

Document of  
The World Bank

FOR OFFICIAL USE ONLY

Report No: 105019-ME

## **MONTENEGRO**

# **ACHIEVING SUSTAINABLE AND INCLUSIVE GROWTH AMIDST HIGH VOLATILITY**

## **SYSTEMATIC COUNTRY DIAGNOSTIC**

March 30, 2016

International Bank for Reconstruction and Development (IBRD)  
Country Unit ECCU4  
Europe and Central Asia Region  
International Finance Corporation (IFC)  
South Europe Division  
Multilateral Investment Guarantee Agency (MIGA)  
Europe Hub



**WORLD BANK GROUP**

## MONTENEGRO

**Government Fiscal Year:** January-December

### Currency Equivalents

(Exchange Rate Effective as of February 29, 2016)

USD 1.00:EUR 0.908

### Weights and Measures:

Metric System

## ABBREVIATIONS AND ACRONYMS

ADSL	Asymmetric Digital Subscriber Line	MONSTAT	Statistical Office of Montenegro
ALMP	Active Labor Market Policies	MTMA	Ministry of Transport and Maritime Affairs
ANC	Antenatal Care	NAP	National Action Plan
BEEPS	Business Environment and Enterprise Performance Survey	NC	National Communications
CA	Child Allowance	NCD	Non-communicable Diseases
CAD	Current Account Deficit	NEET	Not in Education, Employment, or Training
CAR	Capital Adequacy Ratio	NGO	Non-Governmental Organization
CBCG	Centralna banka Crne Gore	NHDR	National Human Development Report
CEAC	Central European Aluminum Company	NMS	New Member States
CEM	Country Economic Memorandum	NPL	Non-performing Loans
CEPEJ	The European Commission for the Efficiency of Justice	OECD	Organization for Economic Cooperation and Development
CSO	Community Service Organization	OOP	Out-of-pocket
CSW	Centers for Social Work	PAYG	Pay-As-You-Go
DB	Doing Business	PECI	Projects of Energy Community Interest
DSL	Digital Subscriber Loop	PEFA	Public Expenditure and Financial Accountability
EAM	Employment Agency of Montenegro	PIFC	Public Internal Financial Control
EC	European Commission	PISA	Programme for International Student Assessment
ECA	Europe and Central Asia	PMR	Product Market Regulation
EM-DAT	Emergency Events Database	PPS	Purchasing Power Standard
EPCG	Elektroprivreda Crne Gore AD Niksic	R&D	Research & Development
EPL	Employment Protection Legislation	RAE	Roma, Ashkaelia, and Egyptians
EU	European Union	RCA	Revealed Comparative Advantage
EUROSTAT	Statistical Office of the European Union	RE	Renewable Energy
FAO	Food and Agriculture Organization	SA	Social Assistance
FDI	Foreign Direct Investment	SAI	State Audit Institution
FMS/MOP	Family Material Support	SCD	Systematic Country Diagnostic
GDP	Gross Domestic Product	SEE	South East Europe

GEM	Global Entrepreneurship Monitor	SEETO	South East Europe Transport Observatory
GNI	Gross National Income	SEI	Social Exclusion Index
GNP	Gross National Product	SFRY	Socialist Federal Republic of Yugoslavia
GoM	Government of Montenegro	SME	Small and Medium Enterprises
GVA	Gross Value Added	SOE	State Owned Enterprise
HBS	Household Budget Survey	SOGI	Sexual Orientation and Gender Identity
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immune Deficiency Syndrome	SSN	Social Safety Net
HPP	Hydro Power Plant	SSV	Services for Social Work
ICT	Information and Communications Technology	T&D	Transmission and Distribution
IDP	Internally Displaced Persons	TEA	Total Early-Stage Entrepreneurial Activity
IEA	International Energy Agency	TFP	Total Factor Productivity
IFC	International Financial Company	TPP	Thermal Power Plant
IFI	International Financial Institutions	UFGE	Umbrella Facility for Gender Equality
IMF	International Monetary Fund	UN	United Nations
IPSAS	International Public Sector Accounting Standards	UNCTAD	United Nations Conference on Trade and Development
IT	Information Technology	UNDP	United Nations Development Program
ITF	International Transport Forum	UNECE	United Nations Economic Commission for Europe
KAP	Kombinat Aluminija Podgorica	UNESCO	United Nations Educational, Scientific and Cultural Organization
LFS	Labor Force Survey	VAT	Value Added Tax
LGBT	Lesbian, Gay, Bisexual, and Transgender	WB	World Bank
LPI	Logistics Performance Index	WBGES	World Bank Group Entrepreneurship Snapshots
LTD	Loan-to-Deposit	WDI	World Development Indicators
METR	Marginal Effective Tax Rate	WEF	World Economic Forum
MICS	Multiple Indicator Cluster Surveys	WHO	World Health Organization
MIPA	Montenegrin Investment Promotion Agency	WTO	World Trade Organization
MLSW	Ministry of Labor and Social Welfare	WTO TFA	World Trade Organization Trade Facilitation Agreement
MoF	Ministry of Finance		

Vice President:	Cyril E. Muller, ECAVP
Country Director:	Ellen A. Goldstein, ECCU4
GP Director:	Satu Kahkonen, GMFDR
Practice Managers:	Ivailo Izvorski, GMFDR Carolina Sanchez-Paramo, GPVDR
Task Team Leaders:	Anna Fruttero, GPVDR Sanja Madzarevic-Sujster, GMFDR

## ACKNOWLEDGEMENTS

This report is the product of the World Bank team led by Anna Fruttero (Co-TTL, Senior Economist, GPVDR) and Sanja Madzarevic-Sujster (Co-TTL, Senior Economist, GMFDR), relying on the WBG's Montenegro country team as well as other sector-specific experts from across the World Bank Group. The sections on poverty and shared prosperity were analyzed by Anna Fruttero, Rodrigo Salcedo du Bois and William Seitz (GPVDR). Sanja Madzarevic-Sujster, Suzana Petrovic (GMFDR) and Milenko Popovic (Consultant) provided a macroeconomic, growth and fiscal management analysis. Trade and competitiveness inputs were drafted by Feyi Borroffice, Wolfgang Fengler, Michael Joseph Ferrantino, Violane Konar-Leacy, Tarik Sahovic, Siddarth Sharma, and Gonzalo J. Varela (GTCDR). Johanna Jaeger (GFMDR) provided inputs for finance sector. Social protection and inclusion and labor market issues were analyzed by Zoran Anusic (GSPDR), Giovanna Bua, Anna Fruttero and Will Seitz (GPVDR), Phil Crehan (GFAGE), Boryana Gotcheva (consultant), Naima Hasci (GSURR), and Nichola Dyer (ECCU4). Olivera Jordanovic (GSURR) prepared land issues input, while Ana Holt (GHNDR) contributed to the health section. Maurizio Guadagni and Silvia Mauri (GFADR) contributed to the agriculture sector analysis. Katelijn Van den Berg and Frank Van Woerden (GENDR) focused on climate change, environment and natural resources issues; Stjepan Gabric (GWADR) on water section; Dzenan Malovic (CASEE) and Jari Varyrynen (GEEDR) provided energy section inputs, while transport and ICT part was analyzed by Baher El-Hifnawi (GTIDR), Natalija Gelvanovska and Ievgeniia Viatchaninova (GTIDR). Aleksandar Crnomarkovic, Georgia Harley, and Raymond Muhula (GGODR) provided governance analysis. Dragana Varezcic and Boba Vukoslavovic (ECCBM) provided the administrative and logistical support. The valuable help was provided by Raymond Bourdeaux, Timothy Johnston and Gallina Vincelette (Program Leaders, ECCU4) and Zoran Martinovski (Country Officer, CEUMA). Edgardo Favaro provided support and guidance in finalizing the report.

The report was undertaken under the guidance of Ellen A. Goldstein, Country Director, ECCU4; Satu Kahkonen, Practice Director, GMFDR; Ivailo Izvorski, Practice Manager, GMFDR; Carolina Sanchez-Paramo, Practice Manager, GPVDR; Tatiana Proskuryakova, Country Manager, ECCBM; and Gallina A. Vincelette, Program Leader, ECCU4. Peer reviewers for this SCD were Theo Thomas (Lead Economist, GMFDR), Dirk Reinermann (Program Manager, Southern Europe, ECAVP) and Javier Baez Ramirez (Senior Economist, GPVDR).

This Systematic Country Diagnostic (SCD) is being prepared to inform a new Country Partnership Framework for Montenegro for the FY16-20 period. The purpose of the SCD is to identify the most critical constraints and opportunities to accelerate progress towards the twin goals—reduction in poverty and improvement of shared prosperity (i.e. the growth of income of the bottom 40 percent of population against the income of top 60 percent of population). The team would like to thank government counterparts, in particular the Ministry of Finance, international partners, private sector, academia and civil society who kindly participated in two rounds of in-country consultations. The team remains grateful for the feedback and comments received.

## Table of Contents

EXECUTIVE SUMMARY .....	x
<b>I. INTRODUCTION</b> .....	<b>1</b>
<b>II. COUNTRY CONTEXT</b> .....	<b>3</b>
<i>Socio-Political Context</i> .....	3
<i>Economic Context—From Boom to Bust</i> .....	4
<b>III. POVERTY, SHARED PROSPERITY, AND GROWTH</b> .....	<b>7</b>
<i>Poverty and Shared Prosperity Trends</i> .....	7
<i>Composition of Growth and Employment—the Key Determinants of Poverty Changes</i> .....	11
<b>IV. STRENGTHENING RESILIENCE TO SHOCKS AND VOLATILITY</b> .....	<b>19</b>
<i>Macroeconomic Risks and Fiscal Sustainability</i> .....	19
Growth and Sustainability Prospects .....	24
<i>Social Sustainability and Exclusion</i> .....	28
<i>Financial Sustainability</i> .....	36
<i>Environmental Risks</i> .....	38
<i>Emerging Priorities</i> .....	40
<b>V. STRUCTURAL CONSTRAINTS TO GROWTH</b> .....	<b>41</b>
<i>Productivity, Trade and Investment Climate</i> .....	41
Productivity and International Trade.....	41
Private Sector and Entrepreneurship .....	45
Product and Labor Regulatory Environment .....	48
<i>Human Capital</i> .....	52
Demographics, Migration, Labor Force Participation and Gender .....	52
Health .....	57
Education .....	59
<i>Physical Infrastructure</i> .....	62
Transport .....	62
Ports and Logistics.....	64
Electricity .....	65
Information and Communication Technologies .....	68
<i>Emerging Priorities</i> .....	71

<b>VI. INSTITUTIONAL CONSTRAINTS TO GROWTH</b> .....	73
<i>The Legitimacy of the State, Transparency and Accountability</i> .....	73
Voice and Accountability .....	75
Trust and Informality .....	77
Corruption .....	78
Justice and Rule of Law .....	79
Regulatory Barriers .....	82
<i>Public Service Delivery</i> .....	82
Social Services .....	83
Infrastructure Services .....	90
<i>Emerging Priorities</i> .....	92
<b>VII. PRIORITIES AND OPPORTUNITIES</b> .....	93
<i>Priorities and Opportunities</i> .....	95
<i>Knowledge Gaps</i> .....	98

## Tables

Table 1: GDP per capita in 1980 by Region and Republic .....	3
Table 2. Two Very Different Periods: Demand-Side Growth .....	13
Table 3. Employment Growth, 2000-14.....	15
Table 4. Government Consumption to GDP: Small States.....	20
Table 5. Migration and Aging: Small States and Other States .....	20
Table 6. Small States, Montenegro and World Economy.....	21
Table 7. Medium-Term Fiscal Framework, Percent of GDP .....	25
Table 8. Logistics Costs of Trading Internationally.....	43
Table 9. Business perception of “biggest obstacle” for firm growth.....	49
Table 10. Contribution of Education and Knowledge to Growth in Montenegro, 2000-13.....	59
Table 11. Montenegro PISA Performance Over Time .....	61
Table 12. Condition of State Roads.....	63
Table 13. International Benchmarks for Transport Infrastructure Investment as a percent of GDP .....	64
Table 14. Road User Payments to the Montenegro Government, 2006-2013 in Million Euros .....	64
Table 15. Enterprise Survey.....	78
Table 16. Priority Areas to Progress toward the Twin Goals in Montenegro .....	97

## Figures

Figure 1. Real GDP Growth in Montenegro and ECA Countries .....	5
Figure 2. Current and Capital Account, Percent of GDP, 2005-15 .....	5
Figure 3. Credits and Non-Performing Loans.....	5
Figure 4. Credit Growth by Sector, 2008-15, Percent .....	6
Figure 5. Poverty Rates in the Region, \$5 PPP/day .....	7

Figure 6. Changes in Poverty Mirroring Economic Growth .....	7
Figure 7. Vulnerability Increased more than Poverty, Percent.....	8
Figure 8. Vulnerability is Highest in Central, but Increased the most in the South, Percent.....	8
Figure 9. Growth Incidence During the Boom and the Bust Periods .....	9
Figure 10. Shared Prosperity Over Time.....	10
Figure 11. Gini Coefficients in the Region .....	10
Figure 12. Poverty Rate by Household Head’s Occupation, 2013, percent.....	10
Figure 13. Poverty Rate by the Number of Children in the Household, 2013, percent.....	10
Figure 14. Rural Poverty is Higher but the Poor are Increasingly Concentrated in Urban Areas .....	11
Figure 15. Share of Labor Income in Total Household Income for Various Groups .....	12
Figure 16. Wages and Transfers are the Main Poverty Reducing Factors .....	12
Figure 17. Labor Market Developments, 2006-15.....	13
Figure 18. Employed by Education Attainment, 2008-15 .....	13
Figure 19. Growth Performance Explains Changes in Poverty Between 2008-2013 .....	14
Figure 20. Number of Income Earners in Poor Households.....	14
Figure 21. Sectoral Decomposition of Gross Value Added in Montenegro, 2000-14.....	15
Figure 22. Gross Value Added Growth by Sectors, 2002-2008 and 2009-2014 .....	15
Figure 23. Labor Force Participation in Montenegro, 2006-2015.....	16
Figure 24. Labor Force Participation Rate in ECA, 2014.....	16
Figure 25. Lower Educated and New Entrants Face Higher and Longer Unemployment .....	18
Figure 26. Unemployment is More Prevalent Amongst Youth and New Entrants in the Labor Market.....	18
Figure 27. Sector Value Added Growth Rates Volatility .....	22
Figure 28. Employment Growth Volatility .....	22
Figure 29. Demand-Side Sources of Growth in Montenegro, 2000-14 .....	22
Figure 30. Current Account and Capital Inflows,.....	23
Figure 31. External Debt to GDP Ratio, Percent .....	23
Figure 32. Fiscal Deficits, Percent of GDP .....	23
Figure 33. Public Debt and Guarantees, Percent of GDP .....	23
Figure 34. Gross Public Debt, Percent of GDP.....	26
Figure 35. Fiscal Deficit, Percent of GDP.....	26
Figure 36. Labor Productivity, EU and Montenegro .....	27
Figure 37. Volatility of Changes in Income and .....	28
Figure 38. Density Function of Household Expenditure .....	28
Figure 39. Change in Share of Labor Income in Total Income .....	29
Figure 40. Average Growth in Income Sources.....	29
Figure 41. Dependency Ratio, Percent of 15-64.....	29
Figure 42. Future Adequacy Among Lowest in Europe.....	29
Figure 43. Adults (15+) that saved any money in the past year, 2014 .....	30
Figure 44. Adults (15+) with an Account at a Formal Financial Institution .....	30
Figure 45. Economic Mobility.....	31
Figure 46. Migration out of Municipalities, percentage change, 2011-13 .....	31
Figure 47. Migration to Capital, percentage change 2011-13 .....	31
Figure 48. Ethnic Structure and Activity Rates per Municipalities.....	32
Figure 49. Nightlights, 2004 and 2011 .....	33

Figure 50. Nonperforming Loans, percent of total loans.....	37
Figure 51. Natural disasters in Montenegro, 1991-2014 .....	38
Figure 52. Factor-Input Sources of Growth in Montenegro, 2000-13 .....	41
Figure 53. Productivity in Montenegro and Peer Countries (GDP per Employee) .....	42
Figure 54. Wage and Productivity Growth, Percent 2000=1.....	42
Figure 55. Goods and Services Exports, Percent of GDP, 2014 .....	42
Figure 56. Very Few Montenegrin Firms Trade Internationally .....	42
Figure 57. Montenegro’s Commercial Services Export Growth Relatively Slow Compared to Peers.....	43
Figure 58. Merchandise Exports By Technological Content, 2006-11 .....	43
Figure 59. Agricultural Employment Data, 2010.....	45
Figure 60. Agriculture Value Added per ha of Arable Land, 2006-12 average ag. GDP in 2005 US\$ .....	45
Figure 61. Entry Density and GDP per Capita, 2008-12 .....	46
Figure 62. Total Early-Stage Entrepreneurial Activity .....	46
Figure 63. Line of Credit or Loan (Reason For Not Applying).....	47
Figure 64. Source of Working Capital .....	47
Figure 65. Access to Finance.....	47
Figure 66. Collateral Value, as Percent of Loan Amount.....	47
Figure 67. Limited Internet Use by Firms.....	48
Figure 68. Firms Are Less Likely to Innovate .....	48
Figure 69. Ease of Doing Business, 2016 .....	48
Figure 70. Mean Rankings in the Ten Areas Measured by Doing Business, 2016 .....	48
Figure 71. Aggregate Product Market Regulation Score, 2013.....	49
Figure 72. Hiring and Firing Practices .....	50
Figure 73. Employment Protection Legislation (EPL) in Montenegro .....	50
Figure 74. Monetary Redundancy Costs .....	51
Figure 75. Procedural Redundancy Costs .....	51
Figure 76. Difficult to Fill a Vacancy.....	51
Figure 77. Online Freelancers, Percent of Labor Force and Their Lifetime Earnings, December 2014.....	52
Figure 78. Total Population by Age Groups and Gender, 2010 .....	53
Figure 79. Total Population by Age Groups, 1950-2100.....	53
Figure 80. Change in Dependency Ratio.....	53
Figure 81. Inactivity Due to Family Duties: by Education Level and by Age.....	54
Figure 82. Men Leaving the Labor Market too Early for Retirement .....	54
Figure 83. Sector of Occupation in the Last Job .....	54
Figure 84. Employment Rate of Female Living With a Person in Need of Care in Montenegro, 2011 .....	55
Figure 85. Youth Not in Education or Employment (NEET).....	55
Figure 86. Tax Wedge and Effective Tax Rates for a One-Earner Couple with Two Children in Montenegro, 2012 .....	56
Figure 87. Ownership of Household Assets, Percent.....	57
Figure 88. Life Expectancy, 2013 .....	57
Figure 89. Duration of Health Problem.....	58
Figure 90. Adults 15+ Reporting Health Problems.....	58
Figure 91. Population With Primary Attainment or Less (Ages 15-64), Ethnicity and Location .....	60
Figure 92. Pre-School Attendance, 2011.....	60

Figure 93. Within Country Differences in Pre-School Attendance, 2005 and 2013.....	61
Figure 94. Early Leavers from Education and Training, 2011 .....	61
Figure 95. PISA Scores and GDP per Capita in ECA, 2012 .....	61
Figure 96. Skills Mismatch by Education, 2011 .....	62
Figure 97. Skills Mismatch by Occupation, 2011.....	62
Figure 98. Montenegro’s Scores in the Infrastructure Pillar.....	62
Figure 99. Road Fatalities per Million of Population in Montenegro and Select Countries, 2012 .....	63
Figure 100. Road Accident Rates in Montenegro from 2005 to 2013 .....	63
Figure 101. Burden of Customs Procedure, 2015 .....	65
Figure 102. Quality of Port Infrastructure, 2015.....	65
Figure 103. Logistics Performance Index (LPI) .....	65
Figure 104. Incidence of Power Outages and Their Reported Losses.....	66
Figure 105. Electricity System .....	66
Figure 106. Electricity Consumption Per Capita .....	67
Figure 107. Energy Intensity in 2012 Measured in Total Final Consumption (in toe) per Unit of GDP (in 2005 USD) .....	67
Figure 108. Electricity Prices.....	68
Figure 109. Sector Output and Gross Value Added, 2011-2014.....	68
Figure 110. Gross Value Added by ICT and Other Sectors, 2012-2014.....	68
Figure 111. Number of Households per Internet Service Provider .....	69
Figure 112. Global Competitiveness in ICT .....	69
Figure 113. Investments in Electronic Communications, EUR terms, percentage change, 2012 over 2011..	70
Figure 114. Investments in Electronic Communications Sector, Percent of Revenues .....	70
Figure 115. Selected World Governance Indicators, 2014.....	73
Figure 116. Efficiency of Public Spending .....	73
Figure 117. General Government Spending, Percent of GDP.....	74
Figure 118. Montenegro: Employment by Sectors, 2014.....	74
Figure 119. Public Sector Wages Relative to Private Sector Wages by Occupation, Percent Differential ...	75
Figure 120. Employment by Job Tenure and Sector, 2013 .....	75
Figure 121. Trust in Government.....	77
Figure 122. Percent of Respondents Satisfied with Service Delivery.....	77
Figure 123. Corruption in Dealing with Public Services .....	78
Figure 124. Frequency of Informal Payments.....	78
Figure 125. Irregular Payments for Favorable Judicial Decisions (7 as best).....	79
Figure 126. Ease of Contract Enforcement (out of 189 countries).....	80
Figure 127. Number of Legal Aid Cases Granted (per 100,000 inhabitants) .....	81
Figure 128. Days to Obtain a Construction Permit.....	82
Figure 129. Share of Management Time Spent Dealing with Regulations.....	82
Figure 130. Disability Pensions in Montenegro.....	84
Figure 131. Pupil Teacher Ratio (Primary), 2014.....	85
Figure 132. Net Primary School Enrolment.....	85
Figure 133. Public Health Expenditure in 2013, Percent of GDP .....	86
Figure 134. Total Health Expenditure and GDP per Capita in ECA (1995-2013) .....	86
Figure 135. Hospital Beds .....	86

Figure 136. Maternal Mortality Rate, 2013.....	86
Figure 137. Adults (age 16 and above) Reporting Medical Insurance Coverage, 2011 .....	87
Figure 138. Center for Social Work Employee Structure in Montenegro, 2012 .....	89
Figure 139. Access to Public Services, bottom 40 and upper 60 .....	90
Figure 140. Access to Public services, Rural and Urban .....	90
Figure 141. Population Connected to Wastewater Collection and Wastewater Treatment Plants .....	91
Figure 142. Priorities Set by Stakeholders, October 2014.....	94
<b>Boxes</b>	
Box 1. Poverty Measurements and Cross-Country Comparisons .....	7
Box 2. Profile of the Poor and the Bottom 40 .....	10
Box 3. Managing Volatility in Small States: Lessons Learnt.....	19
Box 4. Multidimensional Indicator of Poverty.....	33
Box 5. The State of Two Strategic Sectors .....	44
Box 6. Social Assistance Disincentives Characteristics .....	55
Box 7. Capacity in the Welfare System .....	88
<b>Annexes</b>	
Annex 1. Literature .....	99

## EXECUTIVE SUMMARY

### *Montenegro is a small state undergoing two transitions*

**Montenegro is a young small state<sup>1</sup> in the Western Balkans undergoing a political and economic transition, working to achieve European Union membership.** Montenegro, with a population of 624,000, was initially part of the Socialist Federal Republic of Yugoslavia (SFRY), from 1992 part of the federation with the Republic of Serbia, and then became independent in 2006. Independence followed a decade of conflicts in the territory of the former SFRY as well as a transition from a command and control to a market economy.

**The political transition from a state in a federation to a sovereign nation striving to harmonize its institutions and legal framework with the *acquis communautaire* required an expansion of government capacities.** Public goods and services such as defense, property rights, and economic management had been supplied up until independence, at least in part, by the federal government. National institutions had to be created to assume these functions upon independence. EU-compatible regulatory bodies, capacity to absorb EU funds and harmonize the legal framework with those of the EU, require new capacity to be built. Because Montenegro is a small state, the already high costs of developing and running national institutions at the central and local government levels are compounded by a limited capacity to exploit economies of scale in the provision of public goods and services.

**The economic transition to a market economy has required a reduction of the footprint of the state in the economy and strengthening of market institutions.** The legacies of the former SFRY were a large and bloated government, large public employment, including in State Owned Enterprises (SOEs), large government spending and expectations of a paternalistic state. Moving away from this model to create a favorable environment for the development of the private sector has had its costs in terms of the social costs associated with a reduction of public sector employment and restructuring of SOEs and rationalization of public spending.

**The incompleteness of both transitions is visible in the still large presence of the state in the economy, the high rate of unemployment and the low level of capacity utilization that characterize Montenegro's economy.** Even at the peak of the economic cycle, in 2008, the rate of unemployment was above 17 percent. At the root of the phenomenon is the dislocation of production and commercial channels associated with the disappearance of the command economy and the slow development of markets, a phenomenon labeled *disorganization*.<sup>2</sup> The unfinished reform agenda also has resulted in low labor force participation (high *inactivity*) which is a strong determinant of low household income and of vulnerability to poverty. In the Balkans, the complexities intrinsic to transition were greatly exacerbated by conflicts in 1990's and political uncertainty.

