, 25 percent more than previous year) - Securities Commission adopted the regulation for trade in shares from mass voucher privatization. - Presidential elections failed (about 46 percent of Montenegrin citizens came to the polls),

		- Privatization of Niksic's Ironworks initiated.
2003	January	<ul style="list-style-type: none"> - The new government is formed – Mr. Djukanovic is the Prime Minister, - Parliament of the Republic of Montenegro adopted the Constitutional Charter of the State Union between Serbia and Montenegro and Law for Constitutional Charter Implementation.
	February	<ul style="list-style-type: none"> - Second round of presidential elections failed, with turnout of only 47.7 percent of Montenegrin citizens at the polls - European Bank for Reconstruction and Development became shareholder in the Euromarket Bank
	March	<ul style="list-style-type: none"> - The government adopted an Agenda of economic reforms, - Council of the Central Bank of Montenegro reduced required reserves for commercial banks from 50 percent to 23 percent.
	April	- Introduction of VAT
	May	- Montenegro Banka privatized through sale to Slovenian Nova Ljubljanska Banka.
	June	- Joint customs office of Serbia and Montenegro established.
	July	- Parliament adopted supplementary budget.
	August	- Action plan for harmonization of economic systems of Serbia and Montenegro adopted.
	September	<ul style="list-style-type: none"> - Reform of pension system started with adoption of the new pension insurance law. - Two additional laws adopted: anti money laundering law and law on repayment of frozen foreign currency deposits to citizens of Montenegro.
	October	- Privatization of hotels continued
	November	<ul style="list-style-type: none"> - Government of Montenegro adopted PRSP. - Donors' meeting in Brussels - Free Trade Agreements between Serbia and Montenegro and Albania, Bulgaria and Moldova signed in Rome.
	December	<ul style="list-style-type: none"> - The new Labor Law adopted in the Parliament, - Budget for 2004 adopted. - Collective agreement between Chamber of Commerce and trade union signed.
2004	January	<ul style="list-style-type: none"> - Transfer of the public payment system (ZOP) to commercial banks. - The Government of Montenegro and six Montenegrin commercial banks signed contracts for micro-credits scheme worth 13 million euros. This credit line is designed to stimulate employment and to finance projects in agriculture and tourism.
	February	<ul style="list-style-type: none"> - Privatization continued with the sale of Hotel Splendid, and issuing of tenders for the factories Beranka, Niksic Still mill, - Changes in the positions of ministers of finance and international economic relations. - The government signed the protocol on establishing joint maritime company with Norwegian Th. Jacobsen.
	March	<ul style="list-style-type: none"> - The Parliament of Montenegro adopted several new laws: law on railways, law on political parties, law on restitution of disposed property rights and repatriation, law on civil procedure, and law on executive procedure. - EU adopted plan for technical and financial assistance to SEE – CARDS (Community Assistance for Reconstruction, Development and Stabilization), of which earmarked amount for Montenegro is 18 million euros.
	April	<ul style="list-style-type: none"> - The initial results of the Decree on Tax Relief for New Employees was that around 40,000 new employees were registered, - Adopted Law on Tax on the use of passenger vehicles, Law on supreme auditing institution, Foreign trade law, Law on civil servants salaries, Law on tax of insurance premiums, - Implementation of FTA with Bosnia started.
	May	- Supplementary budget adopted.