**A high rate of unemployment even during boom time indicates that the economy is operating well below its potential.** This aspect of the Montenegrin economy (and of several other states in South Eastern Europe) is important for understanding the links between economic growth, the rate of unemployment, and poverty reduction, and for evaluating the contribution of transitory factors (domestic and external) and of permanent/structural shifts towards inclusive growth over the next decade.

### *The past decade: from economic boom to bust*

**In the past decade, Montenegro's economy has followed closely the business cycle in Europe and to a lesser extent Russia.** As a small, open economy that does not have its own currency,<sup>3</sup> Montenegro is

---

<sup>1</sup> Small states analyzed in the report are defined as sovereign nations with population below two million. The population threshold selected is somewhat arbitrary and is intended merely to facilitate the presentation of stylized facts.

<sup>2</sup> Blanchard and Kramer, "Disorganization", *The Quarterly Journal of Economics*, Vol. 112, No. 4, November 1997

<sup>3</sup> The Deutsche mark used since 90's was replaced by the unilateral decision with euro in 2002.

extremely vulnerable to external shocks, primarily through the channels of its main trading partners and of countries from which it receives capital. The expansion of the activity of European banks in Montenegro and international capital inflows provided the stimulus that triggered the expansion of the economy until 2008. Subsequently, the international financial crisis of 2008, with its consequences for European banks, was the spark that induced the recession of 2009 and the slowdown of economic growth in the following five years. The coherence between the path of Montenegro and Europe's economic growth illustrates the vulnerability of the economy of this *small state* to the vagaries of the business cycle in a region that has not yet stabilized from the turmoil prompted by the financial crisis and the sovereign debt troubles in the euro area.

**From 2005 to 2008 Montenegro experienced an economic boom, driven by large capital inflows<sup>4</sup> and rapid increase in government expenditure.** During this period real growth increased at an average of nearly 5 percent a year, progressively reaching a double-digit peak in 2007. The growth was spurred by a large inflow of capital that stimulated aggregate demand. The mirror image of these inflows was a large deficit on the current account of the balance of payments reaching almost the equivalent of half of the country's GDP and an increase in Montenegro's external debt.<sup>5</sup> While most of the capital inflows financed higher imports, they also had a major effect on sectors such as construction, tourism, real estate, and services. The stimulus effect prompted by international capital inflows was magnified by a rapid increase in government expenditure (to over 51 percent of GDP in 2008), explained in part by the transition to an independent state.

**The boom was followed by a bust, triggered by a brusque reduction in the level of capital inflows due to the international financial crisis.** The high reliance on international capital inflows in the pre-crisis period left the country highly vulnerable to capital account reversal. The external finance tightening of about 30 percent of GDP between 2009 and 2014 caused: a contraction of domestic aggregate demand, especially a collapse in investment; a severe fall in the rate of growth of GDP; a sharp fall in net imports; an increase in the fiscal deficit (as government revenues declined but non-discretionary spending did not fall by the same amount); and a drastic fall in domestic credit to the private sector.<sup>6</sup> During the economic bust and stagnation in 2009-15 the rate of growth of GDP fell, initially abruptly, and hovered around an average of 1.9 percent thereafter. It also led to an increase in the unemployment rate and an increase in poverty.

### *Growth has become less pro-poor*

**During the boom years, growth led to poverty reduction while in the bust and stagnation growth became less pro-poor.** The growth elasticity of poverty went from -1.97 between 2005 and 2008 to 4.02 between 2009 and 2013. This means that during the boom years, a one percentage increase in growth was accompanied by almost 2 percent reduction in poverty, whereas over the last few years a one percent increase in growth has been accompanied by a 4 percent increase in poverty. Indeed, poverty decreased sharply until 2008 and then started increasing again, as did vulnerability. Poverty followed a U-shaped pattern up to 2012: it fell from about 11 percent in the mid-2000s, to its lowest point of 4.9 percent in 2008, and then it bounced back above 10 percent by 2012. It declined to 8.6 in 2013, the last year for which data are available. Vulnerability<sup>7</sup> also has been increasing since 2008. In 2013, almost 30 percent of the population was either poor or vulnerable, with most of this increase in urban areas led by the downsizing of the ailing metal industry.

**The composition of growth and its volatility can help explain this change.** During the boom years, increased demand for labor came from sectors heavily reliant on unskilled labor. This led to a fall in the unemployment rate, a steady decline in poverty and an increase of the income of households in the bottom

---

<sup>4</sup> Tourism, real estate, and the banking sector were major recipients of capital inflows.

<sup>5</sup> While most capital inflows took the form of foreign direct investment there was also a sharp increase in the external debt ratio (it reached 106 percent of GDP in 2008).

<sup>6</sup> The mirror images of these last two phenomena were fast growing debt and a sharp increase in the level of non-performing loans in bank portfolios.

<sup>7</sup> Households whose consumption per adult equivalent is below 1.50 times the poverty line.

40 percent of the population. Thus poverty was very responsive to changes in the rate of GDP growth because of the pattern of economic growth, in particular the importance of investment in labor-intensive sectors such as construction and part of the service sector. During the economic bust and stagnation, the level of growth was lower but also the demand for labor shifted towards higher skill levels. The sectoral composition of employment growth as well as the educational structure of employment suggest that more jobs are being created in higher skill sectors. Employment of tertiary educated labor increased by over 40 percent by 2014 compared to 2008, while the employment of workers with at most primary education faltered by over 40 percent during the same period, thus limiting its poverty reducing effect. However, as more new entrants in the labor market have higher levels of education, a growing cohort of the unemployed has higher education. The volatility of growth itself is another factor that can undermine the link between growth and poverty reduction. Volatility prevents a sustained growth process that is necessary to reduce poverty.

### *Employment is key for poverty eradication*

**Increased employment is key to reducing poverty in Montenegro, but structural factors may hinder its effect.** The sustained and large poverty reduction before the crisis, shows how an economic boom resulting in increased demand for unskilled labor can shift households above the threshold. However, looking ahead there are important factors that may hinder Montenegro's ability to benefit from future growth episodes, which may result in increased demand for skilled labor (tourism, financial sector and real estate have seen the highest employment growth between 2009 and 2014, while mining and manufacturing the lowest). The gap in educational attainment between the poor, the vulnerable and the rest are substantial: 67.5 percent of the head of household in poverty have achieved primary education or less, compared to 41 percent of the vulnerable and 11.7 percent of the rest. Only 4.6 percent of the poor head of households have tertiary education compared to 26 percent of the non-vulnerable. This suggests that the poor are less likely to be able to benefit from the increased demand for labor in the expanding sectors.

**On the supply side, low participation rates and high structural unemployment imply that a large share of the population does not benefit from a buoyant labor market.** The increase in aggregate demand during the boom brought down unemployment; even so, it still remained extremely high by international standards. Beyond high unemployment, with 54 percent of individuals in the labor force in 2015, Montenegro has one of the lowest levels of labor force participation in Europe. Less than half of working age women were in the labor force in 2015, though this number has been increasing over the last 4 years. The rate of unemployment amongst youth is almost twice as high as the EU average, with about 38 percent of youth unemployed in 2015.

**Several structural factors seem to be responsible for the low participation rates and high unemployment.** There are three main factors identified behind the high unemployment and low labor force participation:

(i) *The incomplete economic transition.* Over the last decade Montenegro has seen shedding of workers from the restructuring and closing of traditional firms and the declining importance of agriculture, public sector and SOEs as sources of employment, while the private sector still struggles to be the engine of growth. This has resulted in increase in unemployment for workers in their mid-forties and older, as well as increases in early retirement. Mid-career and older workers laid off find it harder to be retrained for employment in different sectors.

(ii) *Labor mismatches:* Skills per se are not identified as an important constraint on firm growth in employment surveys, except by new and innovative firms. However, there seems to be a demand for low skilled seasonal works mostly filled with seasonal migration to Montenegro. Meanwhile, the outmigration of educated Montenegrins suggests they are unable to find suitable jobs in the country, partly due to the limited linkages between tertiary education and labor markets. In a small country like Montenegro the constraints in terms of supply of sufficient labor in particular sectors or positions can be especially strong.

(iii) *A high reservation wage.* Despite the high number of unemployed, every year an almost equal number of migrants comes to work in Montenegro, and firms complain that they cannot fill vacancies. One

explanation is that Montenegrins lack skills, which would require more targeted active labor market policies. However, many migrants are seasonal low skilled workers, so that lack of skills does not seem to be the problem. Rather, it seems to be the case that Montenegrins have a high reservation wage, which is the wage rate below which they would not be willing to accept a particular type of job. What determines the reservation wage? In the case of Montenegro these factors seem to be at play:

- *Migration and remittances*: As data on migration is limited, the evidence supporting its importance is indirect: workers' remittances are about 10 percent of GDP. However, the household survey underestimates the receipt of remittances (the value of total remittances received according to the household budget survey in 2013 was about 10 times lower than that from the balance of payments data), thus not allowing a thorough analysis of the impact of remittances on labor market dynamics.
- *Public and private transfers* may all contribute to a high level of reservation wage in Montenegro. Intergenerational transfers are anecdotally quite high in Montenegro, where children stick together with the elderly in the same household, sharing assets and income accumulated/generated by the older generation. Further, a massive sale of real estate prior to the crisis also delayed employment decisions. Social assistance design with high marginal effective tax rates may weaken incentives to take up part-time, temporary, or seasonal employment at levels below the social assistance threshold. Disregarding such earnings partially or fully for the purposes of the social assistance income test could significantly improve attachment of social assistance beneficiaries to the formal labor market.
- *Informality*. Based on the citizens' survey done by UNDP, the overall scale of informal employment in Montenegro is at 29.3 percent of total labor force. Given that the size of informality is severely underestimated in the labor force survey, this could explain the underestimation of labor force participation. Another important feature of the informal sector that can increase the reservation wage of potential workers, is the illicit activities conducted by organized crime. Montenegro sits on the transit route of cigarette smuggling and human, drug, and arms trafficking<sup>8</sup>. It is interesting to notice that the majority of Montenegrin firms do not see informality as a major constraint to business: only 11 percent of the firms surveyed view informality as a major constraint to business.
- *Public sector queuing*: Public sector acts as a safety net. Employment in public sector and SOEs in Montenegro at 32 percent of total employment is comparably high. While there is no evidence on public sector wage premium, except for some occupations in state-owned companies, the jobs are more secure and prestigious, causing queuing.

### *Retooling the growth model*

**The financial cum economic crisis at the end of 2008 stalled Montenegro's convergence with the rest of the EU.** Growth of GDP per capita (at PPS) that averaged 16 percent per year between 2005-08 shifted to a decline of 0.6 percent a year on average in 2009-14 and stalled convergence of incomes. Montenegro's GDP per capita in 2014 remained unchanged at 41 percent of the average of the EU28 compared to 2008. Capital growth which was supporting convergence prior to 2008 also slowed down. Unemployment remained stubbornly high nationwide, and as a result, the poverty rate rose reversing gains prior to the crisis.

**Although the level of economic activity regained its 2008 level by 2013, the still high unemployment rate raises the question of how Montenegro can put its underutilized human and physical resources back to work.** Situations of high and protracted open unemployment such as that observed in Montenegro

---

<sup>8</sup> "Organised Crime and the Fight Against Crime in the Western Balkans: a Comparison with the Italian Models and Practices", SAPUCCA for European Commission - Directorate-General Home Affairs, 2013, also UNODC (2008), Crime and Its Impact on the Balkans.

have been rare in modern market economies. Transitioning from high open unemployment to full employment can sometimes be accelerated by an *exogenous* stimulus factor: for instance, capital inflows or expansionary fiscal policy. In the case of Montenegro, these factors were precisely at work between 2005 and 2008 and have created large imbalances that still need to be unwound.

**Looking ahead, monetary or fiscal policy would not likely provide an effective stimulus to the Montenegrin economy.** Having outsourced monetary policy by adopting the euro as its currency, Montenegro cannot use exchange rate policy to offset (even partially) the effect of international capital flows on credit and the level of economic activity. The role of monetary policy is limited to changes in reserve requirements, a notoriously poor instrument for influencing credit in the economy. The role of fiscal policy depends on the available fiscal space that has been largely exhausted in the previous boom and bust episode.

**Restoring a growth at any cost via expansionary fiscal policy is a high risk strategy.** In theory, public investment could help stimulate an economic recovery; in practice, the constraints are enormous. The first serious limitation is that, as in most countries in the world, it is unlikely that government has at hand a selection of investment projects that pass a rate of return test and may be implemented on short notice. In fact, the rate of return to capital remained largely unchanged over the last 15 years despite massive public and private sector investments mostly in civilian constructions and real estate. Under the current circumstances, the selection of the highway project as a stimulus to growth appears to be a step backwards. Second, fiscal deficit averaged 5 percent of GDP since the 2008 crisis outbreak, leading to more than doubling the public debt. The sovereign credit rating of the country (three notches below the investment grade) and the existing level of public debt (at 68 percent of GDP) and refinancing needs (at around 17 percent of GDP in 2016-17) limit financing possibilities. The size of non-discretionary spending (like public administration wage bill, increasing health and pension expenditures, growing arrears in hospital payments, and a disconnect between the current health/pension insurance benefit package and available resources) and tax revenue collection does not provide much fiscal space for a large expansion of government expenditures.

**It is also unrealistic to expect a drastic change in the financial situation affecting the region.** The subdued state of the regional economy and the recession in Russia suggest that foreign direct investment (FDI) is unlikely to play a role similar to 2005-08. Even so, although a major change in FDI is unlikely does not mean that *foreign investors* may not play an important role by ensuring that investment projects already completed or near completion can be made productive. Net FDI amounted to about 140 percent of GDP in 2007-13. A back of the envelope calculation suggests that if this investment were to yield a two percent rate of return, GDP would grow from this sole factor by roughly two percent per annum. Whether the net national product increases by that much or not will depend on complementary investments and the development of service supporting activities needed to ensure that the new capital added has a high marginal contribution.

**To achieve sustainable and inclusive growth, Montenegro needs to facilitate the role of the private sector as engine of growth and job creation in the country.** A dynamic and competitive private sector is an essential condition to job creation in the country. However, it also needs to ensure that social protection programs play their role as risk management tools and a last resort program for the poor and vulnerable without creating disincentives to labor market participation.

### *Challenges and options going forward*

**Strengthening resilience to shocks and volatility should be at the center of Montenegro's strategy going forward.** The vulnerability of Montenegro's small, open economy to external and natural shocks, along with the pro-cyclicality of its most important sectors and underlying tax system, place a premium on ensuring sustainability, through building public (reserves, fiscal space, secure access to capital markets) and private (savings, skills) buffers. Besides being prepared with buffers and investment in human capital for the volatility that always comes, the government needs to strengthen the financial framework to ensure that future surge of capital flows do not cause booms; and strengthen the fiscal framework to ensure that exaggerated spending does not occur in boom times.

**Additionally, Montenegro’s strategy should focus on facilitating private sector job creation through increasing productivity and flexibility and ensuring connectivity with the big EU block.** Montenegro has attracted capital and should maintain its business environment appealing to investors. Looking ahead, economic growth will largely (though not exclusively) depend on total factor productivity rather than on factor accumulation. With the growing volatility of foreign capital inflows and large external debt, it is highly unlikely that capital accumulation will be a dominant factor of growth in the future. Moreover, the aging population calls for mobilizing the existing labor force and moving people from inactivity to the labor market by addressing incentives for work and labor demand. More efficient use and utilization of existing capital and labor can strongly support a more sustainable and less vulnerable growth model. However, job creation may not be sufficient to eliminate poverty. The country is faced with large unemployment amongst the youth but also middle aged workers who have difficulties finding jobs. Not only the level of growth matters, but also its composition, as the inclusiveness of growth depends on the demand for low skilled jobs. Thus, social protection programs may be needed to ensure that the worst off benefit from increased growth.

**In a small country like Montenegro, strengthening labor mobility is essential.** Given the economic opportunities may not be uniformly distributed across the country, there can be positive gains in earnings for those who move internally, especially in a small country like Montenegro. Migration can play an important role in family survival strategies.

**Finally, as Montenegro moves towards EU accession there is need to focus more strategically on strengthening its institutions to improve service delivery and strengthen public trust in the state.** Governance issues that matter for reducing poverty and increasing opportunities for shared growth in Montenegro would need to focus on three pillars: (i) governance issues that are critical for the stability of the state, like building trust and accountability; and reducing informality; (ii) governance issues that are critical for private enterprises, like reducing corruption, strengthening the rule of law, and ensuring regulatory quality; and (iii) governance issues that are critical for citizen satisfaction, like access to justice and service delivery.

**Against this background, the following priority objectives are seen as fundamental for the achievement of the twin goals:**

- (i) Increasing resilience to shocks and volatility;
- (ii) Reducing unemployment and inactivity, in particular amongst the young; and
- (iii) Facilitating private sector development.

On the basis of these, this SCD identifies eleven priority actions. The prioritization of policy actions relied on a thorough review of the evidence, a process of team discussion, and engagement with local stakeholders to identify the most critical barriers to sustainable achievement of the twin goals.

	IMPACT ON PRIORITY OBJECTIVES			IMPACT ON TWIN GOALS	
	Increase resilience to shocks and volatility	Reduce unemployment and inactivity	Facilitate private sector development	Poverty	Shared prosperity
Ensure sound fiscal policy	✓			High	High
Ensure financial stability through strengthened bank regulation and supervision and NPL resolution	✓			Medium	High
Strengthen the social protection system to safeguard against shocks	✓			High	Medium
Safeguard against environmental risks and protect natural resources	✓			Medium	High

	IMPACT ON PRIORITY OBJECTIVES			IMPACT ON TWIN GOALS	
Increase access to economic opportunities, including for vulnerable groups (youth, rural population)		✓		High	High
Increase quality of human capital, including through strengthened education and skill acquisition		✓		High	Medium
Facilitate activation and strengthen incentives for work		✓		High	High
Improve commercial and institutional integration with the EU			✓	Medium	High
Improve connectivity and infrastructure integration			✓	Medium	Medium
Level the product and labor market playing field to foster private sector development			✓	Medium	High
Strengthen governance, public service delivery and the rule of law			✓	High	High

## I. INTRODUCTION

1. **Montenegro is a small and open<sup>9</sup> upper middle-income transition economy that gained independence in 2006 and is negotiating accession to the European Union.** Montenegro has a population of 622,000 and a GNI per capita of \$7,320. It started negotiations with the European Union in June 2012 and strives to join by 2020 ahead of the other countries in the Western Balkans. In the negotiation process so far<sup>10</sup>, two chapters have been provisionally closed and twenty two chapters have been opened, including chapters 23 and 24 which together sketch out a comprehensive reform agenda in the area of the rule of law.

2. **Montenegro has gone through a period of economic boom and poverty reduction followed by one of economic bust, stagnation, and an increase in poverty.** The economic boom, from 2000 to 2008, was triggered by a large inflow of capital that stimulated aggregate demand and led to a steady increase in the rate of growth, and a fall in the rate of unemployment. During the boom, there was a steady decline in the percentage of households below the poverty line and an increase in the income of households in the bottom 40 percent. The period of economic bust and stagnation, from 2009 to 2014, was triggered by an initial *sudden stop* in capital inflows—prompted by the international financial crisis, while falling aggregate demand reduced output and the demand for labor, resulting in a partial reversal of the earlier gains in poverty reduction.

3. **Montenegro has no currency of its own, which puts large emphasis on sound fiscal policy and the country's competitiveness.** Montenegro unilaterally adopted the euro in 2002 without officially joining the euro zone, which means economic adjustments to meet the convergence criteria might be required as part of the European Union accession process. While using an external currency provides price stability following earlier problems with hyperinflation, the tradeoff is that fiscal policy is therefore the main economic management policy instrument available. Countercyclical fiscal policy can require significant discretionary spending, yet the budget of Montenegro is characterized by the predominance of non-discretionary spending, namely pensions and public sector wages. System-wide solvency and liquidity indicators in the banking sector appear broadly sound, but significant pockets of vulnerabilities exist among domestically-owned banks. In this context, the absence of a policy interest rate and the significant limitations to its lender of last resort function reduce the central bank's ability to influence bank lending.

4. **Montenegro's economic growth cycle follows closely the business cycle in Europe.** The correspondence between the path of Montenegro and Europe's GDP illustrates the vulnerability of the economy to the vagaries of the business cycle in a region that has not yet stabilized from the turmoil prompted by the financial crisis of 2008-10 and the subsequent sovereign debt crisis in some euro area countries.

5. **These cyclical vulnerabilities are occurring in the context of an unfinished transition from command and control to a market economy.** The transition to market rules has been accompanied by high and protracted unemployment and low levels of capacity utilization of machinery, equipment and physical infrastructure in all countries in the region.<sup>11</sup> In the Balkans, the complexities inherent to this process were exacerbated by conflict and political uncertainty. The high unemployment rate even at the peak of the economic cycle in 2008 (at above 17 percent) suggests that the roots underlying low potential growth in Montenegro and other countries in the Balkans are way deeper than the business cycle and can be traced to the legacy of socialism and an unfinished reform agenda.

---

<sup>9</sup> The trade in goods and services equals to GDP in 2014, higher than Croatia's 91 percent, but below Slovenia's of 145 percent.

<sup>10</sup> The negotiations focus on the terms under which the applicants will adopt, implement and enforce *acquis communautaire* (the accumulated legislation, legal acts, and court decisions that constitute the body of the European Union law).

<sup>11</sup> Blanchard and Kramer, "Disorganization", The Quarterly Journal of Economics, Vol. 112, No. 4, November 1997

6. **The development challenges facing Montenegro are a combination of cyclical and structural factors and require a two-pronged approach.** The cyclical factors are the state of the economies in Europe, Russia and South Eastern Europe (SEE)—the short- to medium-term prospects of these economies; and the country’s macro-fiscal situation. The main structural factors are the level of regional integration, the level and quality of human and physical capital, the legacy of a socialist past, and the weak development of the private sector. The legacy of socialism is visible in the still large influence of the public sector and in the weight of the pension system and public administration cost in overall government expenditure. The weakness of the private sector is evident in the state of the financial sector, the high number of companies literally being insolvent with accounts blocked for years, the development of private firms, and the limited trade links between Montenegro and the rest of the world.

7. **This Systematic Country Diagnostics is organized into six parts.** The first part presents a brief overview of the country’s recent socio-political and economic context. The second part examines the links between poverty, income distribution and economic growth, through the labor market, against the background of large changes in international capital flows and the unfinished structural reform agenda. The third part, examines the sustainability and vulnerability of the current growth model. The fourth part examines the structural constraints to sustainable and inclusive growth and poverty reduction, while the fifth part reviews the governance and the rule of law foundations. The assessment of each constraint is followed by a description of what the Government of Montenegro (GoM) is doing to address the issue. The sixth part examines priorities and opportunities.

## II. COUNTRY CONTEXT

### *Socio-Political Context*

8. **Montenegro was amongst the poorest regions of the Social Federal Republic of Yugoslavia (SFRY).** After World War II, Montenegro became a constituent republic of the Socialist Federal Republic of Yugoslavia (SFRY). Along with other republics in the former federation, Montenegro had significant autonomy in setting tax rates and revenue-raising activities. However, it was also among the recipients of the solidarity contributions that were distributed from the Federal Fund for Accelerated Development of the Less-Developed Regions funded by the better off regions in SFRY.

9. **Montenegro's current economic structures grew out of Yugoslavia's socialist economic model based on worker self-management.** From the 1960's, industrial policy in the former Yugoslavia focused on the establishment of new manufacturing facilities closer to raw material sources. During that period, the aluminum company Kombinat aluminijska Podgorica (KAP) and the steel mill Niksic were established.<sup>12</sup> The oil crisis of the 1970s contributed to growing economic problems. Inflation rose and unemployment increased, while the nexus between the banking sector and social enterprises contributed to a rise in SFRY indebtedness. External debt increased by an average of 18 percent per year between 1960 and 1980<sup>13</sup> and, by the early 1980s, Yugoslavia's debt was around one third of GDP.<sup>14</sup>

10. **During the 1980's the SFRY was plagued with stagnation and growing regional disparities.** Real GDP growth, which averaged 5.8 percent per year during the 1970s slowed to an annual average of just 1 percent between 1980 and 1989. Inflation reached over 200 percent in the late 1980s. Regional disparities worsened. GDP per capita in northern regions was \$3,233 but only \$1,580 in southern regions (Table 1). Montenegro's GDP per capita at the time was \$2,086.<sup>15</sup> The unemployment rate in SFRY reached 17 percent, while another 20 percent of the SFRY labor force was underemployed.

11. **Economic fragmentation of Yugoslavia contributed to its political disintegration, which ended with a series of conflicts in the 1990s, and with Montenegro and Serbia establishing a**

**Table 1: GDP per capita in 1980 by Region and Republic**

Slovenia	\$5,193
Croatia	\$3,314
Vojvodina	\$3,189
Serbia (narrow)	\$2,534
<b>More Developed Regions (North)</b>	<b>\$3,233</b>
Montenegro	\$2,086
Bosnia and Herzegovina	\$1,737
FYR Macedonia	\$1,721
Kosovo	\$812
<b>Lesser Developed Regions (South)</b>	<b>\$1,580</b>

Source: World Bank.

<sup>12</sup> The KAP produced its own alumina, extracting it out of the bauxite shipped from Niksic bauxite mine. The factory also had its own production of pre-baked anodes, while the smelter has an installed capacity of 120,000 tons of liquid aluminum per year. The plant had its most difficult times during UN-imposed economic sanctions on FR Yugoslavia during which the production was reduced to 13 percent of capacity. At its peak, KAP contributed around 7 percent of GDP and two-thirds of all exports. On December 1, 2005, KAP was privatized to the Central European Aluminum Company, a Cyprus-based company. As of 2008, KAP has struggled to survive the impact of global economic crisis. The low price of aluminum, market-based electricity pricing and overstaffing, had resulted in KAP generating losses and overreliance on government subsidies. In 2009, the government issued guarantees amounting to EUR130 million (4.4 percent of the 2009 GDP) to prevent bankruptcy of the company in exchange for half of the stakes owned by CEAC. Finally, in 2013 the KAP was put under the bankruptcy procedure after the government repaid called guarantees.

<sup>13</sup> <http://mises.ca/posts/articles/the-economy-of-titos-yugoslavia-delaying-the-inevitable-collapse/>

<sup>14</sup> <http://www.jstor.org/discover/10.2307/151992?uid=3739584&uid=2&uid=4&uid=3739256&sid=21104941813567>

<sup>15</sup> World Bank data.

**federation in 1992.** Under the prime minister's "Markovic economic program" in the 1990s, state revenues that had previously gone as transfer payments to the republics and provinces went instead to service Yugoslav debt to the Paris Club and London Club. From 1989 through September 1990, more than a thousand companies went into bankruptcy in the SFRY, while by 1990 annual GDP had shrunk by 7.5 percent.<sup>16</sup> The conflicts in the region that started with the quest for independence of several republics mostly resulted in peace accords, involving full international recognition of new states, but with massive economic damage to the region. The republics of Serbia and Montenegro together established a federation in 1992. In parallel, the collapse of the command and control economy at the beginning of the 1990s with the loss of guaranteed markets and suppliers, and political uncertainty greatly disrupted the life of the Montenegrins. *Disorganization*<sup>17</sup> of traditional forms of production affected workers and all forms of capital. The new market rules to help allocate available human and non-human resources to economic activity did not emerge automatically. The disintegration of the Yugoslav market and the imposition of UN sanctions in May 1992 were followed by the greatest economic and financial crisis in Montenegro since World War II. As of 1993, production had collapsed, the country was undergoing the second hyperinflation in its history and about two-thirds of the population was below the poverty line. This was a period of an abrupt transition until the country's independence in 2006.

12. **In 2006, following a referendum, Montenegro declared independence from Serbia, and four years later, it was granted candidate status for European Union membership.** Montenegro has continued its transformation toward a more service-based economy, with the proclaimed goals of becoming an elite tourist destination in the EU. Efforts have been made to attract foreign investors into tourism investments, as well as into large infrastructure projects, meant to facilitate tourism development. Montenegro experienced a real estate boom in 2006 and 2007, with many wealthy foreigners buying property on the Montenegrin coast. By 2008, Montenegro was receiving more foreign investment per capita than any other nation in Europe. Due to foreign direct investment, the Montenegrin economy grew at a very fast pace until the onset of the global crisis.

13. **Harmonization with the *acquis communautaire* as well as a free trade agreement with the EU is a good foundation for Montenegrin convergence.** The 2015 EU Progress Report for Montenegro<sup>18</sup> suggests that the country undertook some further steps towards a functioning market economy and that it should be able to cope with competitive pressures and market forces within the EU over the medium term, provided that it continues to address current weaknesses through appropriate structural reforms. In particular, strong political commitment is essential for the deep and lasting reforms necessary to strengthen the rule of law, fight against corruption, increase the efficiency of the judiciary, and protect fundamental rights. Depoliticization of the civil service and increased professionalism is also required, while a state aid-compatible solution is urgently required for KAP, which has been sold to a private owner during bankruptcy procedure.

#### ***Economic Context—From Boom to Bust***

14. **Over the last decade, the Montenegrin economy grew on average by 3 percent annually, following closely the business cycle of Europe and Central Asia (ECA).** Average real growth between 2001 and 2015 was 3 percent (Figure 1), but it was 5 percent between 2001 and 2008 and only 0.8 percent between 2009 and 2015. Indeed, the period includes two distinctive episodes: an economic boom in 2001-2008 when the rate of growth of GDP increased progressively until its double-digit peak in 2007; and an economic bust in 2009-15 when the rate of growth of GDP fell, in 2009 abruptly (by 5.7 percent), and remained at 1.9 percent on average for the remaining period. Montenegro's cycle showed much more variance: the growth at peak was double digit and higher and two dips much deeper, than in the rest of Europe

<sup>16</sup> Kiss J. (1994), "Debt Management in Eastern Europe, Eastern European Economics", May-June 1994, p 59.

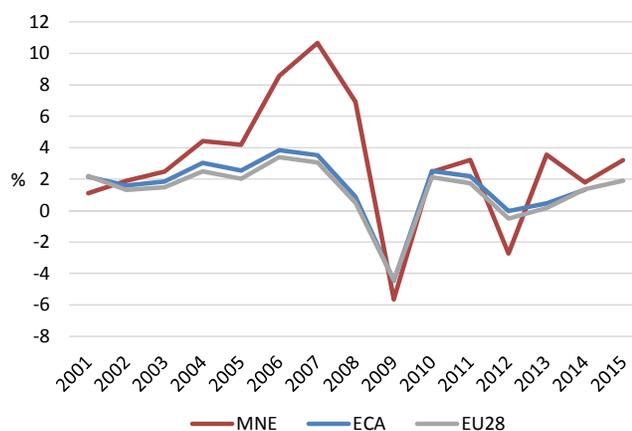
<sup>17</sup> The noun disorganization is used here in the sense described by Blanchard, Olivier and Michael Kramer QJE Vol. 112 (No.4), Nov. 1997, 1091-1126. The authors describe the situation following the collapse of the command and control economy and before the new market economy rules help establish a new equilibrium.

<sup>18</sup> [http://ec.europa.eu/enlargement/pdf/key\\_documents/2015/20151110\\_report\\_montenegro.pdf](http://ec.europa.eu/enlargement/pdf/key_documents/2015/20151110_report_montenegro.pdf)

and Central Asia.

15. **The driving force of the economic boom was a massive inflow of capital.** At the peak of the economic boom in 2008 capital inflows were about 46 percent of GDP. Very large external capital inflows (mostly in the tourism, real estate, and banking sectors) boosted domestic demand and led to double-digit growth of 10.7 percent in 2007, placing Montenegro among the world's fastest growing non-oil economies. Implementation of a comprehensive reform program geared toward privatization and a low-tax, pro-business environment during the pre-crisis years led to robust growth and a rise in employment of over 17 percent from 2001 to 2008. Private consumption's share in GDP went up from about 70 percent in 2000 to 91.2 percent in 2008.

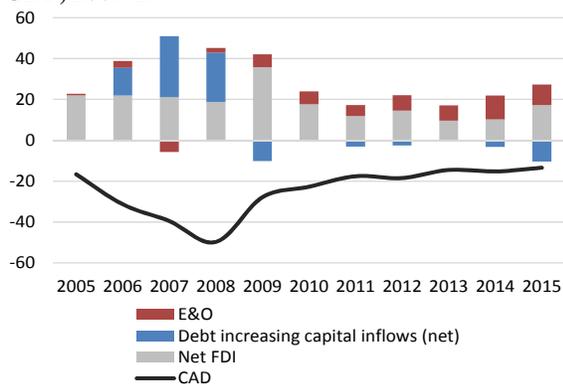
**Figure 1. Real GDP Growth in Montenegro and ECA Countries**



Source: MONSTAT, World Development Indicators (WDI), Eurostat.

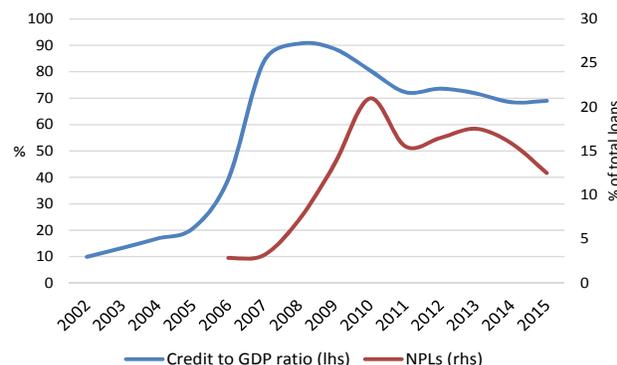
16. **The mirror image of these large capital inflows was a large deficit on the current account of the balance of payments (Figure 2).** While most of the capital inflows financed higher imports, they had a major effect on aggregate domestic demand, especially in sectors such as construction, tourism, real estate and services. Commercial banks supported private-sector activities with an expansion of credit that led to a rapid expansion of imports of goods. Consequently, the external imbalances widened, with the external debt to GDP ratio reaching 106 percent and the current account deficit an alarming 50 percent of GDP in 2008.

**Figure 2. Current and Capital Account, Percent of GDP, 2005-15**



Source: CBCG, MONSTAT, World Bank staff calculations.

**Figure 3. Credits and Non-Performing Loans**

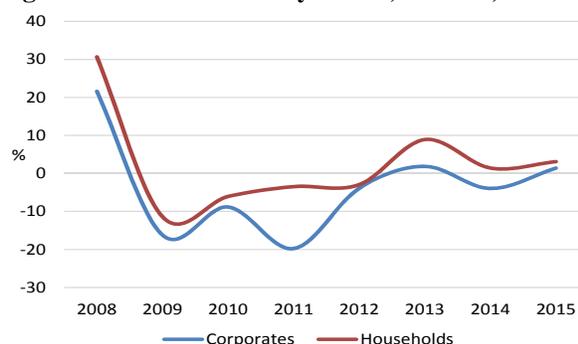


17. **The economy has yet to fully recover from the collapse of the pre-financial crisis lending boom, as balance sheet weaknesses and bank deleveraging have hampered economic growth.** In the run-up to the 2008 crisis, sizable capital inflows fueled a demand boom and imbalances, including reckless bank lending, a housing bubble, and rapid increase in public and private debt. Total credit annual growth averaged 77 percent in 2003-08, bringing the credit to GDP ratio to 90.7 percent by 2008 (Figure 3) and the loan-to-deposit (LTD) ratio to 167 percent at its peak in April 2009. The bursting of the asset bubble resulted in a large stock of NPLs, deteriorating bank profitability, and significant debt overhang that has contributed to a sustained contraction in credit and weak investment.

18. **The overreliance on external capital inflows made Montenegro very vulnerable to the sudden decline in capital flows at the onset of the global financial crisis.** The tightening of external financing that started in 2009, induced a reduction in the current account deficit by almost 22 percentage points of GDP between 2008 and 2009. As external demand for metals collapsed, so did the import of inputs for the aluminum export industry. As a result, the current account deficit shrank to 28 percent of GDP in 2009. The tightening caused a contraction of domestic aggregate demand, especially a collapse in investment and in imports. The fall in the rate of growth of GDP was severe (from 6.9 percent in 2008 to –5.7 percent in 2009) and a painful deleveraging of the private sector occurred.

19. **The global economic crisis led to a severe credit crunch** (Figure 4). The onset of global economic crisis also led to a nearly 22 percent fall in bank deposits between August 2008 and end-2011 and a severe fall in credit: from end-2008 to 2011 credit fell by 16 percent bringing the loan to deposit ratio down to 118 percent by end-2012 from over 160 three years earlier. The most affected sectors were the metal industry, construction and financial activities. Parent bank credit also became scarcer and borrowing from parent banks as a share of total liabilities fell from 20 percent in 2008 to 13 percent in 2012.

**Figure 4. Credit Growth by Sector, 2008-15, Percent**



Source: CBCG, MONSTAT, World Bank staff calculations.

20. **The driving force of the economic bust was a dramatic change in investors’ perceptions of financial risks.** The change in the banks’ attitudes had little to do with Montenegro’s economic realities which had shown growing vulnerabilities well before the global crisis. As with other European banks following the 2008 crisis, banks in Montenegro suddenly became more mindful of their exposure to financial risk.<sup>19</sup> Such risk perceptions continue to affect the Montenegrin economy. After a short-lived recovery in 2010-11, the country faced another contraction of 2.7 percent in 2012 with manufacturing and construction leading the decline, this time triggered by the sovereign debt crisis in Europe. The current account deficit continued to shrink, but remained high by global standards at above 13 percent of GDP in 2015 albeit funded by foreign direct investments (FDI) in tourism and real estate. The economy has returned to growth recovering the output lost since 2008, again supported by investments in real estate and tourism, as well as public investments.

21. **Inefficiencies and vulnerabilities in the financial sector hamper private sector growth and pose fiscal and financial stability risks.** Montenegro’s growth potential is hampered by an inefficient financial system, with high costs of intermediation and high level of non-performing loans. Growing risks in domestic banks and weaknesses in bank regulation and oversight pose fiscal and financial stability risks. In the absence of independent monetary policy and to complement sound fiscal management, a macro prudential framework should be established as well as limitations to the central bank’s lender of last resort function require further attention. Restoring normal lending conditions remains a serious challenge hampering economic growth. The ongoing implementation of the law on voluntary restructuring of loans (“Podgorica approach”) is a welcome step in addressing NPLs but would need to be complemented by additional measures including reversing the loosening of regulatory standards observed over the last several years to ensure timely recognition and write-off of NPLs, strengthening enforcement, allowing the exit of unviable corporations, and removing the legal bottlenecks that are still seen to hamper the disposal of impaired assets by banks.

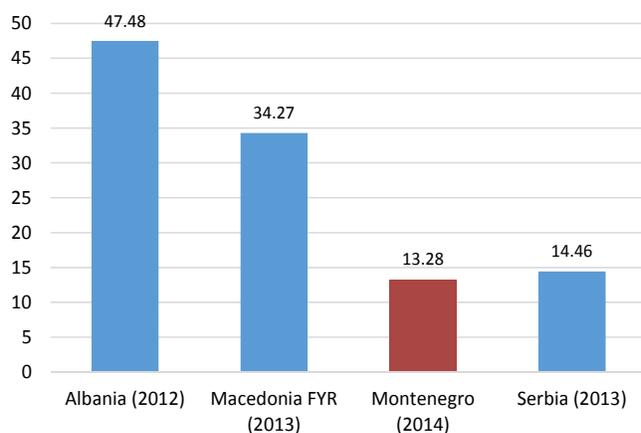
<sup>19</sup> Eichengreen, B. (2010). “Globalization and the crisis”. IFO Institute for Economic Research at the University of Munich, CESifo Forum, Vol. 11, Issue 3, p. 20-24, October 2010.

### III. POVERTY, SHARED PROSPERITY, AND GROWTH

#### Poverty and Shared Prosperity Trends

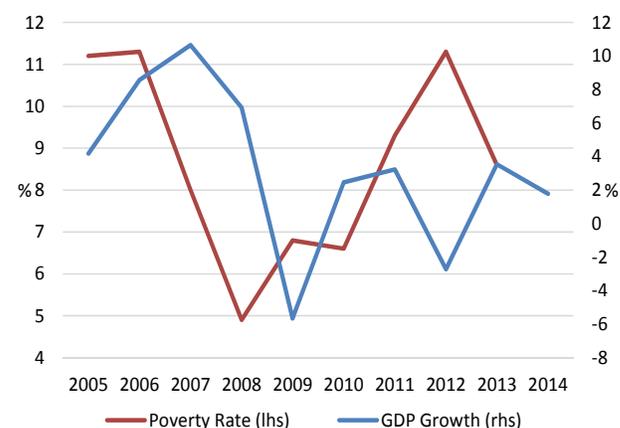
22. **With a poverty rate of 8.3 percent,<sup>20</sup> Montenegro has one of the lowest poverty rates in the Balkans.** Using comparable poverty measures, Montenegro has a poverty rate slightly higher than Serbia's and lower than those of Albania, and FYR Macedonia (Figure 5) (Box 1).

**Figure 5. Poverty Rates in the Region, \$5 PPP/day**



*Note:* Latest available poverty rates.  
*Source:* World Bank staff calculations.

**Figure 6. Changes in Poverty Mirroring Economic Growth**



*Source:* MONSTAT.

#### Box 1. Poverty Measurements and Cross-Country Comparisons

Montenegro uses the Household Budget Survey (HBS) administered by the national statistics agency (MONSTAT) to measure poverty. Montenegro uses an absolute poverty line, estimated using the cost of basic needs approach with a minimum calorie requirement of 2288 kcal/daily per person. The poverty line was first estimated in 2006 at €144.68 per adult equivalent<sup>21</sup> per month, and is updated annually for inflation. In 2013, the inflation-adjusted poverty line was €186.45 per equivalent adult.

The World Bank measures poverty in a different manner for cross-country comparison. To account for cross-country differences in prices, the International Comparison Program's purchasing power parity correction factor is used, instead of local prices. In Europe and Central Asia there are also specific items of consumption that are not usually included in the World Bank welfare aggregate. These items are nonetheless often included in national approaches, leading to compositional differences in welfare aggregates. Poverty reported by the World Bank for the purposes of international comparisons is usually made in terms of 2005 international US dollars at \$1.25/day, the mean of the national poverty lines for the 15 poorest countries of the world at the time the line was set. In Europe and Central Asia, the \$5/day line is commonly applied to reflect the higher cost of heating and utilities faced by individuals living in that region.

*Note:* For more information, please refer to the ECAPOV website at: <http://go.worldbank.org/RR8JUWFGU0>

*Source:* The World Bank Group.

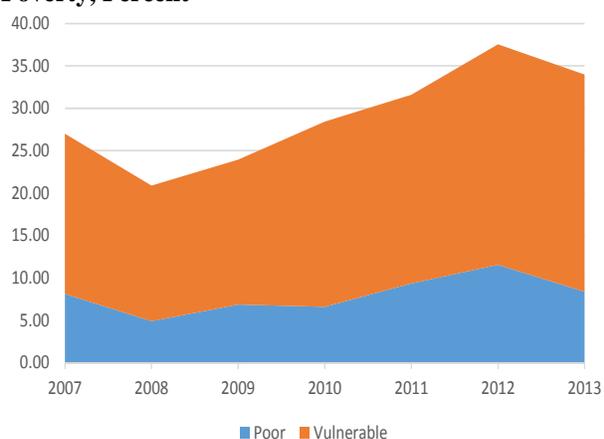
23. **Since its independence, Montenegro has gone through a period of economic boom and poverty reduction, followed by one of economic bust, stagnation, and increasing poverty and vulnerability**

<sup>20</sup> Using the latest available national absolute poverty line.

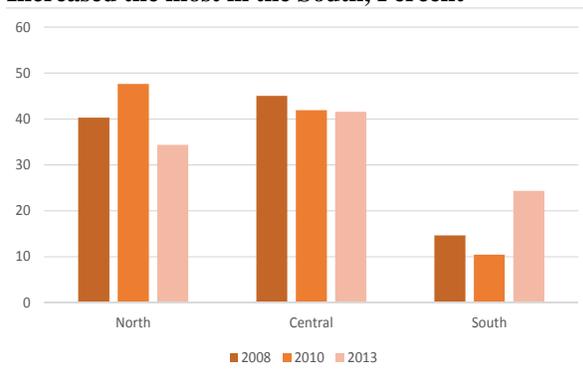
<sup>21</sup> Adult equivalence in Montenegro follows the OECD standard, defined as the weighted sum of the number of household members, where the first adult in household counts as 1.0, the second (and any subsequent) adult as 0.5, and each child is weighted by 0.3 up to the age of 14 years.

(Figure 6). Though over the past decade Montenegro's growth averaged 3 percent annually, boom-and-bust cycles in growth led to commensurate lagging declines and increases in poverty rates. With strong growth leading up to the financial crisis in 2009, Montenegro made steady progress in poverty reduction: poverty rates declined from 11.3 to 4.9 percent between 2006 and 2008. During the economic bust period, the rate of growth of GDP fell, initially very abruptly, and poverty reached 11.3 percent in 2012, only to decline again in 2013 (the last year for which poverty data are available) as the economy picked up again. Vulnerability increased even more than poverty since 2008: the percentage of vulnerable households (those with a consumption per adult equivalent below 1.50 times the poverty line) increased from 18.9 percent in 2007 to 26 percent in 2013 (Figure 7). Most of this increase happened in urban areas where the percentage more than doubled, from 10 percent in 2009 to 22 percent in 2013. In terms of regions, the South saw the percentage of vulnerable more than double while the North saw a decline. In the Central region the percentage remained stable at around 40 percent (Figure 8).

**Figure 7. Vulnerability Increased more than Poverty, Percent**



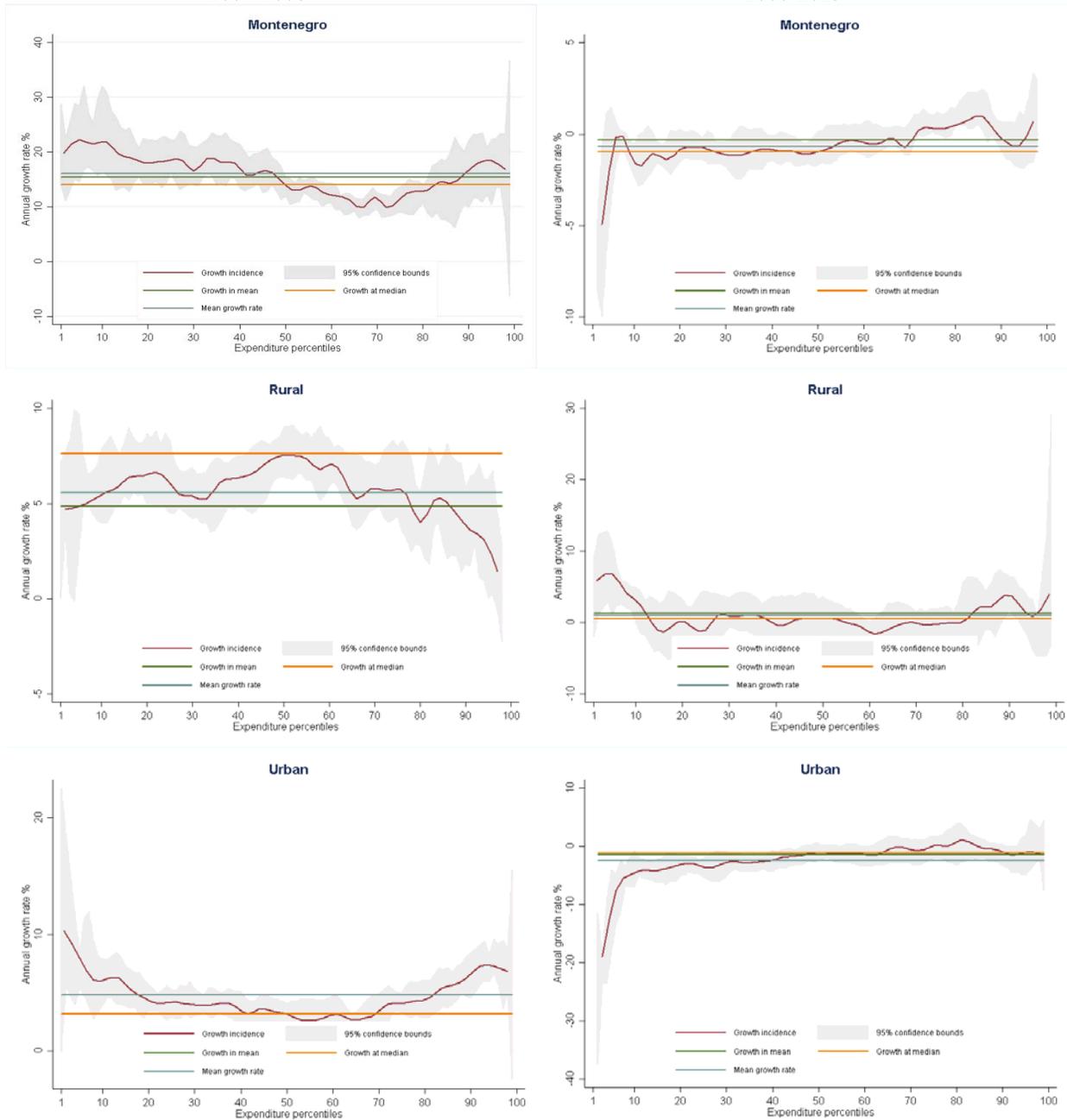
**Figure 8. Vulnerability is Highest in Central, but Increased the most in the South, Percent**



Source: World Bank staff calculations using HBS 2007-13.