		<ul style="list-style-type: none"> - The Parliament of the Union was established and MPs voted for the establishment of the last missing institution of the State Union – the State Union Court. - Announced Tender for the sale of a part of the company Radoje Dakic. - Government adopted decree which allows reduced tax on wage bill by 5 percentage points on July 1st, and additional 5 percentage points in December.
	June	<ul style="list-style-type: none"> - Control share package of the Niksic Ironwork, i.e. 59.27 percent of the share capital, was sold to the company "Midland," - World Bank approved credit of seven million dollars for health reform and five million dollars for pension system reform - The government adopted the Decree on Foreign Exchange Currency Savings Conversion into Bonds. Nominal value of issued bonds is EUR 150 million, - The agreement on succession of former SFRY came into force, - Adopted Law on Changes in Law of Privatization of the Montenegrin Economy, Law on prevention of conflict of interests, Law on tax free zones and Law on roads.
	July	<ul style="list-style-type: none"> - Several new laws adopted: Law on Mortgage, Law on Investment Funds, amendments on the Law on Pension and Invalid Insurance. - Montenegrin maritime company bought the first ship. - The first installment of the repayment scheme for frozen foreign currency deposits was paid to persons - European Commission representatives handled the document: European Partnership with Serbia and Montenegro to the state union council of ministers.
	August	<ul style="list-style-type: none"> - Privatization continued: company "Jakic" from Pljevlja was sold to the American company Prim Pacific, and preliminary Tender for sale of the Aluminum Mill from Podgorica was announced. Norwegian company Telenor, one of the owners of mobile lines operator "Pro Monte", bought the rest of the shares (55.9 percent) thus became the only owner. - The new law on game of chance started to be implemented
	September	<ul style="list-style-type: none"> - Shares and portions of property of the companies Crnagoraput, Zitoproduct, Lovcen and Centrojadrin were offered for privatization through public auction. - The Board of Directors of the World Bank approved SAC2 in the amount of US\$ 18 million. - The Government decided to establish the fund for the refund of the nationalized property.
	October	<ul style="list-style-type: none"> - Tender for sale of 51 percent of shares in Telekom Crne Gore was issued. - The government has increased temporary customs on flour (to 30 percent) due to requests from the local suppliers.
	November	<ul style="list-style-type: none"> - Closing date for the tender opened for the privatization of KAP has been prolonged to January 20. - Serbia and Montenegro signed an agreement with Russia on settling the old debt in non-convertible currencies (amount of US\$306.8 million).
	December	<ul style="list-style-type: none"> - Tax on wages reduced by further 5 percentage points. - The new budget for 2005 has been adopted. It envisages total government expenditure of 492 million euros. - Several laws adopted: Law on protection on the work, amendments on the law on social insurance, law on labor, employment law and law on pension insurance.

ANNEX 2. MONTENEGRO--STATISTICAL TABLES

Table A.1. Montenegro—Key Macroeconomic Indicators

Indicator	2000	2001	2002	2003	2004
Real sector developments					
GDP, mln EUR	1,022.2	1,244.8	1,301.5	1,433.0	1,535.0
GDP, mln USD	944.1	1,114.9	1230.2	1621.0	1909.4
GDP real growth	3.1	-0.2	1.7	2.3	3.7
Industrial production growth (y-o-y)	3.3	-2.0	0.6	2.4	13.8
Agriculture growth, (y-o-y)	-5.0	7.0	6.6	1.0	3.5
Public finances					
Central government revenues, % GDP	28.7	23.3	26.7	25.7	27.3
Central government expenditures, % GDP	37.0	26.3	30.8	29.9	31.3
Budget deficit before grants, % GDP	-8.3	-3.0	-4.1	-4.2	-4.0
General government revenues, % GDP	na	38.0	35.1	34.8	36.5
General government expenditures, % GDP	na	42.3	38.6	37.6	37.7
General government deficit after grants, %GDP	na	-1.6	-1.8	-4.0	-3.1
Privatization revenues, EUR mln	0.0	0.0	66.4	15.8	7.7
Privatization revenues, % GDP	0.0	0.0	5.1	1.1	0.5
Debt service, EUR mln	na	59.5	48.9	55.7	52.0
Prices					
Inflation (CPI, eop)	24.8	24.0	9.4	6.7	4.3
Inflation (CPI, average)	24.7	22.9	17.5	7.0	3.4
Costs of living (eop)	22.4	26.6	9.5	6.2	1.5
Foreign Trade					
Export of goods, mln USD	161.3	210.8	305.1	304.9	474.1
Import of goods, mln USD	354.5	647.4	706.7	713.4	1014.3
Trade deficit, mln USD	-193.2	-436.6	-401.6	-408.6	-540.2
Export of goods, mln EUR	174.7	235.3	320.8	270.6	381.6
Import of goods, mln EUR	383.9	726.3	742.8	629.9	812.5
Trade deficit, mln EUR	-209.2	-491.0	-422.0	-359.3	-430.9
Export of goods in EUR, as %GDP	17.1	18.9	24.7	18.8	24.9
Import of goods in EUR, as %GDP	37.6	58.3	57.1	43.7	53.0
Trade deficit, as %GDP	-20.5	-39.4	-32.4	-24.9	-28.1