24. **Growth has become less pro-poor post crisis: the poorest benefited the most from the boom but were hit hardest by the bust.** The growth elasticity of poverty went from -1.97 between 2005 and 2008 to 4.02 between 2009 and 2013. This means that during the boom years a one percentage increase in growth was accompanied by an almost 2 percent reduction in poverty, whereas over the last few years a one percent increase in growth has been accompanied by a 4 percent increase in poverty. The growth incidence curves for the two periods show how in the period of high growth in average consumption in 2007 and 2008, consumption of the bottom 40 grew faster than that of the top 60. This contrasts with what happened in the following six years when, during a period of stagnant growth, consumption growth for the top 60 was higher than that of the bottom 40. There were also differences across regions. In a context of higher growth in 2007-08, the poorest and richest percentiles gained more in urban areas, while the middle of the distribution gained the most in rural areas. In the period of no growth, the poorest suffered the most with negative growth in urban areas, while in rural areas they saw positive growth (Figure 9).

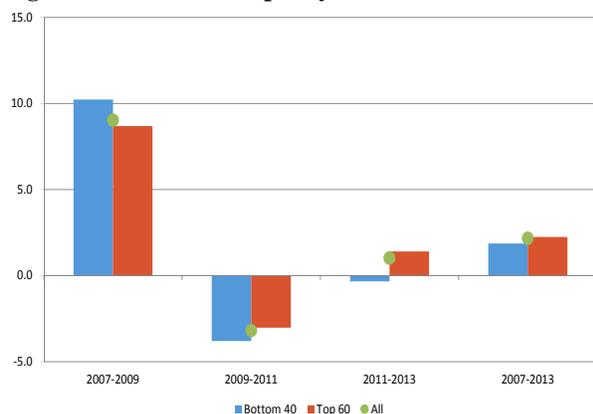
**Figure 9. Growth Incidence During the Boom and the Bust Periods**  
**2007-2008**



Source: World Bank staff calculations using HBS 2007-13.

25. **Overall, average growth in consumption over the 2007-2013 period has been positive but with substantial variation within this period and across locations.** Over the period 2007-2013, average growth of consumption was 2.5 percent, with the bottom 40 growing slightly less than the top 60. However, there was large variation across periods (Figure 10). Between 2007 and 2009 consumption grew substantially, with the bottom 40 experiencing more gains than the top 60. During the following two years growth turned negative with the bottom 40 more affected. Then between 2011 and 2013 (the last year for which data is available) consumption growth resumed for the top 60 but remained slightly negative for the bottom 40. Still, inequality with the Gini coefficient at 26.2 in 2013 remains the lowest in the Western Balkans (Figure 11).

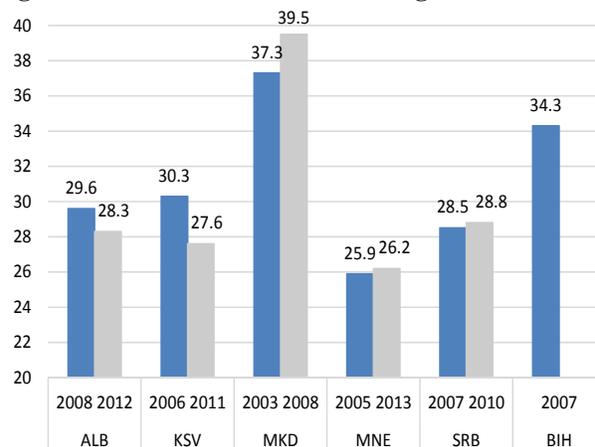
**Figure 10. Shared Prosperity Over Time**



*Note:* Shared prosperity is defined as growth in the income of the bottom 40.

*Source:* World Bank staff calculations using HBS 2007-13.

**Figure 11. Gini Coefficients in the Region**

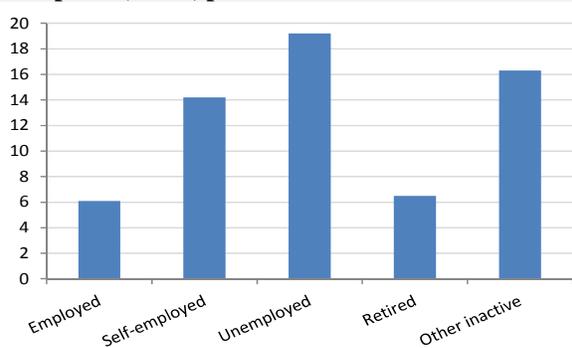


*Source:* Ceriani and Dávalos (2014) and own calculations.

**Box 2. Profile of the Poor and the Bottom 40**

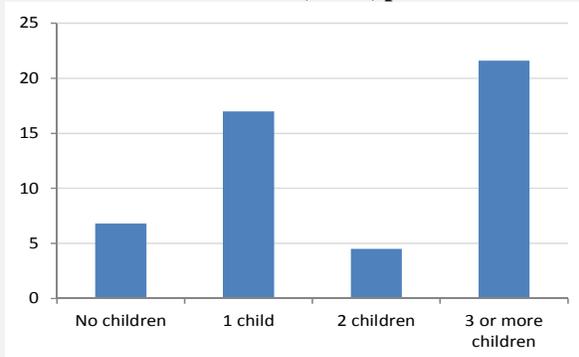
**Activity rates are closely linked to poverty and vulnerability.** The poor and vulnerable are more likely to be unemployed than the non-vulnerable, and this percentage has significantly increased between 2008 and 2013, especially for the vulnerable. The poverty rate in 2013 was the largest (around 19 percent) in households with an unemployed head followed by those with an inactive household head (Figure 12). The poverty rate for households with a retired head was 6.5 percent, while the one for employed heads was 6.1 percent. The percentage of the poor living in households with an unemployed head increased threefold, from 11.3 percent in 2008 to 33 percent in 2013. Another 30 percent of poor households had a retired head. On average about one-third of adults in poor households were employed in 2013, whereas two-thirds of adults of non-vulnerable households were employed. Also, 45 percent of the vulnerable and 39 percent of the non-vulnerable population lived in households with a retired household head, compared to only 30 percent among the poor. Likewise, on average, more than two-thirds of household members in non-vulnerable households received pensions, while about half of household members in poor and vulnerable households obtained this source of income.

**Figure 12. Poverty Rate by Household Head's Occupation, 2013, percent**



*Source:* MONSTAT.

**Figure 13. Poverty Rate by the Number of Children in the Household, 2013, percent**



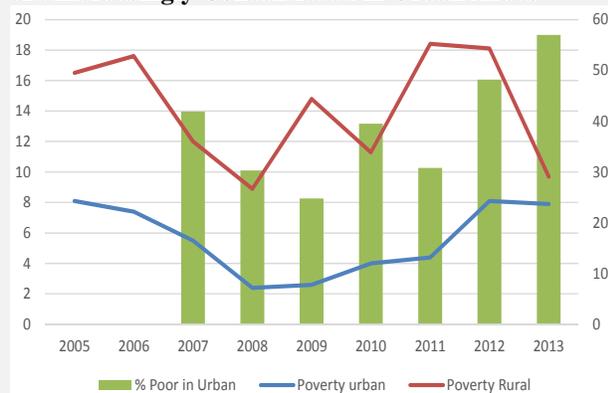
**The bottom 40 percent counts on relatively few working-age household members to provide for larger households.** Less well-off households are larger and have more dependents, especially children (Figure 13), while the well-off have smaller households, fewer children and a relatively higher share of members over 65 years old. Households in the bottom 40 percent have a high dependency rate: each employed household member has to provide for about four other persons, as opposed to two in the top 60 percent. This pattern is the result of both a higher child dependency ratio and lower employment rates for working-age individuals at the bottom of the distribution. A high

rate of dependency on employed household members makes households highly vulnerable to job loss, illnesses or other shocks affecting income earners.<sup>22</sup>

**Poor households have lower levels of education, lower land ownership and access to health services.** Poor people tend to be significantly less educated than other groups: 77 percent of the poor have attained primary education or less in 2013, while this percentage is 51 and 33 for the vulnerable and non-vulnerable. Nevertheless, an improvement is shown in the access of the poor to higher levels of education between 2008 and 2013. Land holdings worsened significantly between 2008 and 2013, especially for the poor. In 2008, about 25 percent of the poor had more than one hectare of agricultural land; this number dropped to 1.6 percent in 2013. Access to health services is more limited for those with lower household income. Only two-thirds of poor mothers have four or more antenatal care visits, compared to 91 percent of the wealthiest quintile, and the quality of ANC service is worse for poor women and Roma. In 2013, 88 percent of all children (24 to 35 months) were fully immunized, compared to 78 percent for the poorest quintile, and only 12 percent for Roma.

**The poverty rate has consistently been higher in rural than in urban areas, but the majority of households below the poverty line as well as in the bottom 40 percent reside in urban areas.**<sup>23</sup> Poverty rates fell in both areas between 2005 and 2008. In 2009-13 rural poverty rates exhibited higher volatility and no distinctive trend. Meanwhile the urban poverty rate had an upward trend due to labor shedding in troubled industries (Figure 14).<sup>24</sup> The share of the poor (and bottom 40) living in urban areas has been increasing, though not constantly, and reached 59 percent in 2013 (58 percent). The share of the poor and bottom 40 living in the capital of Podgorica and other cities increased over this period. The share of the poor living in rural areas was the lowest in 2013 with 40.9 percent.

**Figure 14. Rural Poverty is Higher but the Poor are Increasingly Concentrated in Urban Areas**



*Note:* Poverty rates are on the left axis, while the share of the poor in urban areas on the right axis.

*Source:* World Bank staff calculations using HBS 2005-13.

### **Composition of Growth and Employment—the Key Determinants of Poverty Changes**

26. **Labor income represents about a third of total income of the poor compared to more than half for the non-poor** (Figure 15). The labor income share is much lower for the poor reflecting higher rates of unemployment or inactivity among the poor than the non-poor. Less than 20 percent of the working age<sup>25</sup> poor earn some income from labor (wages, business income or farming).

27. **Non-labor income represents a high share of income as social protection benefits are relatively generous in Montenegro by ECA standards.** This is particularly valid for the generosity of the benefits that are social insurance contribution-based. Due to the application of rigorous means testing of the last resort program and the monthly child allowance, overall social assistance is accurately targeted to the poor, and both pensions and social assistance transfers have provided a buffer to poor and vulnerable families.

28. **Changes in poverty mirror changes in labor market performance, especially employment.** If one isolates the role played by different income factors in reducing poverty in Montenegro (Figure 16)<sup>26</sup>, employment and agricultural income are the factors behind the reduction in poverty in 2007-08 and an increase

<sup>22</sup> Ceriani, L. and M. E. Dávalos (2014).

<sup>23</sup> Overall, around two thirds of the population lives in urban areas.

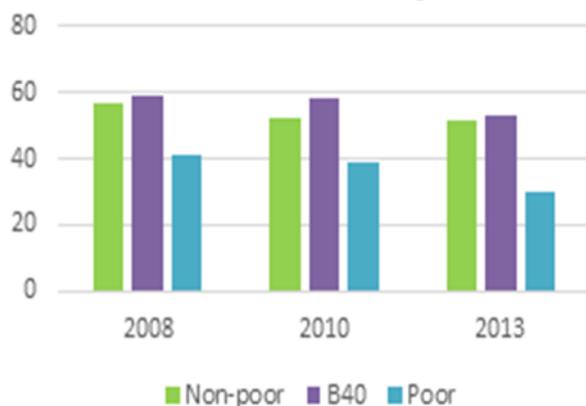
<sup>24</sup> The share of households below the poverty line residing in urban areas increased from 46 percent in 2009 to 58 percent in 2013; the share of households in the bottom 40 percent residing in urban areas increased from 25 percent in 2009 to 40 percent in 2013.

<sup>25</sup> Individuals aged 15 to 64.

<sup>26</sup> Following Barros et al. (2006) and Azevedo, Sanfelice, and Cong Nguyen (2012).

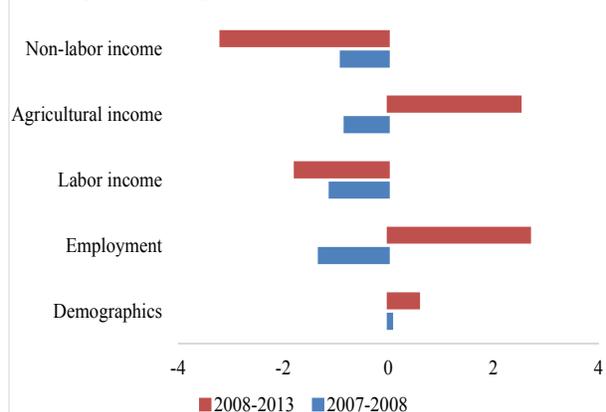
in poverty from 2008 to 2013. Non-labor income, as one would expect, contributed in both periods to reducing poverty, and its role was especially strong during the bust period, thus working as a buffer in a time of crisis. Among non-labor income the component that played a major role was pensions. While employment had a negative effect, labor income had a positive effect on poverty reduction even in 2008-13. Between 2007 and 2013, the share of income from wages increased by about 2 percentage points for the poor, and the share of social assistance income almost tripled to 39 percent – driven mostly by categorical transfers (such as pensions). Overall, the primary driver of poverty reduction between 2007 and 2013 was pensions, followed by social assistance and wages. Since 2011, however, wages have become the single most important driver of poverty reduction. The limited impact of social assistance on poverty during the economic downturn is due to the low coverage of last resort social assistance among the poor, despite high spending on social transfers.

**Figure 15. Share of Labor Income in Total Household Income for Various Groups**



Source: World Bank staff calculations using HBS 2007-13.

**Figure 16. Wages and Transfers are the Main Poverty Reducing Factors**



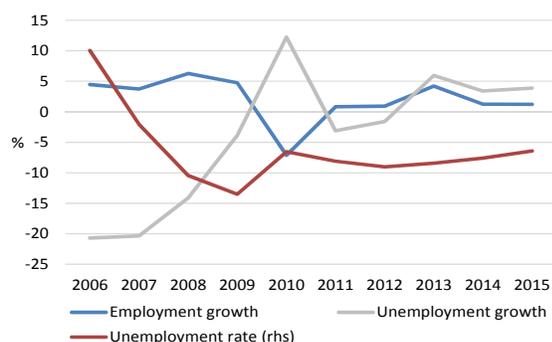
Note: Changes in poverty rates due to various income and labor market factors

Source: World Bank staff calculations using HBS 2007-13.

29. **Growth led to reduction in unemployment; however, unemployment remained high even during boom years** (Figure 17). Changes in economic growth trends since 2006 were directly associated with changes in the rate of unemployment: unemployment fell steadily when the economy expanded and increased when the economy stagnated. But it is not only the level of demand for labor that matters, also the composition of demand for labor and, in particular, the effect of the increase in demand for low skilled labor, as it is an important determinant of changes in poverty. While employment responds to growth, even at the peak of growth unemployment levels remained very high, which suggests a large structural component that the business cycle is not able to wipe away.

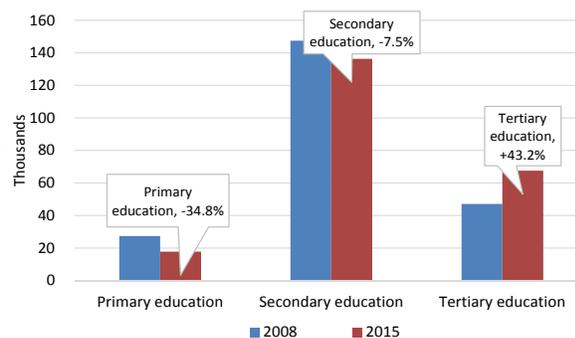
30. **The composition of economic growth largely determined the changes in poverty.** The main reason why changes in poverty have been so responsive to changes in the rate of GDP growth is that the latter resulted in a significant change in the labor demand for low skilled workers. During the boom, demand for (mostly) low skilled labor increased and resulted in a reduction of unemployment, while in the bust the number of employed unskilled individuals (primary or less) decreased constantly. The increase in the demand for labor was mostly for low-skilled workers, and these are the categories where the incidence of unemployment is higher: 43 percent less were employed with primary education in 2014 compared to 2008, while the demand for highly educated grew by the same percent (Figure 18). This effect was the result of the *composition of economic growth* as traditionally labor-intensive activities such as construction, mining, and retail trade greatly expanded during the economic boom. This was reversed in the bust and stagnation period.

**Figure 17. Labor Market Developments, 2006-15**



Source: MONSTAT, World Bank staff calculations.

**Figure 18. Employed by Education Attainment, 2008-15**



Source: MONSTAT, World Bank staff calculations.

31. **Domestic demand led the growth during the boom.** Total growth in GDP between 2000 and 2008 was over 40 percent. Household consumption and investment were the most dynamic components of domestic demand, while exports also had a strong contribution to overall growth (Table 2). All of these aggregates had a large import component, which contributed negatively to total growth (131 percentage points).

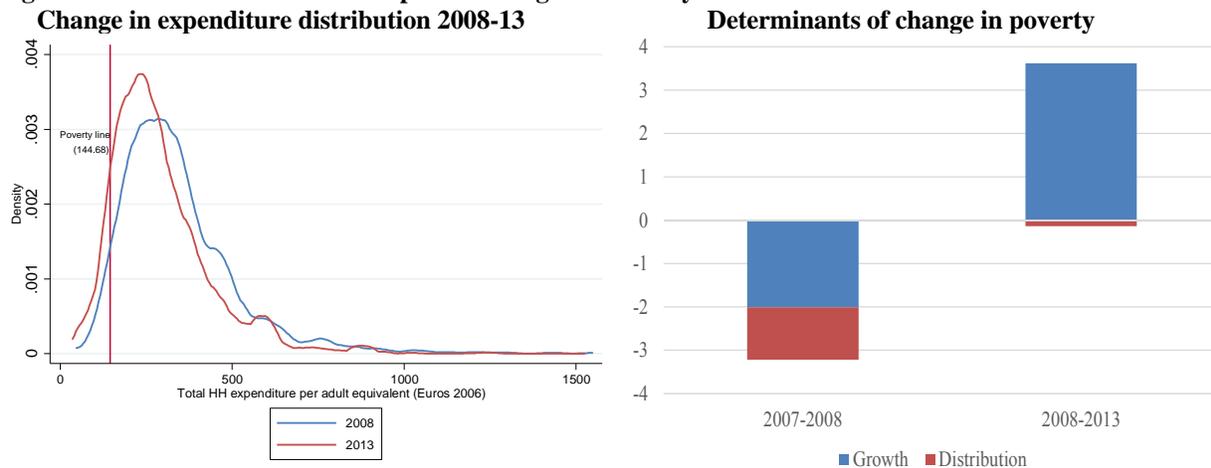
**Table 2. Two Very Different Periods: Demand-Side Growth**

Concept	2000-08	2009-14
Growth of GDP	40.2	2.6
Growth explained by household consumption	55.0	-9.6
Growth explained by government consumption	18.2	1.6
Growth explained by investment	50.2	-31.6
Growth explained by exports	48.1	-3.5
Growth explained by imports	-131.3	45.7

Source: MONSTAT, World Bank staff calculations.

32. **Growth in average household expenditure explains most of the changes in poverty.** Between 2008 and 2013, the distribution of household expenditure changed. Using the Datt-Ravallion decomposition, it is possible to identify the importance of changes in average expenditure and changes in the distribution of expenditure in determining poverty changes. Positive pre-crisis expenditure growth reduced poverty and the distribution of expenditure reinforced this. Between 2008 and 2013, average expenditure growth was negative and poverty increasing, and the changes in the distribution of expenditure were poverty reducing albeit statistically very small (Figure 19).

**Figure 19. Growth Performance Explains Changes in Poverty Between 2008-2013**

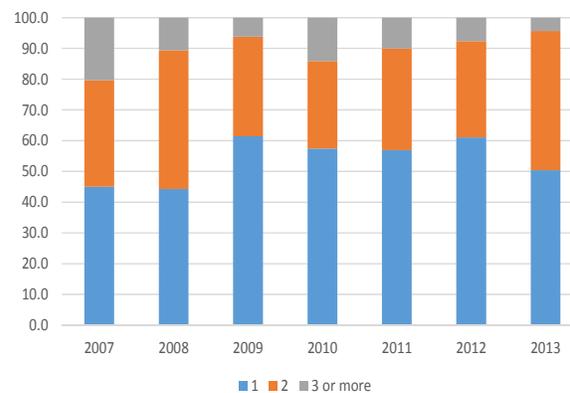


Source: World Bank staff calculations using HBS 2007-13.

33. **The high elasticity of poverty with respect to growth in the boom years was the result of changes in the rate of unemployment and a high density of households with incomes close to the poverty line.**

Unemployment fell rapidly during the economic boom but has increased since the crisis hit: the percentage of poor households with just one income earner increased from 44 percent to 61 percent and while it decreased in 2013 it was still 50 percent (Figure 20). The same may be observed from the perspective of changes in the level of employment. According to the Labor Force Survey (LFS) the highest employment rate was recorded in 2008 (43.2 percent) and the lowest in 2006 (34.5 percent). Figure 19 illustrates the high density of households just above the poverty line. This means that for a large number of households a small change in income can mean a fall into or out of poverty.

**Figure 20. Number of Income Earners in Poor Households**

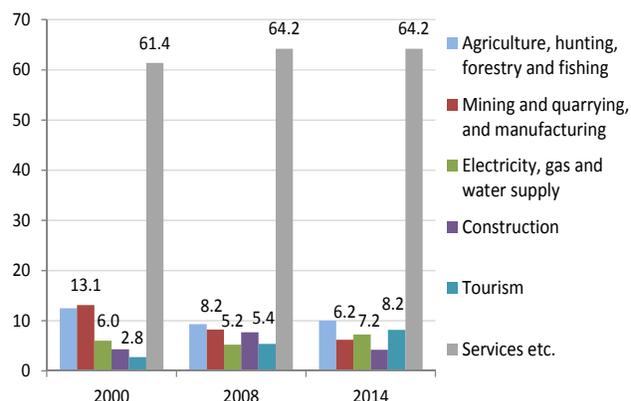


Source: World Bank staff calculations using HBS 2007-13.

34. **Growth shifted to services** (Figure 21).

According to the sectoral structure, production shifted from agriculture, mining, and manufacturing towards construction and services. In the 2010-14 period, the decline in agriculture and manufacturing was offset by an increase in the share of construction and services with tourism leading the shift. Services reached 72 percent of gross value added (GVA) in 2014. Trade, finance, transport, and tourism are dominant sectors in the GVA structure. Given the fact that a large share of FDI inflows has gone into the purchase of real estate and into the tourism sector rather than greenfield or productive investments, the structure of GVA in Montenegro is not surprising. Between 2010 and 2014, Montenegro achieved an annual services export growth rate of over 7 percent, faster than all peer countries, reaching 30 percent of GDP in 2014. Small services subsectors helped with the rebound, including computer and information and insurance services.

**Figure 21. Sectoral Decomposition of Gross Value Added in Montenegro, 2000-14**



Source: MONSTAT, WB staff calculations.

**Table 3. Employment Growth, 2000-14**

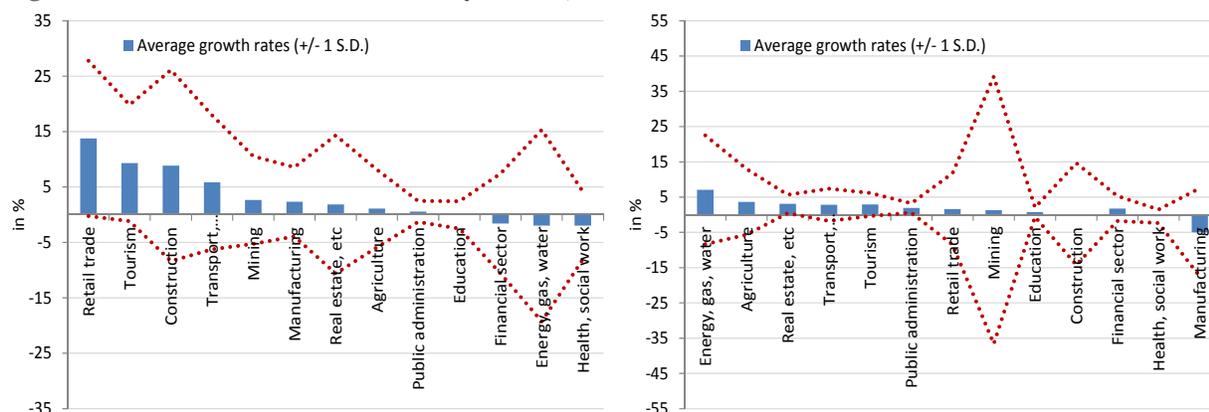
	2000-08	2009-14
Agriculture	1.1	0.0
Mining	-1.8	-10.1
Manufacturing	-0.3	-10.6
Energy, gas and water	1.5	5.6
Construction	4.1	0.9
Retail trade	5.2	2.2
Tourism	6.3	1.1
Transport, communication, etc	-0.8	2.3
Financial sector	1.3	3.6
Real estate, etc	3.1	8.6
Public administration	11.1	2.0
Education	0.1	0.7
Health and social work	1.3	-1.4
Other	1.8	12.4

Source: MONSTAT, WB staff calculations.

35. **Economic growth has been accompanied by a significant reshuffling of labor resources in the economy.** The clearest indicator is the average growth of employment by sector (Table 3) which illustrates the decline of manufacturing and mining employment and the increase in the importance of service sector activities (public administration, real estate, retail trade, financials, and tourism) and construction (by 2008) in explaining overall employment. Before the crisis, survey-based employment growth was at above 6 percent per annum on average; however, the post-crisis period is characterized by stagnant employment on average with a major downsizing in mining and metal manufacturing industry. Service sectors (public administration, utilities, finance and real estate) created new jobs.

36. **A large variation in growth is observed across several sectors in the two periods.** The rate of economic growth by sector of origin (Figure 22) illustrates the sectors that led the expansion and those that contracted. However, a low rate of growth does not imply the sector did not contribute to overall economic growth. For instance, the rate of growth of the agriculture sector in 2002-08 was rather low but this may have been consistent with an increase in productivity if the sector released sufficient factors of production to be used in other parts of the economy. Retail trade, construction, and manufacturing have not only observed different growth rates between the two periods, but also large variations within those periods suggesting high volatility.

**Figure 22. Gross Value Added Growth by Sectors, 2002-2008 and 2009-2014**



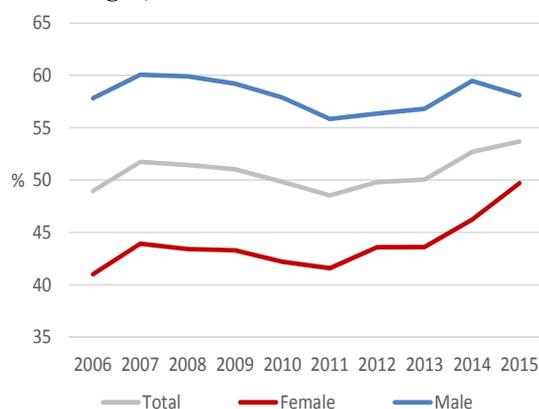
Note: Red-dotted lines show standard variation of +1/-1 compared to average rate.

Source: MONSTAT, WB staff calculations.

37. **Montenegro exhibits low labor force participation that has only recently reached the pre-crisis**

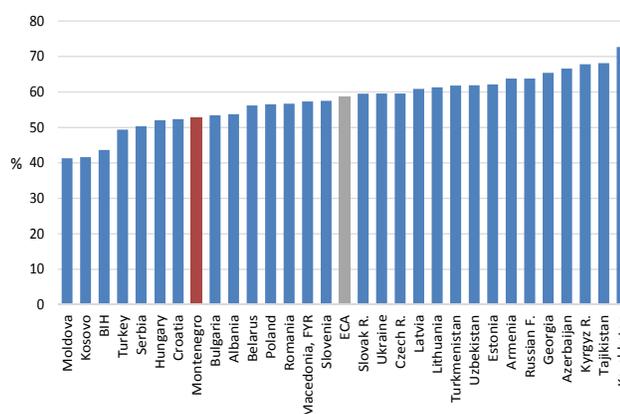
levels (Figure 23 and Figure 24). With 53.7 percent of active individuals in the labor force, Montenegro has one of the lowest levels of labor force participation in the ECA region with only couple of countries having a lower rate. The situation is similar with respect to employment rate, which stands at about 44 percent.

**Figure 23. Labor Force Participation in Montenegro, 2006-2015**



Note: The participation rate is for population 15+.  
Source: MONSTAT.

**Figure 24. Labor Force Participation Rate in ECA, 2014**



Note: Percentage of active persons in the total population aged 15+. It indicates the relative size of the labor supply.  
Source: World Bank WDI 2015.

38. **Participation rates are similar across socio-economic groups but behind these similar levels lie large differences.** Employment rates are significantly lower for the poor and the bottom 40 than for the top 60. Among the poor and the bottom 40 unemployment is much higher and a larger share of the population is inactive. The top 60 has the lowest share of inactive and unemployed. While the high levels of out of the labor force rates have to do with the aging population, high levels of retirement and inactivity are found among younger cohorts too. In 2007 and in 2013 over half of the population in the age group 55-59 was out of the labor force, with the large majority being retired.

39. **Several structural factors seem to be responsible for the low participation rates.** There are three main factors identified behind the high unemployment and low labor force participation:

(i) *The incomplete economic transition.* Over the last decade Montenegro has seen shedding of workers from the restructuring and closing of traditional firms and the declining importance of agriculture, public sector and SOEs as sources of employment, while the private sector still struggles to be the engine of growth. This has resulted in increase in unemployment for workers in their mid-forties and older, as well as increases in early retirement. Mid-career and older workers laid off find it harder to retrain to be employed in different sectors.

(ii) *Labor mismatches:* Skills per se are not identified as an important constraint on firm growth in employment surveys, except by new and innovative firms. However, there seems to be a demand for low skilled seasonal works mostly filled with seasonal migration to Montenegro. Meanwhile, the outmigration of educated Montenegrins suggests they are unable to find suitable jobs in the country, partly due to the limited linkages between tertiary education and labor markets. In a small country like Montenegro the constraints in terms of supply of sufficient labor in particular sectors or positions can be especially strong.

(iii) *A high reservation wage.* Despite the high number of unemployed, every year an almost equal number of migrants comes to work in Montenegro, and firms complain that they cannot fill vacancies. One explanation is that Montenegrins lack skills, which would require more targeted active labor market policies. However, many migrants are seasonal low skilled workers, so that lack of skills does not seem to be the problem. Rather, it seems to be the case that Montenegrins have a high reservation wage, which

is the wage rate below which they would not be willing to accept a particular type of job. What determines the reservation wage? In the case of Montenegro these factors seem to be at play:

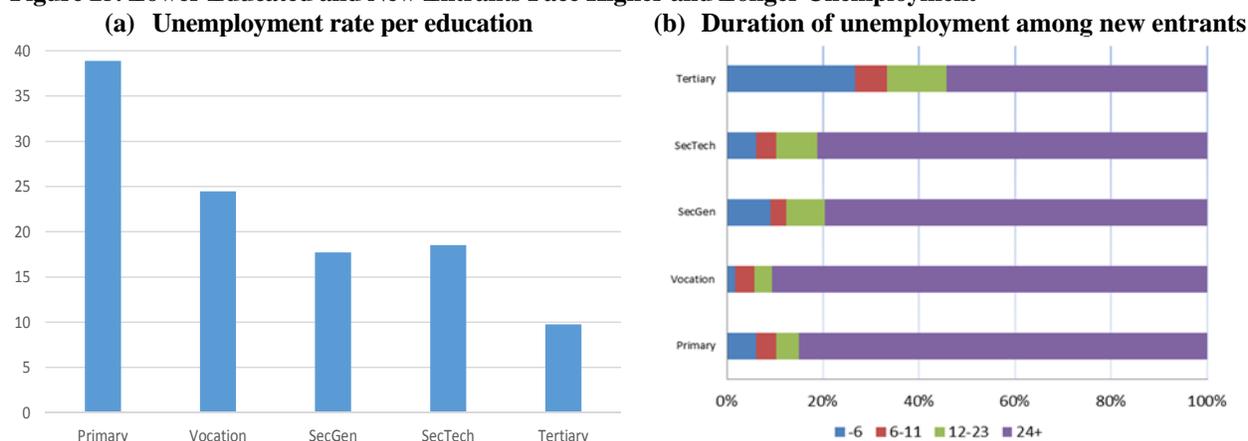
- *Migration and remittances*: As data on migration is limited, the evidence supporting its importance is indirect: workers' remittances are about 10 percent of GDP. However, the household survey underestimates the receipt of remittances (the value of total remittances received according to the household budget survey in 2013 was about 10 times lower than that from the balance of payments data), thus not allowing a thorough analysis of the impact of remittances on labor market dynamics.
- *Public and private transfers* may all contribute to a high level of reservation wage in Montenegro. Intergenerational transfers are anecdotally quite high in Montenegro, where children stick together with the elderly in the same household, sharing assets and income accumulated/generated by the older generation. Further, a massive sale of real estate prior to the crisis also delayed employment decisions. Social assistance design with high marginal effective tax rates may weaken incentives to take up part-time, temporary, or seasonal employment at levels below the social assistance threshold. Disregarding such earnings partially or fully for the purposes of the social assistance income test could significantly improve attachment of social assistance beneficiaries to the formal labor market.
- *Informality*. Based on the citizens' survey done by UNDP, the overall scale of informal employment in Montenegro is at 29.3 percent of total labor force. Given that the size of informality is severely underestimated in the labor force survey, this could explain the underestimation of labor force participation. Another important feature of the informal sector that can increase the reservation wage of potential workers, is the illicit activities conducted by organized crime. As broadly documented by UNODC or EU, Montenegro sits on the transit route of cigarette smuggling and human, drug, and arms trafficking<sup>27</sup>. It is interesting to notice that the majority of Montenegrin firms do not see informality as a major constraint to business: only 11 percent of the firms surveyed view informality as a major constraint to business.
- *Public sector queuing*: Public sector acts as a safety net. Employment in public sector and SOEs in Montenegro at 32 percent of total employment is comparably high. While there is no evidence on public sector wage premium, except for some occupations in state-owned companies, the jobs are more secure and prestigious, causing queuing.

40. **The labor market is especially difficult for new entrants.** Unemployment rates among new entrants have increased for all levels of educational attainment, though the problem is less severe the higher the level of educational attainment. The share of new entrants with tertiary education who have been unemployed for over two years increased substantially between 2011 and 2013. Unemployment rates among the youth are currently twice as high as in other age brackets. About 40 percent of individuals between 15 and 24 years old are unemployed compared to 20 percent between 25 and 49 years old and 12 percent in the older cohort of 50 to 64 years old. In 2013, the unemployment rate among unskilled workers (those with primary education or less) was 38 percent (Figure 25), compared to 19 percent among the low skilled (those with vocational training and secondary education) and 10 percent among those with a tertiary degree.

---

<sup>27</sup> For references see footnote 8.

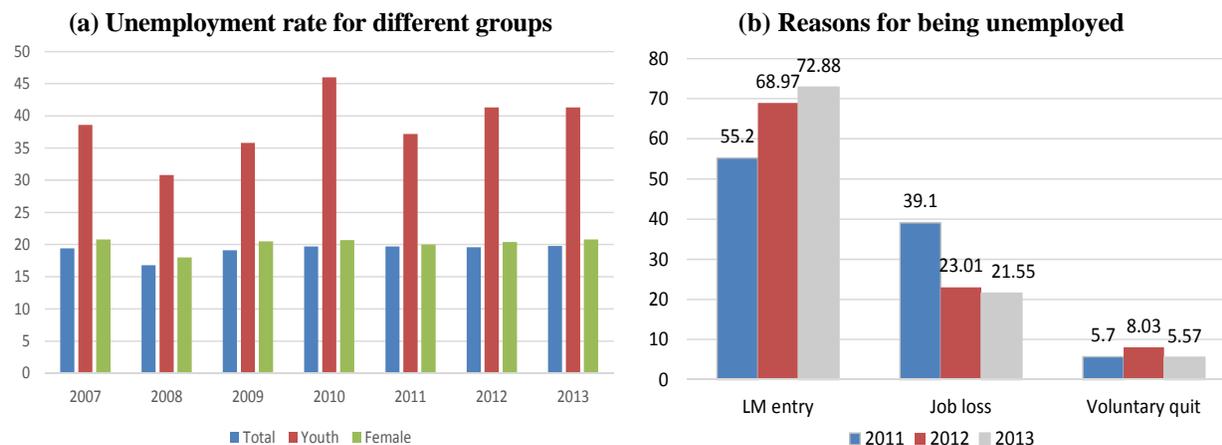
**Figure 25. Lower Educated and New Entrants Face Higher and Longer Unemployment**



Source: LFS 2013.

41. **The vast majority of unemployment is long-term: 77 percent of the unemployed have been looking for a job for over one year.** Finding a job when entering the labor market is proving increasingly difficult and the number of individuals chronically unemployed has been at that level for a longer period of time.<sup>28</sup> Over 70 percent of the unemployed in 2013 were new market entrants (compared to 55 percent in 2011) and 80 percent of them had been looking for a job for over a year (Figure 26). Among individuals with primary or vocational education, the percentage of the unemployed for over 24 months rose to over 85 percent in 2013.

**Figure 26. Unemployment is More Prevalent Amongst Youth and New Entrants in the Labor Market**



Source: World Development Indicators and LFS.

42. **Summarizing, to achieve progress in the twin goals Montenegro needs sustained growth, that generates broad based employment but it also needs to ensure that people can access the employment opportunities that are being created.** Volatility undermines the effectiveness of growth in reduction of poverty, thus the next chapter will look at how to strengthen resilience to shocks. Facilitating private sector development to ensure job creation and increased productivity is essential to the growth model that Montenegro is pursuing. Chapter V will look at what are the existing structural constraint to growth and to the ability of individuals to benefit from this growth. Chapter VI looks at the overarching constraints in governance and rule of law.

<sup>28</sup> Chronically unemployed or long-term unemployed are defined as the unemployed who have been jobless for more than one year.

## IV. STRENGTHENING RESILIENCE TO SHOCKS AND VOLATILITY

*Montenegro as a small state is exposed to vulnerabilities at the macroeconomic level and it has struggled to achieve robust growth post-crisis. While growth in the mid-2000s was comparable to the ECA average, the economy has not seen sustained growth since the 2008 crisis. Vulnerabilities at the macro level have been passed on at the household level. Managing these is necessary to ensure macroeconomic stability, growth of incomes of the population, and sustainability.*

### **Macroeconomic Risks and Fiscal Sustainability**

43. **As a small state and because of its economic structure, Montenegro is exposed to external shocks at the macroeconomic level that lead to high volatility.** Small states have been plagued by highly erratic economic growth, which in the long run impedes growth, worsens income inequality, and increases poverty. During the 2000s, small states have had noticeably higher growth volatility than their larger counterparts—and lower growth rates. Their current accounts are considerably more volatile than those of larger states with similar income levels reflecting higher terms-of-trade volatility. In the fiscal sector, greater volatility is seen in both revenue (linked to greater reliance on trade taxes) and expenditures (often associated with “lumpy” capital spending, spending responses to natural disasters, and a lack of discipline related to weak governing capacity) (Box 3).

#### **Box 3. Managing Volatility in Small States: Lessons Learnt**

The small states are located in many regions of the world.<sup>29</sup> They span the spectrum of income levels with social indicators reflecting a wide range of development. But the one common problem they face are constraints because of their size:

- *Narrow production base.* Although their economies are not uniform, all of them face problems establishing a competitive economic base. And where they do compete, it is typically in one or two goods or services (mainly tourism or financial services), leaving them vulnerable to ups and downs in a handful of industries.
- *Big government.* Measured by the ratio of government expenditures to GDP, small states tend to have bigger governments than do larger states. This is partly a reflection of the diseconomies of scale that make the provision of public goods and services more costly than in larger states. In addition, a large share of expenditures is relatively inflexible—such as those directed to all-too-common natural disasters—or hard to reduce, such as the public wage bill. The high level of expenditure has often led to high levels of debt.
- *Poorly developed financial sector.* Domestic financial sectors lack depth, are concentrated, and do not provide their citizens with adequate access to finance. They are dominated by banks, whose high lending rates often hinder investment. In addition, because the private sectors in small states are so tiny, commercial banks often end up financing the government—risking their soundness by becoming heavily exposed to one borrower. This has also complicated economic policy actions meant to lower the debt.
- *Fixed exchange rates.* Small states are more likely than larger ones to peg their exchange rates to another currency. Many of these small states are closely tied to a handful of larger economies that account for most of their export earnings. The peg eliminates exchange rate volatility, which helps smooth export earnings. At the same time, small states need to hold higher reserves than their larger peers—not only to defend their currencies but also to insulate themselves from adverse outside events. Their ability to conduct monetary policy is also more limited.
- *Trade openness.* Small states are more open to trade. Trade-to-GDP ratios are much larger in smaller economies than in larger ones with similar policies that often leaves the small states vulnerable to shocks from terms of trade. Small states also seem to have somewhat lower trade barriers.

Small states have gone through a deep political and economic transition, which implied development of national institutions and governments. Economically most have gone from producers and exporters of a few agriculture commodities into producers and exporters of services. Public goods and services such as security, well-defined

<sup>29</sup> There are number of small states (around 12) in South America and Caribbean, 15 in Africa, 2 in South Asia, 11 in East Asia and Pacific and around ten in Europe and the Middle East.

property rights, and a stable economic environment after independence had to be provided by national institutions, which had a cost. The cost of developing and running national institutions and governments was augmented by the incapacity to exploit economies of scale in provision of public goods and services and by the costs of transforming agriculture- into service-producing economies.

To the extent that there may be economies of scale in the production of public goods small states may be at a disadvantage in production costs (Table 4). The higher share of government consumption of goods and services in GDP is consistent with this hypothesis; even so, the variation across small states in different regions is also consistent with the view that the State of several small states has served as an employer of last resort. This seems to be the case, especially, in European small states and Montenegro.

**Table 4. Government Consumption to GDP: Small States**

Region	2000	2008	2013
Small Caribbean States	13.5	15.4	16.8
Small South Pacific States	20.8	17.4	...
Small African States	20.9	16.9	16.2
Small European States	18.8	19.5	20.1
Montenegro	21.9	22.6	19.8
Small States Total	18.2	16.9	16.8
Other States Total	14.3	15.0	15.5

Source: Favaro, World Bank database.

institutions on their own.

Aging and migration have been two important phenomena for small states. For Caribbean and European small states, the export of people rather than of goods and services has become increasingly important over time (Table 5). The importance of wage remittances as a percentage of GDP is high and consistent with the importance of migration in the labor market. Further, fast aging observed suggests that these states offer less job opportunities that contributes to migratory outflow and to an increase in dependence ratios in these countries.

From 1981 to 2000, the economic performance of small states measured by the yardstick of the growth rate of GDP per capita (Table 6) was about the same as that of other states, until it started losing strength thereafter. Population size (even when combined with geographic remoteness) has not been an insurmountable constraint

to economic growth; what has mattered has been *economic size* that can be achieved through integration to the rest of the world. Most small states have pursued trade with the rest of the world as a means to enlarge their economic opportunities. This is why their trade to GDP ratios is much higher than in other states (states with population higher than two million people). In 2000-13, the exports performance of small states (with the exception of small European states) has been poorer than that of larger states, including in Montenegro. This may be a transitory phenomenon (reflecting the collapse of the old export sector in many small states and the slow emergence of new activities) or may be a sign of deeper difficulties to develop a competitive export sector and manage volatility.

One of the reasons that explains why small states lag their larger peers is volatility. Small states have been plagued by highly erratic economic growth, which in the long run impedes growth, worsens income inequality, and increases

The response to this development challenge varied considerably. Some countries pooled resources regionally and subcontracted<sup>30</sup> some public service provision from these organizations; others developed national institutions. The strategy followed by small European states to join the European Union is a modality of the outsourcing model. By joining the EU, small and non-small states have adopted (*imported*) aspects of the institutional and regulatory framework of more developed nations in the region; by doing so, these states have probably shortened the time that would have been required to develop these

**Table 5. Migration and Aging: Small States and Other States**

Region	2000	2008	2013	2000	2013
	Workers' Remittances (as % of GDP)			Population 65+ (%)	
Caribbean States	3.7	3.5	4.5	6.7	7.1
African States	2.2	3.0	0.9	3.4	4.1
European States	1.0	4.0	5.7	3.5	3.6
Montenegro	..	6.6	9.6	3.7	3.8
Small States Total	2.6	3.0	2.9	5.4	6.7
Other States Total	0.9	1.4	1.4	4.7	5.5

Source: Favaro, World Bank database.

<sup>30</sup> In general, most states use forms of outsourcing to improve the quality of some public services. States outsource part of their defense budget through international treaties; monetary policy through fixed exchange rate regimes; and aspects of their legal systems by allowing appeals to, for example the United Kingdom Privy Council or arbitration of business disputes in an international court.

poverty. During the 2000s, small states have had noticeably higher growth volatility than their larger counterparts—and lower growth rates. Their current accounts are considerably more volatile than those of larger states with similar income levels reflecting higher terms-of-trade volatility. In the fiscal sector, greater volatility is seen in both revenue (linked to greater reliance on trade taxes) and expenditures (often associated with “lumpy” capital spending, spending responses to natural disasters, and a lack of discipline related to weak governing capacity).

**Table 6. Small States, Montenegro and World Economy**

Region	1981-90	1991-00	2001-08	2009-13	2000	2008	2013
	Growth rate of GDP per capita				Trade to GDP, percent		
Small European States	1.8	0.4	5.4	0.5	114.4	134.3	134.3
Montenegro	--	--	4.7	0.2	87.9	133.5	103.9
Small States Total	1.4	1.8	2.6	0.4	103.2	109.3	103.5
Other States Total	1.1	2.0	3.3	1.8	68.7	82.2	75.6

Source: Favaro, World Bank database.

Small states can compensate for their size-related problems by taking steps to exploit their advantages and offset their disadvantages<sup>31</sup>. Small states can tackle their vulnerabilities. In general, these states should pursue the following:

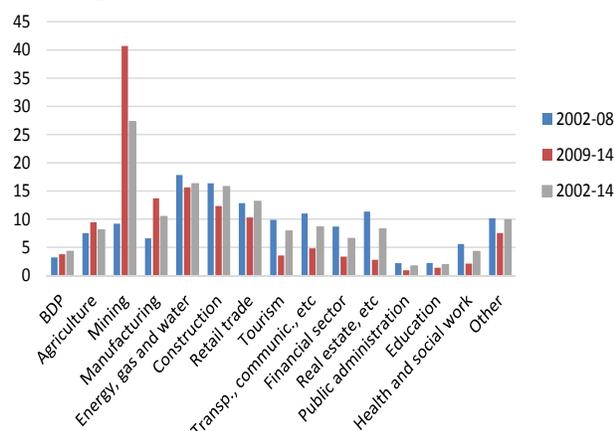
- *Sound economic policies.* The best cure for volatility is prevention through strong policies. For example, revenue volatility can be lessened by reducing dependence on trade taxes. Small states have begun to look at other sources of revenue, and many have successfully adopted value-added taxes. Expenditure volatility can sometimes be reduced through public sector reforms that seek to improve governance and make fundamental structural reforms in the economy. Volatility in the external sector can be reduced by diversifying exports and trading partners. In addition to reducing volatility, small states must foster stability. Steps to increase financial services should be paired with careful supervision by the appropriate legal and supervisory authorities to ensure financial stability. Given their greater exposure to external shocks, small states should accumulate adequate reserves or budget extra spending (fiscal reserves) for potential disasters as well as explore insurance coverage.
- *Regional integration and cooperation.* One way to offset the size disadvantage is to create bigger markets through regional integration.
- *Involvement of the international community.* Small states can also involve international institutions and development partners in identifying common solutions to regional problems. Financial assistance is often crucial for small states. Perhaps most important, international institutions can provide technical assistance and training tailored to the needs of individual states.

Source: Favaro, World Bank.

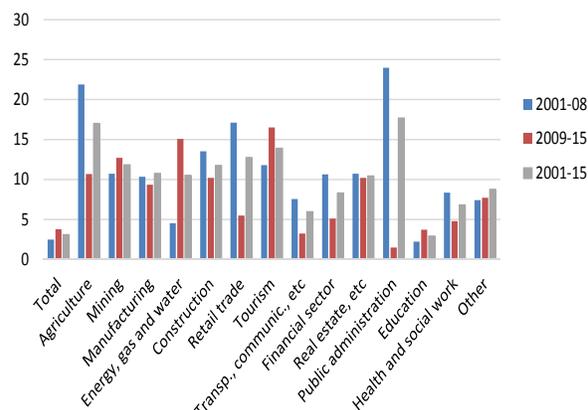
44. **Over the last 15 years, Montenegro has experienced high volatility of its economic sectors as well as in employment** (Figure 27 and Figure 28). These were induced by the massive capital inflow that stimulated consumption, investments and imports during the boom also in sectors that seemed unviable after the crisis. The fast slowdown in inflows exposed the country’s vulnerabilities of the selected growth model: the one that relied on sectors that under the ‘new normal’ could not thrive and compete globally.

<sup>31</sup> Jahan S. and K. Wang (2013). “A Big Question on Small States. Can they overcome their size-related vulnerabilities and grow faster and more consistently?”. Finance & Development. September 2013. This article draws from an IMF Board paper issued in 2013, “Macroeconomic Issues in Small States and Implications for Fund Engagement.