Indicator	2000	2001	2002	2003	2004
CAD before grants, mln USD	na	-307.5	-247.9	-154.0	-189.3
CAD, as %GDP	na	-27.6	-20.1	-10.7	-12.3
CAD after grants, mln USD	na	-175.0	-161.1	-102.0	-143.0
CAD after grants, as %GDP	na	-15.7	-13.1	-7.1	-9.3
Gross official reserves, mln EUR	na	34.5	43.0	38.5	53.5
FDI, mln EUR	na	10.6	86.9	43.8	51.8
FDI, mln USD	na	9.5	84.3	50.5	62.0
Tourism income, mln USD	na	94.9	144.0	151.2	179.7
Monetary					
M1	na	na	402.0	386.1	429.6
M2, mln EUR	na	na	496.0	460.8	536.1
M2, as %GDP	na	na	38.1	32.2	34.9
Wages					
Average net wage in EUR	96.4	108.0	142.2**	174.0	195.9
Average pension, EUR	84.0	98.4	108.7	112.0	123.0
Employment					
Average employment (official), 000	140.8	141.1	140.1	142.7	143.5
Registered unemployment, average in 000	84.1	81.6	80.9	71.7	65.0
LFS unemployment rate	23.2	24.6	24.5	26.9	27.7
Indebtedness					
Public external debt, EUR mln	671.0	674.4	893.6	461.5	488.3
Public external debt, %GDP	65.6	54.2	68.7	32.2	31.8
Public debt, EUR mln	na	na	1149.2	711.2	742.4
Public debt, %GDP	na	na	88.3	49.6	48.4
Memorandum items:					
Population	611,122	613,328	615,534	617,740	620,145
USD per 1 EUR, period average	0.924	0.896	0.946	1.131	1.244

* - in dinars

** - average for 1-6/2002 and 7-12/2002.

Source: MONSTAT; Central Bank of Montenegro; Montenegrin Ministry of Finance.

Table A.2. Montenegro: Balance of Payments, 2001-2004 (EUR thousands)