**Figure 27. Sector Value Added Growth Rates Volatility**



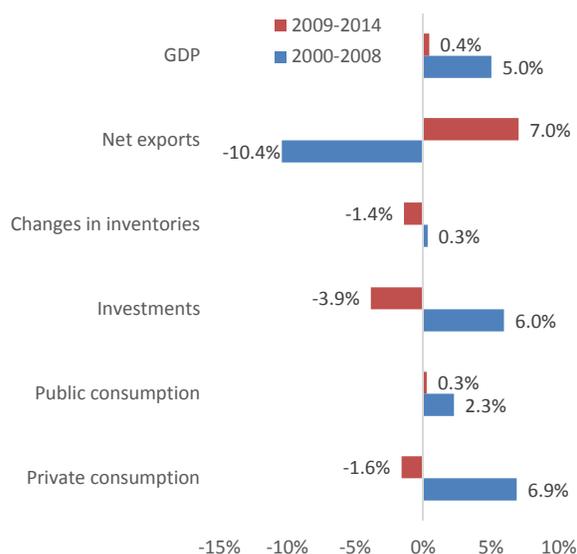
**Figure 28. Employment Growth Volatility**



Source: MONSTAT, World Bank staff calculations.

45. **Montenegrin economy is heavily reliant on imported goods and services; it is also largely vulnerable to changes in global commodity prices.** Both during the economic boom in the pre-crisis period, as well as bust years, imports played a role in reducing the growth in good times and preventing a steeper fall in bad times (Figure 29). During the bust years, a steep fall in imports partially compensated for the negative impact on growth of a fall in household consumption and investment. Underlying this behavior is the fact that investment, consumption and export activities in Montenegro have a high import component. The goods and services consumed, housing residences and utilities built, and goods and services exported are all produced with large share of imported inputs. Thus, changes in global commodity prices will disproportionately impact consumption, investments and competitiveness of the local economy.

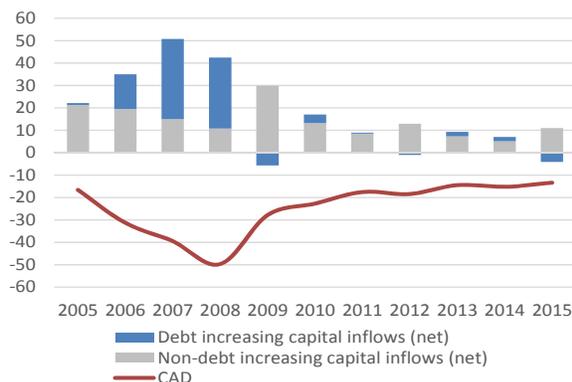
**Figure 29. Demand-Side Sources of Growth in Montenegro, 2000-14**



Source: MONSTAT, World Bank staff calculations.

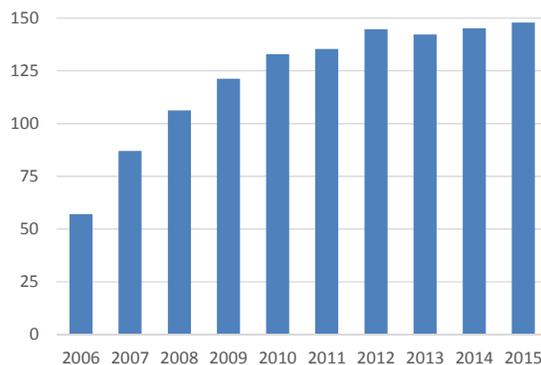
46. **Montenegro's high reliance on capital inflows and tourism to spur economic growth makes it vulnerable to external shocks and geopolitical tensions.** At the peak of the country's growth performance, from 2006 to 2008, Montenegro absorbed on average 28 percent of GDP of foreign capital per year (Figure 30). However, two-thirds of it came in the form of debt creating inflows through banks or company lending. This was also a period when the country's external debt to GDP ratio more than doubled (Figure 31). While the quality of capital inflows improved after the bust, in terms of inflow of non-debt creating flows through FDIs, the external debt continued increasing above 145 percent of GDP as the country still generates high current account deficit at around 14 percent of GDP. This external vulnerability is amplified by the slow pace of economic recovery and current volatility in global markets, including the pressures on the cost of financing. Deleveraging and lower capital inflows may put further pressures on the private sector and households. In addition, much of the financial inflows to Montenegro have been from Russia towards the real estate, which poses a risk to balance-of-payments stability given recent decline in capital inflows by Russian investors.

**Figure 30. Current Account and Capital Inflows, Percent of GDP, 2005-15**



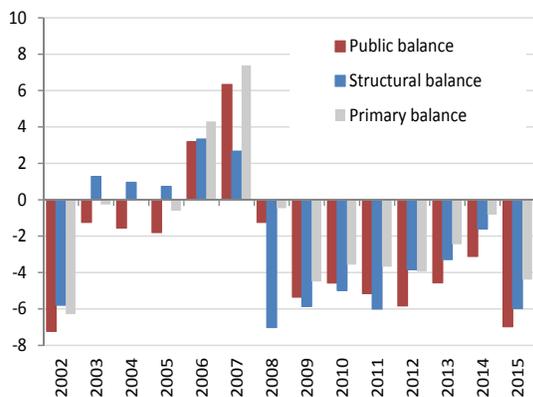
Source: CBCG, MONSTAT, World Bank staff calculations.

**Figure 31. External Debt to GDP Ratio, Percent**



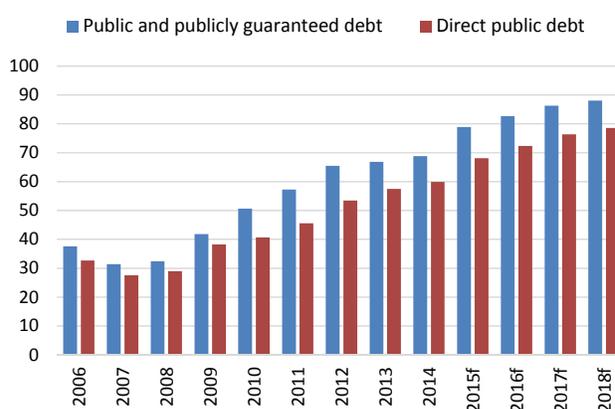
47. **Montenegro depleted the fiscal buffers to use during periods of low demand.** In 2006-08, the years of large positive output gap, Montenegro’s government spending was pro-cyclical, amplifying the already large positive effect of massive capital inflows (Figure 32). Although some of the revenue windfall in this period was used to repay a portion of the old debt, much of the extra revenues was not used to build a contingency reserve fund. Instead, a concomitant rise in spending to above 51 percent of GDP in 2008 left the country exposed to upcoming shock triggered in 2009. The revenues declined by six percentage points of GDP in a single year, while spending adjustment happened slowly (in fact, it still has not adjusted to the ‘new normal’). There was a lost opportunity to save the higher tax revenue collected and build a contingency reserve fund.

**Figure 32. Fiscal Deficits, Percent of GDP**



Source: MoF, MONSTAT, World Bank staff calculations.

**Figure 33. Public Debt and Guarantees, Percent of GDP**



48. **What followed was a severe spending restraint to regain market confidence and fund normal functioning of the country.** By 2011, the government had cut total public spending by 6.5 percentage points of GDP from its peak in 2008 of over 51 percent of GDP. This was done through a freeze in public sector wages, staffing rationalization, and restraint in operations and maintenance costs as well as cut in capital investments. This was done in parallel to repayment of over 5 percentage points of GDP in guarantees to metal industry. By 2014, the government has also strengthened its revenue base and tax collection raising revenues by 5 percentage points of GDP from its low of 39.5 percent of GDP in 2011.

49. **However, despite the government current spending restraints and revenue measures in the 2010-2014 period, public debt doubled since 2008 and overall spending remains elevated.** Fiscal deficit

averaged 5.1 percent of GDP in the 2009-15 period (Figure 32). Moreover, primary deficit averaged 3.4 percent of GDP during the last seven years, leading to a sharp rise in public debt. Montenegro's public debt has doubled since 2008 to above 68 percent of GDP in 2015 (Figure 33). At end-2015 public debt stood at EUR2.4 billion, of which 86 percent was held externally. Additionally, there are issued sovereign guarantees in the amount of 10 percent of GDP that create contingent liability to the state. Most of them are issued to support state-owned companies financing, after the ones to KAP (a private company) and a steel mill have been fully repaid by the state.

50. **The government has also accumulated sizable payment arrears, estimated at close to 11 percent of GDP at end-2014.** Of this, around 80 percent are municipalities' accumulated arrears which adversely affect private sector liquidity and payments discipline and have also impacted banks' abilities to reduce their NPLs. Efforts are currently under way to institute a contract control system, while building the commitment control in the treasury to prevent their recurrence.

51. **Currency risk is limited but is likely to rise.** In Montenegro, around 10 percent of total debt is denominated in foreign currency. Since less than half of foreign currency liabilities (or less than 2 percent of GDP) are dollar denominated, appreciation of the dollar against the euro in 2014 has had a limited impact on Montenegrin public debt (around 0.5 percent of GDP). However, in October 2014, Montenegro agreed to a USD 944.0 million (around 23 percent of the 2014 GDP or 85 percent of the construction value) highway loan with the Chinese Exim Bank<sup>32</sup>. An equal 4-year disbursement profile based on a pre-agreed fixed exchange rate, in case of future fluctuations in the EUR/USD exchange rate would affect the burden of loan repayment. The Ministry of Finance has been exploring options for hedging this risk.

## Growth and Sustainability Prospects

52. **The Government medium-term fiscal framework for 2016-18 suggests further rise in fiscal deficit underpinned by large capital investments and further consolidation of current spending** (Table 7). The Ministry of Finance announced a set of fiscal measures to achieve current spending consolidation: (i) public sector wage system rationalization; (ii) further harmonization of the excise tax on cigarettes; (iii) stricter sanctioning of tax non-payers and fight against informal economy; (iv) new pension indexation and streamlining early retirement options; (v) collection of tax debt through debt-equity swaps and offering a discount for one-time settlement; and (vi) improving the regulatory framework for public procurement.

53. **Achieving sustainable public finances will require ambitious fiscal consolidation in the medium term.** Fiscal deficits for the next three years are swollen by capital spending on the highway project. While earlier medium-term fiscal plans suggested public debt containment once the highway disbursements are over (in 2019), more recent measures, such as the introduction of lifetime benefits for mothers of three and more children, the rise in minimum pensions and wages, and the potential new financing of large infrastructure projects, raise concerns about the ability to sustain fiscal discipline in the medium term. Fiscal plans are also vulnerable to potential cost overruns related to the Bar-Boljare highway construction. A reduction in current expenditures equivalent to around 2 percent of GDP is already anticipated by 2019 – albeit undefined – in the Government's fiscal framework. This is likely to be an underestimate of the actual adjustment needed, for several reasons:

---

<sup>32</sup> At end-October 2014, the Government and China EXIM bank signed the financing contract for highway construction of EUR687 million. This has followed signing of the construction contract in February 2014, and EXIM bank approval of the draft financing contract in September 2014. There are five sections of the Bar-Boljare highway, of which this contract covers only section 3 (3a and 3b) totaling 41 km. The overall cost is EUR809.6 million, of which 85 percent will be covered by the EXIM bank loan. The remaining EUR120 million for the project will be provided through the budget over the expected period of construction (4 years). Domestic firms are expected to contract around 30 percent of the overall project cost. It is estimated that app. 4,000 new workers will be employed over the course of the construction period. Furthermore, the Law on Highway enacted by the Parliament in November allows for a full tax exemption of civil works, labor, and highway-related import by the Chinese construction companies.

- Montenegro's elevated (public and external) fiscal and debt levels are highly sensitive to shocks (related to real GDP growth, financing costs, contingent liabilities, primary balance, exchange rate and most notably to an overrun in financing costs associated with the highway).<sup>33</sup> Under each of these scenarios, debt levels and financing needs far exceed those assumed by the authorities.
- Debt exposure to the US dollar-denominated highway loan (USD944 million signed in 2014) present risks to public finances at the time of loan repayment.
- The recent social (pension and new lifetime benefit for mothers of three and more children increases) and public wage (an increase in the coefficients of professional and managerial staff to allow for wage decompression) policy measures are estimated to contribute more than 2 percentage points of GDP in additional spending on top of Government's initial medium-term fiscal framework as presented in Table 7.
- Historical performance suggests that government deficit targets are typically missed by a large margin (2-3 percentage points of GDP on average per year since 2008) due to over-commitments (public arrears estimated at close to 11 percent of GDP) and contingent liabilities (like guarantees repayment or court suits).

**Table 7. Medium-Term Fiscal Framework, Percent of GDP**

	Outturn 2012	Outturn 2013	Outturn 2014	Preliminary 2015	Projection 2016	Projection 2017	Projection 2018
<b>Total Revenues and Grants</b>	<b>40.9</b>	<b>42.3</b>	<b>44.6</b>	<b>42.4</b>	<b>43.7</b>	<b>42.1</b>	<b>41.1</b>
<b>Current Revenues</b>	<b>40.7</b>	<b>42.0</b>	<b>44.3</b>	<b>42.2</b>	<b>42.8</b>	<b>41.6</b>	<b>40.8</b>
Tax Revenues	36.1	37.5	40.3	38.3	38.5	38.0	37.3
Nontax Revenues	4.6	4.5	4.0	3.9	4.3	3.6	3.5
<b>Grants</b>	<b>0.2</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.9</b>	<b>0.4</b>	<b>0.3</b>
<b>Total Expenditure and Net Lending</b>	<b>46.8</b>	<b>46.9</b>	<b>47.7</b>	<b>49.4</b>	<b>49.9</b>	<b>48.4</b>	<b>46.7</b>
<b>Current Expenditure</b>	<b>42.4</b>	<b>43.4</b>	<b>42.5</b>	<b>41.0</b>	<b>38.9</b>	<b>37.9</b>	<b>36.8</b>
Wage Bill	14.1	12.4	12.7	12.2	12.4	11.9	11.5
Other purchases of G&S	7.4	7.0	8.4	7.0	4.7	4.5	4.4
Interest payments	1.9	2.1	2.3	2.3	2.1	2.5	2.4
Subsidies and current transfers	19.0	21.8	19.1	19.5	19.6	18.9	18.5
<b>Capital Expenditure</b>	<b>4.3</b>	<b>3.6</b>	<b>5.3</b>	<b>8.5</b>	<b>11.1</b>	<b>10.6</b>	<b>10.0</b>
<b>Net Lending</b>	<b>0.1</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.1</b>
Current Surplus/Deficit	-1.7	-1.3	1.8	1.2	4.0	3.7	4.1
Primary Surplus/Deficit	-4.0	-2.4	-0.8	-4.7	-4.1	-3.8	-3.1
<b>Overall Surplus/Deficit</b>	<b>-5.8</b>	<b>-4.6</b>	<b>-3.1</b>	<b>-7.0</b>	<b>-6.2</b>	<b>-6.4</b>	<b>-5.6</b>
<b>Total Financing</b>	<b>5.8</b>	<b>4.6</b>	<b>3.1</b>	<b>7.0</b>	<b>6.2</b>	<b>6.4</b>	<b>5.6</b>
Domestic financing (net)	-2.2	-3.2	-3.4	-4.7	-2.8	-2.1	-1.8
Privatization receipts	0.4	0.8	0.4	0.3	0.1	0.2	0.1
Foreign financing (net)	6.2	4.8	2.8	9.2	8.9	8.3	7.3
Increase in payment arrears (+)	1.4	2.2	3.2	2.2	0.0	0.0	0.0

Source: MoF, MONSTAT, World Bank staff calculations.

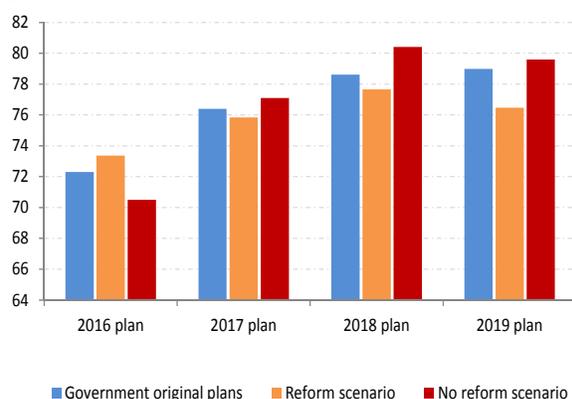
54. **Public debt will trend upwards in the coming years as the government continues disbursing the highway construction loan** (Figure 34). Even under the government medium-term fiscal scenario, public debt will grow to 79 percent of GDP by 2019. Under the current policies scenario, public debt is estimated to

<sup>33</sup> See details in the public debt and external debt sustainability analyses presented in IMF (2016) Montenegro: Article IV Staff report.

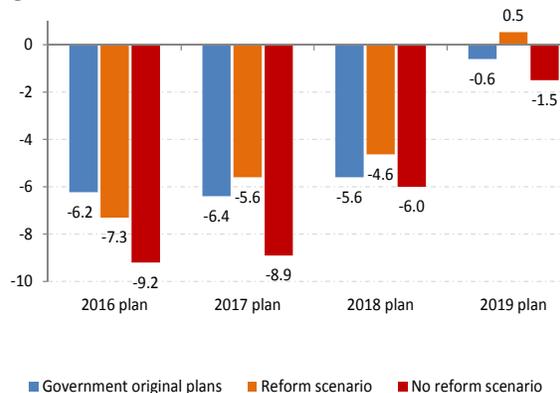
peak in 2018 at close to 80 percent of GDP, before stabilizing. However, this is based on the assumption that the highway construction would end by 2018 and that deficit will be around 8 percent of GDP in the 2016-18 period. There are number of additional risks to this scenario. The largest comes from a potential growth shock. If growth stagnates in the 2016-2020 period instead of expected over 3.5 percent average growth per year, public debt to GDP ratio would surge even further to close to 90 percent of GDP.

55. **Even without additional shocks, public financing needs would remain high in the medium term and would require a careful debt management** (Figure 34). Although sovereign credit rating currently stands at four notches below the investment grade,<sup>34</sup> positive spillover effects from the European Central Bank’s monetary easing improved financing conditions for external borrowing.<sup>35</sup> However, financing conditions tightened since by almost 200 basis points, thus creating additional pressure on deficit and debt. Even before the planned spending expansion, Montenegro had comparatively larger size of the state than most of its peers. This on the other hand required increasing taxes as the deficit and subsequently public debt has been on the rise. With the capital spending at over 9 percent of GDP over the next four years, the recent attempts to lower the cost of the state will be largely reversed.

**Figure 34. Gross Public Debt, Percent of GDP**



**Figure 35. Fiscal Deficit, Percent of GDP**



*Note:* The “no reform” scenario is based on estimates in the 2016 Article IV IMF Staff Report), and the possible reform scenario has been jointly agreed between the World Bank and the IMF.

*Source:* MoF, WB staff calculations.

56. **To meet the Government’s initial medium-term fiscal target and place public debt firmly on a downward trajectory, the country will need to undertake substantial fiscal consolidation** (Figure 35). Fiscal adjustment of 2-2.5 percent of GDP annually, along with investment contraction after the end of the highway project, will reduce public debt in 2019 to a still high 75 percent of GDP, as presented in the reform scenario. To put public finances on a sustainable footing, a primary surplus of about 3 percent of GDP (given the rising interest payments and amortization in 2019 and after) is needed in 2019 to reverse the rising public debt dynamics. In the absence of consolidation (no-reform scenario as presented in the 2016 Article IV IMF Staff Report and in Figure 34 and Figure 35 above), public debt would continue to rise towards 80 percent of

<sup>34</sup> Moody’s outlook was revised to negative, while S&P downgraded the long-run rating from BB- to B+ with a stable outlook. Future downgrades are possible if: (i) fiscal metrics deteriorate further than currently envisaged (5 percent of GDP in 2015 and 4 percent thereafter) from cost overruns related to the highway construction, further costs incurred in relation with KAP legal proceedings and restructuring, or a loosening of the fiscal stance, potentially from expenditure overruns from lower levels of government; (ii) the country finds it harder to roll over its external debt (in 2015 and 2016 around EUR600 million); (iii) large-scale FDI projects stall or do not materialize at all.

<sup>35</sup> In March 2015, the Montenegrin government issued a 5-year bond worth EUR500 million at a rate of 3.87 percent in order to refinance about EUR399 million of 5-year Eurobonds issued in 2010 at a rate of 7.85 percent, to cover the budget deficit (EUR30 million), and to settle healthcare arrears (about EUR36 million).

GDP in the forecasting period, exacerbating in turn, Montenegro's financing needs. The country's vulnerability to shocks, the lack of independent monetary policy, and the structural rigidities of the economy further support the case for imminent fiscal consolidation.

57. **To maintain market access and limit the risks to public finances, policies on the expenditure and revenue side can be pursued.** A reversal of recent policy measures related to rise of social transfers and public sector wage bill, as well as savings on other operational costs, prioritization of public investment decisions, further revenue mobilization and reducing tax expenditures are among the efforts that could have a sustained positive impact on fiscal balances in the medium term and help reverse the growing public debt dynamics. Such measures, if well designed, can bring the estimated average adjustment of 2-2.5 percent of GDP annually by 2019. Strong political will in the face of social pressures will be needed to implement such an ambitious program of fiscal consolidation, aimed at creating the long-term macro-fiscal conditions for higher levels of growth and employment creation.

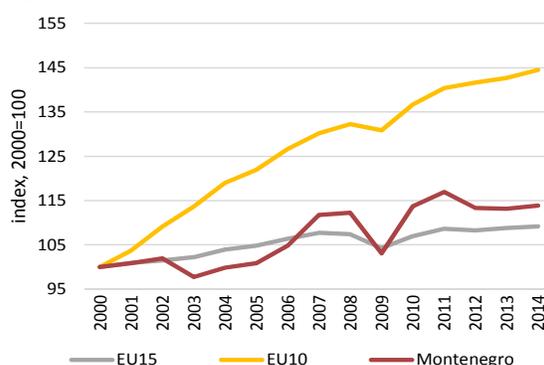
58. **External imbalances are also expected to increase further.** Rising imports related to highway construction would substantially raise external imbalances over a four-year period of planned construction. The current account deficit will widen to close to 20 percent of GDP, given the limited capacity of local economy to deliver adequate labor and material resources. By raising external imbalances and foreign borrowing needs, the highway project will erode Montenegro's ability to deal with fiscal and external shocks.

59. **To capture part of the income generated by the new capital investments, Montenegro has to work hard at developing its capacity to compete with foreign sourced inputs and to develop the skills for Montenegrin workers to compete for the jobs created in the new activities.** The massive capital accumulation during the past decade will increase GDP, but may not necessarily increase the country's GNP. In some of these activities, for example tourism, the flow of income resulting from the additions to the capital stock will depend on an increase in the number of tourist arrivals; the total effect on the Montenegrin economy will depend also on businesses that develop in parallel to the new hotels and shopping centers: restaurants, entertainment, travel guides etc. In an extreme case the GNP may not change at all if all inputs complementary to the initial investment are sourced abroad and the waiters, cooks, and most employees working in the new hotels and tourist facilities are foreign residents.

60. **Montenegro appears relatively costly compared to its peers.** Labor costs are high relative to Western Balkan, but also some of the new EU Member States (EU10). At the same time, productivity has been almost stagnant since the crisis outbreak, unlike in the EU10. More flexibility in wage negotiations and delinking the public sector wage setting mechanism from the private sector should allow real wages to adjust in line with productivity. The IMF estimates that the current account deficit of 7–8 percentage points of GDP (once corrected for E&O) could imply a real exchange rate imbalance of around 15–25 percent.<sup>36</sup> Given the euroization of the economy, internal devaluation through reducing the costs of doing business would be needed to increase the country's competitiveness and thus potential growth.

61. **Summarizing, the current context Montenegro is facing is challenging for sustainable growth and especially to the income of unskilled workers.** Against this background Montenegro has been able to withstand a change in international capital inflows of about 35 percentage points of the GDP in the past four years without experiencing a deep recession

**Figure 36. Labor Productivity, EU and Montenegro**



Source: MONSTAT, EUROSTAT, WB staff calculations.

<sup>36</sup> <http://www.imf.org/external/pubs/ft/scr/2016/cr1679.pdf>

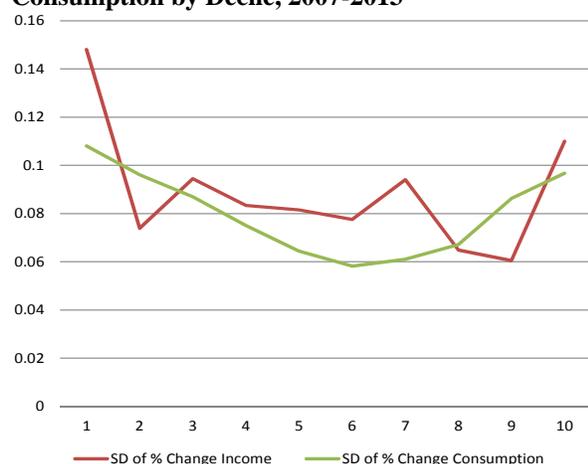
of the type described by Calvo et. at (2010). Even in a contractionary external context it is possible for a small state like Montenegro to navigate the current storm. The smoothness of the transition will depend on a realistic assessment of existing external and domestic challenges (especially in the fiscal and financial sectors); on improvements in the stocks of physical and human capital; on gradually absorbing the cost of a still incomplete transition from socialism to markets; and on strengthening a still fledgling private sector.