	2001	2002	2003	2004
Trade balance	-491,012.8	-421,950.2	-359,330.0	-430,900.0
Exports f.o.b.	235,310.8	320,823.2	270,574.0	381,607.0
Exports f.o.b., excluding export to Serbia	209,792.0	219,388.0	177,575.0	259,553.0
o/w aluminum	157,644.0	165,365.0	109,726.0	158,069.0
Imports c.i.f.	-726,323.6	-742,773.4	-629,904.0	-812,507.0
Imports c.i.f., excluding import from Serbia	-611,473.2	-564,967.4	-413,091.0	-566,716.0
o/w electricity	-37,326.2	-48,923.4	-46,526.0	-48,777.0
Services (non-factor services, net)	97,355.0	101,796.8	111,733.0	139,879.0
Receipts	150,738.0	176,094.4	191,395.0	241,123.0
Expenditure	-53,382.9	-74,297.6	-79,662.0	-101,244.0
Net factor income	-5,138.0	-8,846.0	-20,802.0	-39,231.0
<i>Of which:</i> Net interest	-1,012.0	-649.0	-11,991.0	-23,983.0
Earnings	1,623.0	1,122.0	580.0	586.0
Payments	-6,761.0	-9,968.0	-21,382.0	-39,817.0
o/w interest	2,465.0	1,601.0	12,568.0	24,524.0
Private remittances, net	52,652.5	71,321.0	114,376.0	140,906.0
Inflows	96,849.5	114,793.0	127,945.0	160,704.0
Outflows	-44,197.0	-43,472.0	-13,569.0	-19,798.0
Current account balance, before grants	-346,143.2	-257,678.4	-154,023.0	-189,346.0
<i>(In percent of GDP)</i>	-27.8	-19.8	-10.7	-12.3
Official grants	147,108.5	91,521.5	52,037.0	46,378.0
<i>(In percent of GDP)</i>	11.8	7.0	3.6	3.0
Current Account Balance, after grants	-199,034.8	-166,156.8	-101,986.0	-142,968.0
<i>(In percent of GDP)</i>	-16.0	-12.8	-7.1	-9.3
Foreign direct investment, net	10,636.5	87,327.0	38,725.0	50,015.0
Foreign loans, net	-6,052.0	4,411.0	47,047.0	98,170.0
Medium and long term, net	-6,052.0	4,411.0	47,047.0	98,170.0
Disbursements	2,916.0	23,679.0	114,597.0	176,103.0
Amortization	-8,968.0	-19,268.0	-67,550.0	-77,933.0
Short term, net	0.0	0.0	0.0	0.0
Other capital inflows	-13.0	-174.0	942.0	5,524.0
Commercial banks, net	3,305.0	10,007.0	45,759.0	32,237.0
Capital account balance	7,876.5	101,571.0	132,473.0	185,946.0
Errors and omissions	191,158.3	60,619.8	-31,044.0	-27,937.0
Overall balance	0.0	-3,966.0	-557.0	15,041.0
Financing	0.0	3,966.0	557.0	-15,041.0
Net foreign assets (increase, -)	0.0	3,966.0	557.0	-15,041.0
Central Bank, net	0.0	3,966.0	557.0	-15,041.0
Gross foreign reserves (increase, -)	0.0	3,966.0	557.0	-15,041.0
<i>Of which:</i> IMF purchases	0.0	0.0	0.0	0.0
Gross foreign liabilities (increase +)	0.0	0.0	0.0	0.0
IMF repayment	0.0	0.0	0.0	0.0
Arrears (reduction, -)	0.0	0.0	0.0	0.0
Memo items:				
GDP in EUR	1,244,800.0	1,301,500.0	1,433,000.0	1,535,000.0
USD per 1 EUR	0.8956	0.9449	1.1309	1.2439

Source: Central Bank of Montenegro

Table A.3. Montenegro: Employment and Unemployment, 1997-2004 (average per year in thousands)

	1997	1998	1999	2000	2001	2002	2003	2004
Employment								
Employment (LFS)	178.6	180.4	184.8	181.7	176.6	177.6	168.5	187.3
Employment (official)	147.1	147.2	145.6	140.8	141.1	140.1	142.7	143.5
Unemployment								
Unemployment (LFS)	57.3	50.7	53.3	54.9	57.5	57.7	62.1	71.8
Unemployment (official data)	64	68.3	75.3	84.1	81.5	80.9	71.7	65.0

Source: Labor Force Survey, MONSTAT; Employment Fund for official data.

Table A.4. Montenegro: Consolidated Fiscal Operations, 2001-2005, % of GDP*

	2001	2002	2003	2004	2005*
Total revenue	38.0	35.1	34.8	36.5	36.3
Current revenue	38.0	35.1	34.8	36.2	36.3
Tax revenue	32.9	32.8	32.6	34.5	34.7
Personal income tax	5.4	4.4	4.4	4.2	4.2
Social security contributions	10.8	11.5	10.6	11.2	10.3
Corporate income tax	0.6	1.0	0.9	1.1	1.4
Retail sales tax / VAT 1/	7.1	8.3	9.7	10.3	10.7
Excises	4.4	4.3	4.0	4.0	4.2
Taxes on international trade	4.3	3.0	2.7	2.4	2.6
Other taxes	0.4	0.4	0.2	1.3	1.3
Nontax revenue	5.1	2.3	2.2	1.7	1.5
Capital revenue	0.0	0.0	0.1	0.2	0.0
Total Expenditure and net lending	42.3	38.6	37.6	37.7	36.4
Current Expenditure	38.6	35.5	34.0	34.0	32.4
Net wages, salaries and allowances	9.9	10.0	8.9	9.5	9.1
Payroll Tax	1.6	1.1	1.5	1.7	1.4
Purchases of goods and services	5.9	3.7	4.2	3.5	3.4
Interest payment	0.1	1.0	1.0	1.6	0.9
Subsidies and other current transfers	20.7	19.0	17.9	16.9	17.2
Subsidies to enterprises	1.2	1.9	1.0	0.6	0.4
Transfers to households	19.5	17.1	16.9	16.4	16.8
Other non-interest current expenditure	0.5	0.6	0.5	0.7	0.4
Capital expenditure	2.0	1.5	1.6	2.0	2.8
Foreign financed project spending	0.0	0.6	0.6	1.2	1.1
General reserves	0.6	1.0	0.6	0.7	0.7
Net Lending	1.1	0.7	1.4	1.0	0.5
Transfer to the Union Budget	0.0	0.0	2.2	2.3	2.6
Overall balance before grants	-4.7	-3.8	-4.9	-3.6	-2.7
Overall balance before grants and foreign-financed project loans	-4.7	-3.3	-4.4	-2.4	-1.6
Foreign grants	3.1	2.1	0.9	0.5	0.2
Overall balance including grants	-1.6	-1.8	-4.0	-3.1	-2.4
Financing	1.6	1.8	4.0	3.1	2.4
Domestic financing	1.6	-3.7	1.7	0.6	-9.5
Bank financing	0.8	-3.4	1.1	-0.8	-9.0
Nonbank financing	0.8	-0.3	0.6	1.4	-0.5
Of which: repayment of FFCDs	0.0	-0.3	0.0	-0.3	-0.5
Net Foreign Financing	0.0	0.6	1.3	2.0	1.9
Program	0.0	0.0	0.8	0.9	0.9
Project	0.0	0.6	0.6	1.2	1.1
Amortisation	0.0	0.0	0.0	-0.1	-0.1
Privatization receipts	0.0	4.9	1.0	0.5	10.0

* IMF Projections.

Source: IMF; Montenegrin Ministry of Finance

Table A.5. Montenegro: Consolidated General Government Expenditure by Function, 2002-04*

	2002	2003	2004
	% GDP		
General Government Services	11.57	16.05	14.93
General public services	7.53	11.8	8.97
Defense	0	0	2.08
Public Order and Safety	4.04	4.25	3.87
Community and Social Services	28.21	29.09	27.06
Education	4.52	5.62	5.4
Health	7.25	6.98	6.28
Social Welfare and Protection	15.13	15.33	14.59
Housing and Community Amenities	0.13	0.14	0.09
Sport, Recreation and Religion	1.18	1.02	0.7
Economic Services	2.52	2.35	2.34
Energy and Fuel	0.35	0.08	0
Agriculture, Forestry and Fishing	0.57	0.64	0.61
Mining and Mineral Resources	0.04	0.02	0.04
Transportation and communications	0.79	0.44	0.81
Other economic activities	0.77	1.16	0.89
Other Expenditures	0.1	0.1	0.04
Memo Item 2: GDP (mill euro)	1301.5	1433.0	1535.0

Source: Montenegrin Ministry of Finance

* Data does not include municipalities (local governments).