### *Social Sustainability and Exclusion*

62. **Volatility at the macro level is matched by a volatile micro scenario for the poor in particular.** Income and consumption are more volatile for the poorest and the richest quintiles. Income and consumption have changed substantially from one year to the other (Figure 37). Between 2007 and 2013, consumption has been less volatile than income for all quintiles but the second and ninth deciles. Lower volatility in consumption than in income is what one would expect given that it is optimal for individuals to smooth consumption as much as possible. However, this smoothing is made difficult if individuals are unable to save or do not have sufficient mechanisms to do that.

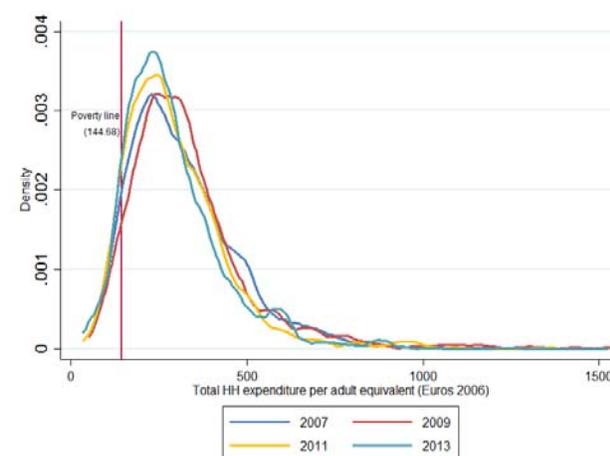
63. **Poverty is very volatile as there is a high mass of households around the poverty line and this has been growing since 2009** (Figure 38). Given the distribution of households around the poverty line, small changes in consumption by those around the poverty line will cause a lot of people to either leave or enter poverty.

**Figure 37. Volatility of Changes in Income and Consumption by Decile, 2007-2013**



Source: World Bank staff calculations using HBS 2007-13.

**Figure 38. Density Function of Household Expenditure**

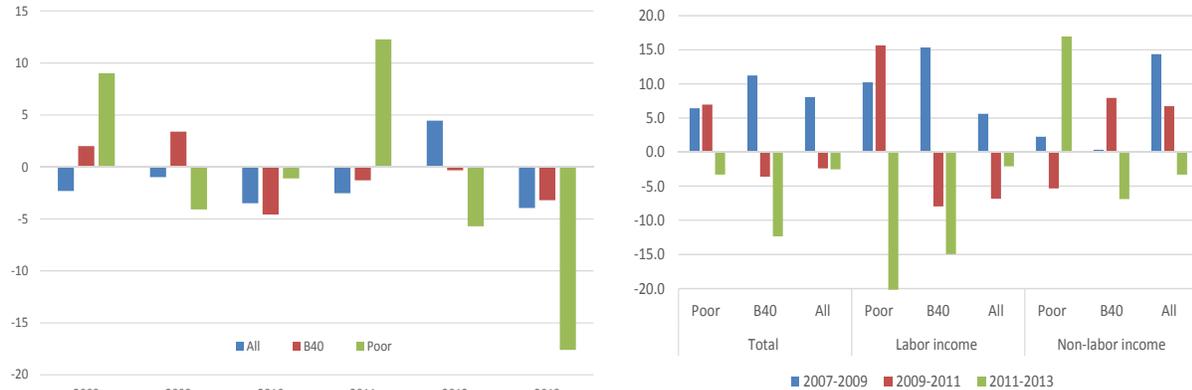


64. **Labor income is more volatile than non-labor income for the poor and the bottom 40** (Figure 39). On average, labor income and non-labor income have a similar level of volatility (measured in terms of standard deviation). However, for the poor and the bottom 40 labor income is more volatile than non-labor income, while the reverse is true for the non-poor and the top 60. Within labor income, wages are the most volatile component for the non-poor (and for the bottom 40), whereas agricultural income is the one exhibiting the highest level of volatility for the poor.

65. **Growth in non-labor income seems to have compensated for the reduction in labor income of the poor but not the bottom 40** (Figure 40). Growth in labor income has been more volatile for the poor and bottom 40. The swing in growth of labor income have been more marked for the poor and bottom 40 than for the average. The poor saw their labor income increase substantially between 2007 and 2011, with wages constantly increasing up to 2010 and agricultural income alternating years of high growth to years of substantial reduction. Labor income decreased substantially between 2011 and 2013, led by a reduction in income from business and agricultural income and despite positive growth in wages. Non-labor income grew slightly between 2007 and 2009 with social assistance high growth in 2009 driving the overall growth. The

decrease of non-labor income in 2009-2011 was due to a substantial reduction in income from pensions that was not compensated by an increase in income from social assistance. Finally, the large growth in non-labor income in the last period of available data, 2001-2013, was due to increases in both pensions and social assistance.

**Figure 39. Change in Share of Labor Income in Total Income** **Figure 40. Average Growth in Income Sources**

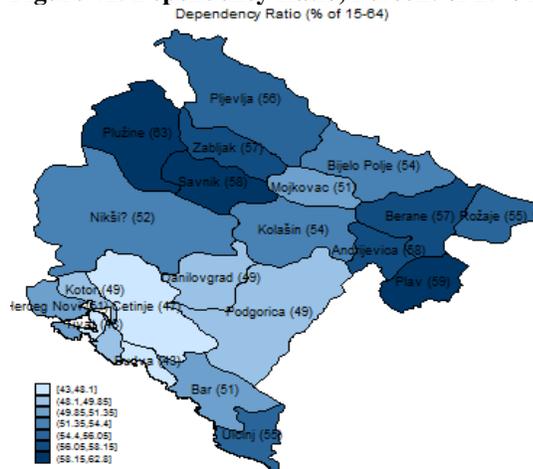


Source: World Bank staff calculations using HBS 2007-13.

66. **At the same time, social spending pressures are increasing.** Given persistently high unemployment, pressure on social safety nets has increased at a time when fiscal resources to provide support to the poor and vulnerable are more limited. There are also longer-term pressures on pensions and health care due to an aging population. Montenegro already allocates around 11 percent of GDP to pensions alone, while early retirement creates further pressures on fiscal sustainability of the system, but also on the already comparatively low labor force participation. Additional 1 percent of GDP in spending for a lifetime benefit for mothers of three and more children introduced from January 2016 will crowd out other better targeted spending. Chapter 6 presents the fiscal analysis on pension and health care spending.

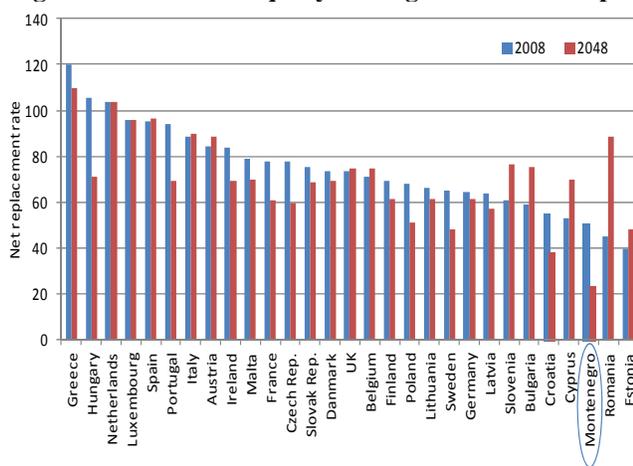
67. **Households face limited pension adequacy in the future due to early retirement.** Aging is occurring (by 2050, there will be 80,000 fewer working age adults), and the dependency ratio is already high, in particular in the north (Figure 41). Future adequacy is among the lowest in Europe (Figure 42).

**Figure 41. Dependency Ratio, Percent of 15-64**



Source: MONSTAT, EUROSTAT, World Bank staff calculations.

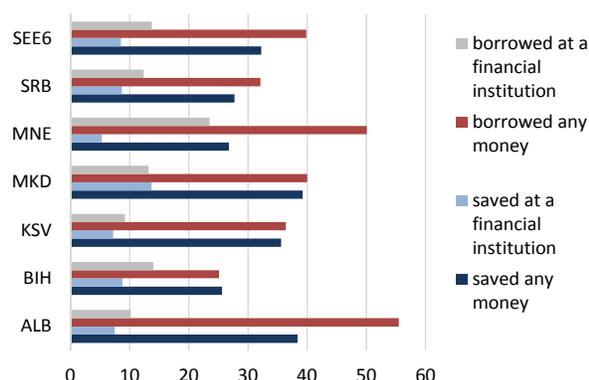
**Figure 42. Future Adequacy Among Lowest in Europe**



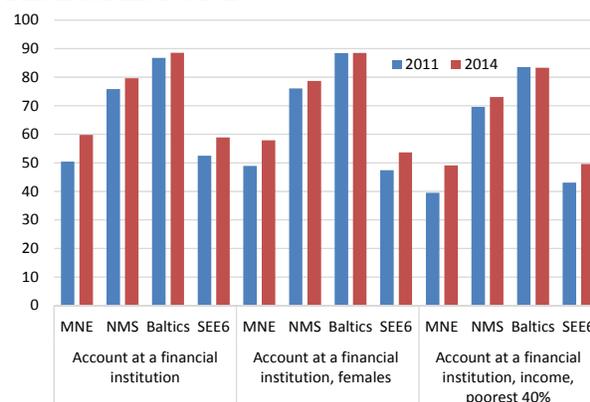
68. **At the same time, the use of savings remains one of the lowest in the region according to the**

**World Bank Global Findex Database.** Lending services have a high outreach compared to regional peers at 23.5 percent of adults getting a loan at a formal financial institution in the past year. However, the usage of saving services are low with only 5.3 percent of adults reporting saving at a formal financial institution (out of 26.8 percent which claimed to have saved any money) in the past year compared to the regional average of 8.5 percent (Figure 43)<sup>37</sup>.

**Figure 43. Adults (15+) that saved any money in the past year, 2014**



**Figure 44. Adults (15+) with an Account at a Formal Financial Institution**



Source: FINDEX 2014.

69. **While access to financial services in Montenegro has been improving in the last couple of years it remains relatively low compared to levels in the new member states (NMS)<sup>38</sup>.** With 59.8 percent of adults reporting having an account at a formal financial institution (a bank, credit union, cooperative, post office, or microfinance institution), access to finance rates have improved by 10 percent, similar to other countries in the region. However, compared to the NMS where on average about 80 percent maintain a bank account, the degree of individual financial penetration is relatively low (Figure 44). There are many differences across income groups and individual characteristics within population.

70. **Although financial deepening advanced, the poor did not benefit from it much and there is also disparity in account penetration by the gender, level of education and location.** The bottom 40 percent are less likely to have a financial account (49 percent of the bottom 40 percent having access to some kind of financial institution, compared to 67.5 percent among the top 60), indicating a particularly large gap in financial inclusion between rich and poor in Montenegro. Women are more constrained in access to finance but the gender gap is not so significant compared to that of some neighboring countries like Kosovo and Bosnia and Herzegovina. The existence of difference in account penetration between population living in rural and urban areas is one of the highest in the SEE6 region. Not surprisingly, adults with a secondary or higher education are on average more than twice as likely to have an account as those with primary education or less, which underscore the importance of education, especially financial literacy, in expanding financial inclusion.

71. **Persistently high unemployment presents a serious concern for policy makers and adds to the concerns of future income adequacy.** Unemployment in the Western Balkans has been historically high and increased significantly during the global economic crisis. Montenegro was not an exception. The employment rate continues to be very low; with about 44 percent of the working-age population in gainful employment. Of particular concern is the high level of long-term unemployment and precarious work. A vast majority of the unemployed youth has been so for a long time. Compounding the conditions for young people is the fact that they are often employed only in part-time, precarious work. Over 60 percent of youth (ages 15-24) have

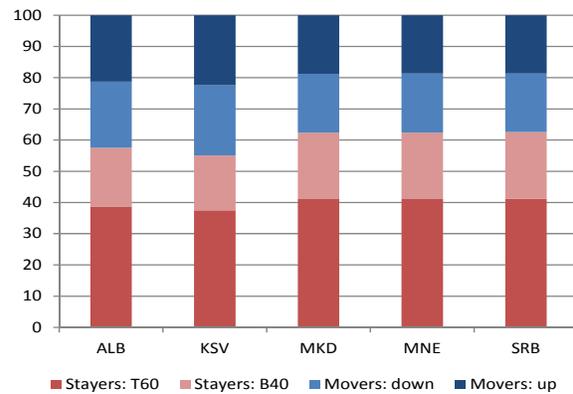
<sup>37</sup> The Central Bank of Montenegro suggests this number is too low.

<sup>38</sup> New Member States are countries that joined the EU since 2004.

a temporary contract, compared to 24 percent of workers between 25 and 54 years old. This compares to Croatia’s 51 percent and Slovenia’s around 35 percent.

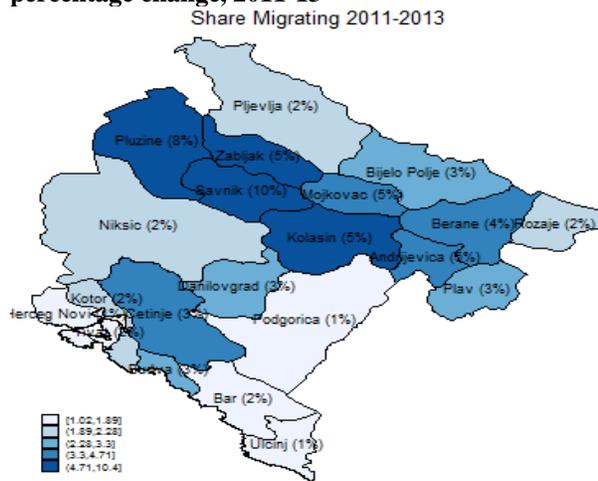
72. **The bottom 40 percent is more vulnerable to setbacks given that they can count on fewer assets to cope with shocks.** The bottom 40 percent count on fewer assets—including social capital—to protect themselves. They tend to be more vulnerable since they have fewer coping mechanisms (e.g. limited access to credit and private transfers). As a result, households in the bottom 40 percent are more likely to suffer large income changes across years. Indeed, volatility in income (measured in terms of standard deviation) is fifty percent higher for the bottom 40 than top 60, while consumption is 25 percent higher. Vulnerability seems to affect, however, all groups: evidence shows high flows in and out the top 60 percent and bottom 40 percent (Figure 45). Overall, high vulnerability to setbacks will affect the ability of individuals to accumulate, use and receive returns to their assets either from lack of certainty about the future or from limited capacity to weather shocks<sup>39</sup>.

**Figure 45. Economic Mobility**



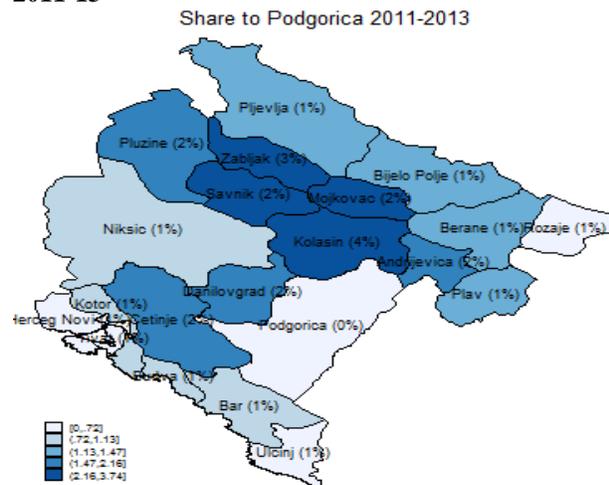
Source: World Bank staff calculations.

**Figure 46. Migration out of Municipalities, percentage change, 2011-13**



Source: MONSTAT, World Bank staff calculations.

**Figure 47. Migration to Capital, percentage change 2011-13**



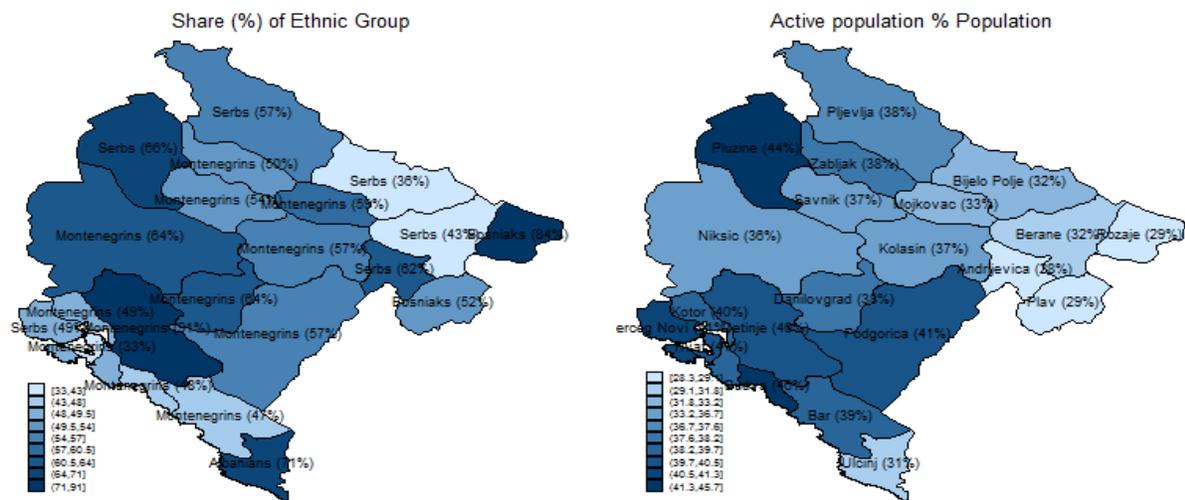
73. **Increasing dependency ratios in some municipalities will continue to burden household budgets, pension balances, and the social system.** According to the census and administrative sources, between 2006 and 2011 the ratio of dependent age residents to prime working age residents in Pluzine increased by 5 percentage points, while Niksic, Podgorica and other Central municipalities experienced declines in dependency ratios. The Northern region will continue to underperform and become more dependent on pensions and social transfers, while the central and southern regions largely stand to benefit from improving demographic trends. Though an imperfect measure, new registrations in the central and southern municipalities came at the expense of canceled registrations in the northern municipalities (Figure 46). More sparsely populated areas in Pluzine and Savnik were most remarkable in these trends though caution

<sup>39</sup> Ceriani, L. and M. E. Dávalos (2014). “First Insights into Promoting Shared Prosperity in South East Europe”, February

should be used when interpreting the results, given the small number of observations. Municipalities receiving the largest share of migrants include Niksic and Podgorica (Figure 47).

74. **Development strategies focusing on individual economic sectors will have implications along regional and ethnic dimensions.** People who self-identify as exclusively Montenegrin – the most numerous group according to the Census data with 45 percent of the total – are concentrated in the center, west, and south of Montenegro. These areas have a larger share of the population active in the labor force on average, and are also where the majority of the financial, commercial, and entertainment industries are based. This part of the country is also where the communication and information industry is most predominant. As a share of the population in each region, relatively more Serbs (29 percent of the total population) live in the north of the country—an area which has a higher concentration of people out of the labor force. Agricultural employment is substantially more common in the north. A large share of the population in the northeast of the country self-identifies as Bosniak, the third largest ethnicity in Montenegro at 8.5 percent of the population (Figure 48). Service sector jobs contribute a comparatively larger share of employment in the northeast.

**Figure 48. Ethnic Structure and Activity Rates per Municipalities**

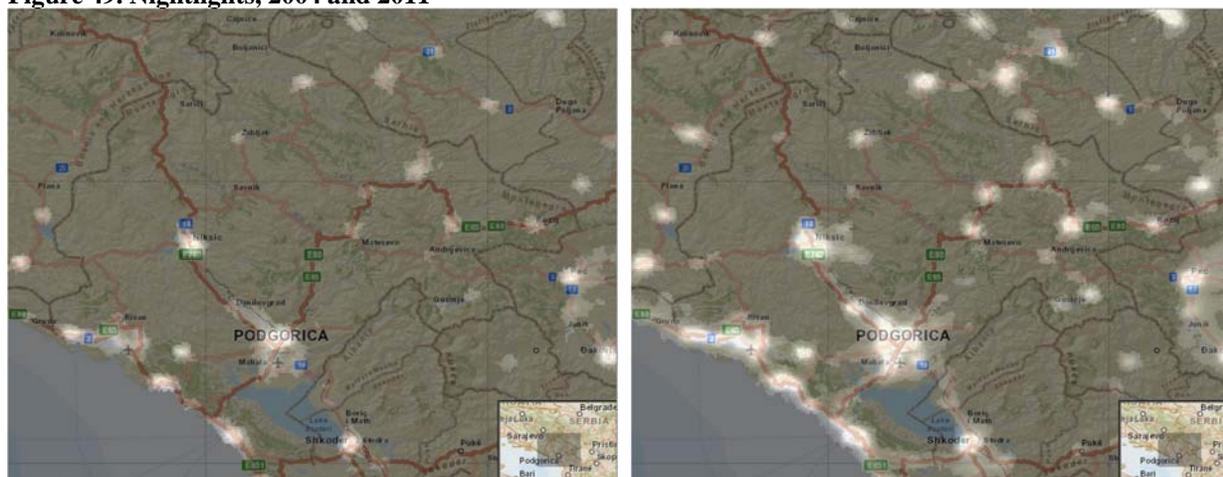


Source: MONSTAT, World Bank staff calculations.

75. **The change in the view of night-lights in Montenegro between 2004 and 2011 underscores the spatial inequities in the country** (Figure 49). Economic growth around Podgorica is clearly visible, as is growth in the Coastal region. The continued darkness over substantial sections of the country, in particular the north, reflects the fact that some parts of the country have either benefited only slightly from economic growth, or were so far behind the others that recent growth has not been enough for them to catch up, or regions where there are disperse populations to which it is hard to provide services (including but not limited to electricity).

76. **In a small country like Montenegro with substantial spatial inequalities in terms of economic activity and outcomes, strengthening and facilitating labor mobility is essential.** Given the economic opportunities are not uniformly distributed across the country, there can be positive gains in earnings for those who move internally, especially in a small country like Montenegro. Migration can play an important role in family survival strategies.

**Figure 49. Nightlights, 2004 and 2011**



Source: [www.blue-marble.de](http://www.blue-marble.de)

77. **There are persistent differences in poverty rates in geographical terms but also in relation to specific groups, including Roma, Ashkaelia, and Egyptians (RAE) who are particularly vulnerable in Montenegro.** According to the 2010 Census, approximately one percent of the population in Montenegro self-identifies as Roma, but expert estimates suggest that between 15,000 and 25,000 Roma reside in Montenegro, with a mean estimate of about 3 percent of the population.<sup>40</sup> The majority resides in Podgorica, Bijelo and Berane, while another sizable share lives along the coast. A 2009 UNDP report found that among RAE groups, more than 14 percent were “excluded” according a Social Exclusion Index (SEI),<sup>41</sup> much higher than the national rate of 3.5 percent. The same report details that some 25 percent of the RAE population had unresolved status in Montenegro and lacked identity documents. Many therefore had limited access to public services, and only 18.4 percent of RAE families received allowances or other social benefits. About 38 percent of RAE owned their houses in 2009, while 50 percent lived in illegally-built structures mainly in city suburbs. Only around 20 percent were employed, while 36 percent had no education and 72 percent were illiterate.

78. **The Government of Montenegro has recently adopted and reformed policies to address social exclusion.** The law on social and child protection was approved in 2013, and a government decree was adopted in early 2014 to set up an institute for social and child protection.<sup>42</sup> The government also adopted the National Action Plan (NAP) for the Implementation of “The Decade of Roma Inclusion 2005/2015” in Montenegro, which was well received by the international community. Despite these advances, there remain significant problems in coordination of these policies, and more effective monitoring is needed.

#### **Box 4. Multidimensional Indicator of Poverty**

Non-monetary poverty indexes are complimentary to more traditional poverty measurement approaches, which use either consumption or income (in the case of Montenegro the national poverty measurement method uses consumption). The objective of using a multidimensional approach is to recognize deprivations and vulnerability which commonly define social concepts of poverty – particularly with respect a lack of access to basic needs – but

<sup>40</sup> Council of Europe, 2012. <http://www.coe.int/en/web/portal/roma/>

<sup>41</sup> Households are considered vulnerable/excluded if their incomes are low (in poverty), they have difficulty in paying utility, mortgage or any other bills and are in arrears, and if they have insufficient access to health services. Individuals are considered as vulnerable/socially excluded if they are unemployed or are employed but social contributions are not paid, if they have less than 8 years of schooling and are no longer in education, and if they have insufficient access to health services.

<sup>42</sup> [http://ec.europa.eu/enlargement/pdf/key\\_documents/2014/20141008-montenegro-progress-report\\_en.pdf](http://ec.europa.eu/enlargement/pdf/key_documents/2014/20141008-montenegro-progress-report_en.pdf)

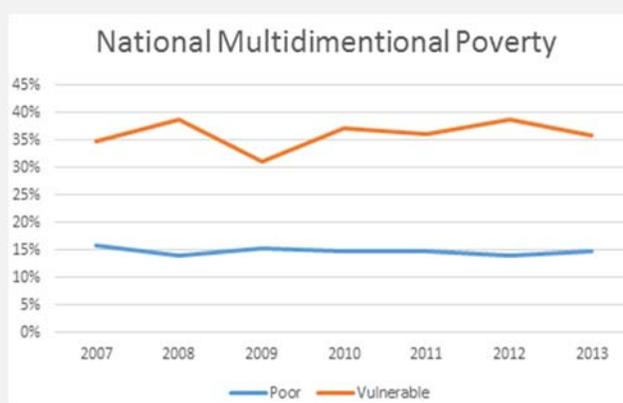
cannot be directly captured in a monetary measure. Attributes of households which can intensify the severity of the experience of poverty, such as living in a household with a young household head, or with retired household members, can also be included in the index to highlight the concern that deprivations are more deleterious for some households than others.

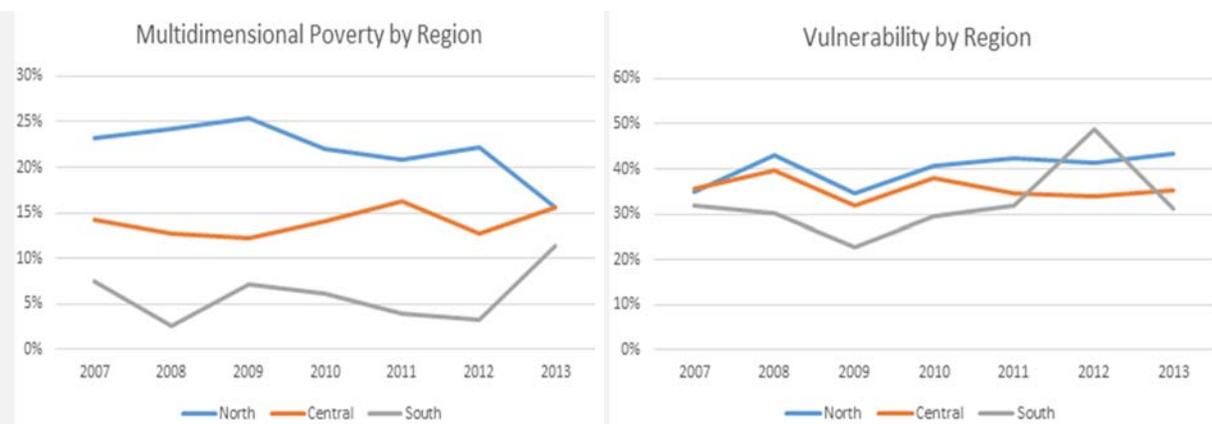
In this version of a multidimensional indicator of poverty developed for the SCD, five dimensions were considered: (i) education; (ii) access to material goods and assets; (iii) access to basic utilities and living conditions; (iv) labor market indicators; and (v) social indicators (mostly reflecting sensitivity to deprivations). Each of the five dimensions were equally weighted, and every indicator was equally weighted within each dimension. A household was considered poor when it was deprived or at risk in more than 33 percent of the weighted measures. A household was considered vulnerable to poverty when it was deprived or at risk in at least 20 percent of the weighted measures, but less than 33 percent.

Education	Not completing primary school on time
	Not completing secondary school on time
Material Access	Bottom 40 of the consumption distribution
	No access to cell phone
	No access to a personal computer
	No home phone
	No refrigerator
Living Conditions	No access to piped water
	No access to sewer system
	No access to toilet
	No electricity connection
	Household overcrowding
Labor	Unemployed members of the household
	Retired members of the household
Social	Household without 2 parents
	Household with a young household head
	Female headed household
	Household with more than 4 dependents

In Montenegro, these measures have been relatively stable at the national level since 2007, though they have varied more substantially at the regional level. It is important to note that in many cases, households move from “poverty” to “vulnerability” (rather than “non-poverty”). An increase in the share of households considered vulnerable could therefore potentially signify either an improvement or a deterioration, depending on the trend in the poverty headcount ratio.

Behind a rather stable indicator at the national level, there is variation across regions. In 2007, multidimensional poverty was higher in the North region, and the lowest in the South region. However, in 2013 this difference almost vanished: multidimensional poverty in the North was the same as in the Central region, and in the South it was only slightly lower. In terms of vulnerability, on the other hand, there was very little difference across the three regions in 2007 but these difference were higher in 2013.





Note: For more information, please refer to the ECAPOV website at: <http://go.worldbank.org/RR8JUWFGU0>

Source: World Bank.

79. **Disabled persons in Montenegro remain underserved.** Overall access to buildings for people with disabilities, including education and medical facilities, remains limited according to the most recent EC Montenegro Report (October 2015). The World Health Organization estimated that 7-10 percent of the total population in Montenegro was disabled in 2009, though no systematic data on this group is regularly collected. The UNDP estimated that the SEI for this group stood at 5 percent at that time. There are few employment opportunities for disabled persons. Results from a survey in 2009 found that while 72 percent used the services of the Employment Agency, only 22 percent had been engaged in some sort of gainful activity in the week prior. Job quality also tends to be problematic, with job satisfaction graded at only 3.6 (compared to the national average of 5.7), on a 1-10 scale.

80. **There are still unregistered internally displaced persons (IDPs) whose status is uncertain.** The IDP status was planned to cease to exist as of January 2015. No provisions have been made for the remaining IDPs who have not yet applied for foreigner status, yet there are still almost 1,500 people in this situation, most of them internally displaced from Kosovo. Only a portion of the IDPs willing to go back to Kosovo have managed to do so. Greater awareness about registration is needed, especially in the Romani and Albanian languages.

81. **Homophobia and social stigma, in particular toward LGBT people, remain pervasive.** In 2009, Human Rights Action found that 71 percent of respondents consider homosexuality an illness and that 50 percent believe that homosexuality is dangerous and the state should suppress it. In 2010, Juventas (an NGO) found that more than 68 percent of respondents believe homosexuality to be a disease, and 61 percent do not believe LGBT people should disclose their SOGI identity in public. In 2012, the LGBT Forum Progress and Centre for Civic Education found that 60 percent of people believe homosexuality to be a disease, and 45 percent do not believe LGBT people should disclose their SOGI identity in public. In 2012, Gallup found that 70 percent of respondents would not want a homosexual neighbor. More than 80 percent of respondents believed that homosexual acts are morally wrong.<sup>43</sup> As recently as 2009, some health professionals considered homosexuality a “disorder” in Montenegro. In a survey by Juventas in 2012, 51 percent of police officers and 48 percent of health providers perceive homosexuality as a disease, though this survey may not be fully

<sup>43</sup> The European Parliament’s Intergroup on LGBT Rights notes that violence has increased recently. Attacks are rarely reported and activists are exposed to discrimination. The EU Intergroup also reported attacks on an LGBT parade in July 2013, resulting in 32 attackers being arrested. Human Rights Action interviewed 30 LGBT people in 2009, 18 of whom reported experiencing a violent attack in public without reporting it. Fifteen reported experiencing or witnessing maltreatment by the police. In a survey by Juventas in 2010, the NGO found that more than 10 percent of police officers and more than 18 percent of health providers perceive verbal violence against LGBT people as acceptable. Nearly 6 percent of police officers and more than 11 percent of health providers accept physical violence against LGBT people, though it is not clear how large a sample was used, and the extent to which the survey was representative.

representative.

82. **But there are positive sign, like the adoption in 2010 of a non-discrimination law that includes sexual orientation and gender identity.** Montenegro has adopted legislation that allows transgender people to identify by their preferred gender after gender reassignment surgery, and in 2012, the Law on Health Insurance was amended to provide coverage for gender reassignment surgery. In 2013, the government worked with various LGBT NGOs to create the 2013-2018 Strategy for Improving Quality of Life of LGBT Persons 2013 Action Plan. The strategy has nine goals to promote LGBT welfare with various elements of safety included in the plan that also includes indicators of success.

### *Financial Sustainability*

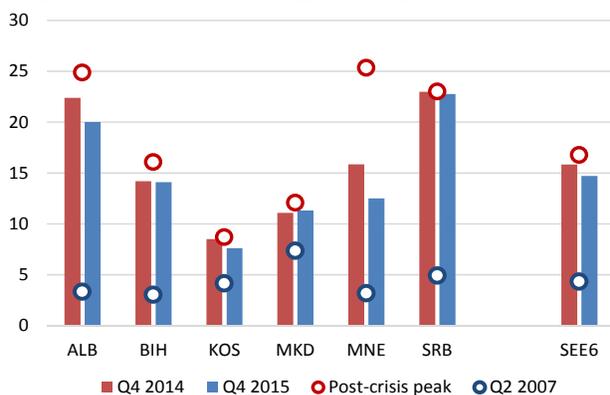
83. **Montenegro's financial sector is dominated by banks, which account for about 90 percent of financial sector assets.** There are fifteen banks operating in Montenegro, and those that are foreign-owned control about 80 percent of banking sector assets. The three largest banks control half of total assets and deposits, with the largest bank alone accounting for 18 percent of assets and 20 percent of deposits. Market for derivatives is underdeveloped and lightly regulated.

84. **Post-crisis trends suggest a shift in the funding structures of Montenegrin banks towards domestic deposit mobilization.** As a result of the crisis, capital flows to Montenegro reversed and financing constraints jeopardized macro-financial stability. Between end-2008 and 2013, Bank for International Settlement reporting banks reduced their cross-border exposure in Montenegro by more than 15 percent of GDP. In contrast, domestic deposits increased to 73 percent of GDP by 2015. Further deleveraging remains a risk to financial stability and economic growth as some parent banks could consider scaling back their presence as a result of continued market and regulatory pressures. Going forward, funding diversification is crucial for further financial sector development and economic growth in Montenegro as domestic deposits are predominantly short-term in nature.

85. **The pre-crisis credit boom was concentrated in the real estate sector and financed mainly by foreign parent banks.** Total credit in Montenegro averaged 41 percent annual growth in 2003-05, increasing credit to GDP ratio to 91 percent by 2008 with the loan-to-deposit (LTD) ratio reaching 145 percent in 2009. Although the Central Bank of Montenegro as prudential supervisor put efforts to slow down credit growth and improve the maturity structure of bank deposit financing by changing the reserve requirements regulation, limiting the credit growth in the largest banks, increasing the bank capitalization, and improving the quality of supervision, more could have been done through micro- macro-prudential policy tools to manage the capital flows into the banking sector, and the accumulating risks.

86. **The global economic crisis caused a severe credit crunch.** As a percentage of GDP, total bank loans to the corporate sector and households dropped from 91 percent in 2008, to 62 percent in 2015. Due to bank asset quality problems and partly subdued demand for commercial loans, credit declined between 2009 and 2012 by an average of 4.3 percent on an annual basis. After a slight improvement in 2013 (3 percent credit growth) mainly driven by household borrowing and accounting methodological change, Montenegro experienced negative credit growth in 2014 because of continued contraction in corporate credit, although lending to the private sector has showed signs of recovery during 2015. Parent bank credit became less available and borrowings from parent banks as a share of total liabilities dropped from 20 percent in 2008 to 13 percent in 2012, bringing the LTD ratio down to 90.9 percent by end-2015. Following a massive withdrawal of deposits from September 2008 to end-2011, total deposits have returned to pre-crisis levels at the end of 2013.

**Figure 50. Nonperforming Loans, percent of total loans**



Source: Central Banks, World Bank staff calculations.

87. **Montenegro's growth potential is hampered by an inefficient financial system, with high costs of intermediation and high level of non-performing loans** (Figure 50). Although on a downward trend, the share of NPLs remains at a relatively high level of 13.4 percent by end-2015 (down from 16.2 percent in mid-2015). Similar to other financial soundness indicators, important variations of NPL ratios are observed within the banking sector, with ratios exceeding 30 percent in two banks. The provision coverage ratio as a share of NPLs was at 48.4 percent at end-2015. As a consequence of rapidly increasing NPLs, many banks had to be recapitalized by shareholders. The capital

adequacy ratio (CAR) of the system stood at 15.5 percent in December 2015, above the prudential minimum requirement of 10 percent, albeit with wide differences among banks. Profitability continues to be very weak with aggregate ROA of -0.1 percent and ROE of -0.7 percent in December 2015. Strong competition in the banking sector has compressed interest rate spreads to the levels threatening the survival of some smaller banks with higher funding and operating costs and weaker client base. There will be additional pressure on profitability by the recent entry of a number of new banks to the market.

88. **To ensure financial sector stability and sustainability, decisive action to deal with weak banks is critical.** A number of domestically-owned banks face significant challenges. As a group, they are less profitable than foreign-owned banks with stronger parents; domestically-owned banks also have significantly higher operating costs. The authorities should develop, as a matter of high priority, time-bound supervisory action plans including capital injection by shareholders. An independent Asset Quality Review (AQR) of all banks is recommended to review loan classification and provisioning practices. At the same time, Central Bank of Montenegro (CBM) should immediately start bank-specific resolution planning consistent with maintaining financial system stability, protecting insured depositors, and minimizing cost to taxpayers.

89. **The framework for NPL resolution has improved in recent years, but a number of important shortcomings remain.** In order to address the NPL problem, the central bank adopted a decision in November 2013 requiring banks to develop resolution strategies for NPLs. These recently strengthened supervisory requirements should be complemented by reversing the loosening of regulatory standards observed over the last several years. In April 2015 the parliament adopted the law on voluntary financial restructuring known as the 'Podgorica approach'. This provides a framework for out-of-court restructuring of economically viable companies, including through purchases of debtors' claims supported by tax and supervisory incentives. In December of 2015 CBM signed an Agreement with the Chamber of Economy of Montenegro and the Ministry of Finance aimed at strengthening the legal framework for voluntary restructuring of loans and foster cooperation between stakeholders with a view to encouraging business entities and banks to enter the loan restructuring process.

90. **Meanwhile, some banks have offloaded part of their bad loans to factoring companies.** However, factoring services are not regulated, creating legal uncertainties for some types of transactions. Hence, the authorities initiated in September 2014 proceedings to prepare a law on factoring to improve the legal framework and establish an appropriate level of supervision.

91. **Access to medium- and long-term funding for small and medium sized enterprises (SMEs) needs to be further enhanced with a view to ultimately contributing to growth and employment.** The development and growth of SMEs is critical for the development of Montenegro. While access to finance is an important factor for enterprise growth, it has become increasingly difficult for private enterprises to obtain

funding in the aftermath of the 2008 financial crisis. The total volume of corporate loans has dropped by 42 percent since 2008 but started to recover in the second half of 2015. Results of the BEEPS survey show that most of the SMEs in Montenegro are financing their needs from internal resources. While more than 96 percent of firms have a checking or savings account, only 54 percent of surveyed enterprises have a loan from a bank.<sup>44</sup>

92. **The non-bank financial sector remains relatively underdeveloped but with potential to grow in the medium to long term.** In 2014, the total annual market turnover of the stock market represented less than 1 percent of GDP, while insurance companies' gross premiums accounted for some 2 percent of GDP. There are 6 microfinance institutions operating in Montenegro accounting for around 1 percent of GDP, with activities mainly targeting the rural population. A wider range of financing instruments is required to meet the varying needs of households and enterprises.

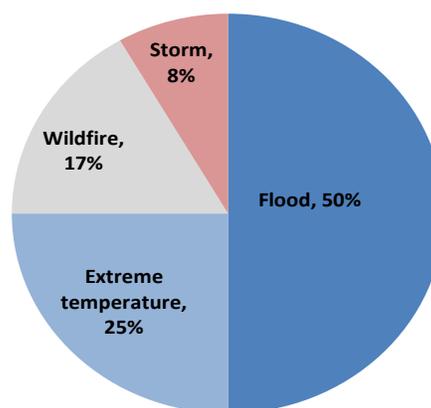
### **Environmental Risks**

93. **Montenegro has ratified and begun to implement all international conventions and protocols on climate change.** Substantial further implementation efforts remain, including those required by the EU climate *acquis*. The Government of Montenegro integrated climate change in its National Strategy on Sustainable Development including urban plans (climate change mitigation and adaptation mechanisms, energy efficiency) and National Communications (NC) on Climate Change. With a Technology Needs Assessment for Climate Change Mitigation and Adaptation undertaken in 2012, Montenegro is now working on the Second NC on Climate Change.

94. **Montenegro is vulnerable to natural disasters, especially floods and earthquakes** (Figure 51). Floods are the most frequent hazard. According to Emergency Events Database (EM-DAT), during the period 1991–2013 there were six destructive floods out of 12 total natural disasters. The country is also prone to extreme temperatures, storms, and droughts. Sixty percent of the population lives within a zone of anticipated seismic intensity greater or equal to magnitude 8 on the Richter scale.<sup>45</sup>

95. **Changes in the quantity and regime of precipitation influenced by the climate-related hazards will in a long-term lead to:** (i) reduced flows and abundance of water resources; (ii) a higher frequency and intensity of floods are expected; (iii) movement of vegetation zones, reduced number of species, drying out of forests and more frequent forest fires. In the coastal area, loss of space and biodiversity and beach erosion due to higher level and temperature of the sea. In agriculture, significantly reduced yields due to sensitivity of crop production to changes in temperature and precipitation reduced available agricultural land and lower content of organic matter in soil.

**Figure 51. Natural disasters in Montenegro, 1991-2014**



Source: EM-DAT.

96. **Climate-related hazards disproportionately affect lower income cohorts.** Despite growing urbanization and an increasing concentration of poverty in urban areas, the majority of poor people are still engaged in the primary sectors, which are most vulnerable to natural disasters, especially floods and storms. Except the fact that natural disaster can leave poorer people without their main income which they earn in primary industries, mainly agriculture, they are facing more difficulties in coping with the consequences from

<sup>44</sup> BEEPS 2013.

<sup>45</sup> Emergency Events Database.

disaster. The important factor is also knowledge and awareness of ever-present risk of disaster.

97. **Along with growing importance of tourism in generating economic gains, the pressure on nature and the environment, mainly in the coastal zone, has strongly increased.** Critical issues are inadequate waste management, insufficient water quality and unplanned/unmanaged fast urban growth, overall poor level of services and poor quality of urban environment in tourism centres potentially creating negative impact on the tourism sector in Montenegro, whose future is largely dependent on high-end tourism. Connection to the sewerage network has risen in the coastal region, but there is still a significant problem with wastewater. The effluents are discharged into the sea untreated or go into the ground from the leaky network of pipes. In many municipalities in the central and northern regions wastewater is either pumped into streams and rivers or infiltrated into the ground. Stress on soils is also caused by the uncoordinated and informal accumulation of domestic waste, especially during tourist season. In addition to soil, there is significant impact on sea water quality at the beaches of Montenegro's coast. Many unique landscapes, cultural heritage towns and natural assets along the coast and in the mountain region are affected by the uncontrolled building of holiday apartments and tourist infrastructure which poses a risk that the most beautiful and important tourism areas will become over built and eventually destroyed.<sup>46</sup>

98. **Unplanned urban development and land use contributes to increased risk of disasters.** Desiring to boost an economic prosperity, plenty unplanned and unregulated constructions was built especially in the coastal area which is seismic sensitive as well as vulnerable to floods. Given the unplanned urban development and land use, a large number of people and their asset are exposed to high risk of natural disaster. However, since 2008, there was a massive reduction in new illegal developments (from 4,000 cases per year to 210 in 2014) led by stricter implementation of regulations and better equipment for inspection service. Poorer people often live in marginal areas in the urban periphery, exhibiting poor social conditions with many of them not having water security or safe sanitation. They have few or no savings to protect themselves in crises; they cannot afford insurance. Thus, natural disasters are likely to increase poverty, particularly among the population with lower household income.

99. **Industrial pollution is a problem.** Although industrial production is stagnant, industrial waste is constantly increasing and poses a constant threat to the environment. According to the Environmental Protection Agency of Montenegro, one of the most important issues is the treatment of industrial waste generated in the past.<sup>47</sup> The existing main industrial waste disposal sites pose risks not just to the immediate environment but also to the public health of surrounding communities through groundwater contamination. In Montenegro, 82 percent of the population is supplied by underground water supply systems. Around 40 percent of the village population does not have regular or good quality drinking water. Many get water from their own individual springs, wells, and cisterns.

100. **Some polluted sites are not far from the country's most valuable natural resources.** The aluminum plant KAP is in the vicinity of Lake Skadar, which is a national park and Ramsar site under the Convention on Wetlands of International Importance, is the most important watershed in Montenegro, and is the largest lake in the Balkans. The area where the KAP is located experienced two record-breaking floods in January and December 2010, and flooding could become more frequent and severe under predicted climatic shifts. The shipyard in Bijela is on the Adriatic Coast in the Boka Bay and 20-30 kilometers away from the Old City of Kotor which, together with part of Kotor Bay, is a UNESCO protected site.

101. **Industrial waste site remediation and management is key for tourism.** Environmental regulations and implementation capacities remain weak. Waste disposal and treatment practices are below EU standards, and improved waste management is required for EU accession. Water quality is also a concern. The

---

<sup>46</sup> UNECE (2007). "Environmental Performance Reviews, Republic of Montenegro", Second Review.

<sup>47</sup> Like in Kombinat aluminijuma Podgorica (red mud basin and industrial waste landfill), Niksic Forge (industrial waste landfill), Shipyard Bijela (clean-up of the contaminants of soil and seawater) and Thermal power plant Pljevlja (ash and slag landfill).

government must align water quality legislation with the *acquis* and implement it.<sup>48</sup> According to the first draft of the National Environmental Approximation Strategy, alignment with EU environmental standards will cost Montenegro and its taxpayers 36 percent of GDP (or EUR1.43 billion) from 2016–2020, mostly in the fields of water, waste management and air quality.<sup>49</sup>

### ***Emerging Priorities***

102. As a small state Montenegro is always going to be subject to a high level of volatility, which it cannot ignore as it comes with the cost of lower long-term growth and rise in poverty. The country can, however, apply policies that would manage consequences of such volatility. The vulnerability of Montenegro's small, open economy to external shocks, place a premium on ensuring sustainability, through:

- *Ensuring sustainable and sound fiscal policy.* Given the rising debt levels and high spending to GDP ratio, Montenegro has limited fiscal space that leave little room to maneuver and increases exposure to any future shocks. While in the near term, consolidation strategy to stem further public debt growth is urgent, over the medium term, managing public finances so as to build buffers to use during periods of low demand is important. Instead, in 2006-08 Montenegro's government spending was *pro-cyclical*, amplifying the already large positive effect of massive capital inflows. There was a lost opportunity to save the higher tax revenue collected and build a contingency reserve fund. Expenditure volatility can be reduced through ensuring long-term fiscal sustainability, moving away from *pro-cyclical* policies. Many small states have built fiscal buffers and designed fiscal rules to prevent the economy from fast occurring shocks. Given their greater exposure to external shocks, small states should accumulate adequate reserves or budget extra spending for potential disasters as well as explore insurance coverage.
- *Ensuring financial stability and managing capital inflows.* Maintaining financial sector stability, implementing complementary policies to improve the allocation of financial resources (by reducing NPLs and building up bank capitalization and liquidity positions, reviving credit growth) are essential to ensure financial stability. The soundness across the system is needed to stimulate lending to creditworthy enterprises and projects. Supervisory integration and macroprudential improvements are key as it has been proven essential to carefully supervise nonbank institutions. Typical prudential measures include maximum loan-to-value (LTV) ratios, limits on domestic credit growth, asset classification and provisioning rules, sectoral limits on loan concentration, dynamic loan-loss provisions, and counter-cyclical capital requirements. High international capital flows will always have a large impact in a small economy like Montenegro: inflows will have a positive stimulus effect on aggregate *demand* and outflows will have the opposite effect. Attention to the financial exposure of firms and banks is even more important with a view to limitations in the lender of last resort framework.
- *Build private sector buffers.* Montenegro should encourage private sector savings and insurance against risk which would cater for the declining pension adequacy as the country ages, and the high exposure to environmental risk as the country copes with the climate change impact.

---

<sup>48</sup> The Montenegro Progress Report, issued by the European Commission in 2014, concluded that Montenegro has made little progress in the areas of environment and climate change. Administrative capacity in all areas of environment and climate change has to be strengthened at both central and local level. Strategic planning, substantial investment and significant further efforts are needed to ensure alignment with and implementation of environment and climate *acquis*.

<sup>49</sup> The most of the costs will refer to the water sector EUR840 million or 59 percent of total costs, with solid waste management accounting for EUR368 million.

## V. STRUCTURAL CONSTRAINTS TO GROWTH

The financial cum economic crisis at the end of 2008 stalled the convergence of incomes with the rest of the EU. GDP per capita (at PPS, EU28=100) in the 2009-14 period suggests stalled convergence of incomes with EU. Although the level of economic activity stabilized by 2013, having regained its 2008 level, the still high unemployment rate (18 percent) and the stalled convergence provokes the following question: how can Montenegro put its underutilized human and physical resources back to work? Montenegro needs a competitive and productive economy with efficient factor markets, more equal human capital and improved connectivity. Economic policy options are limited for a small, open, euroized economy so intensifying structural reforms is key to strengthen Montenegro's growth potential and job creation as well as to shift the economy's production possibilities frontier in terms of: the level and quality of (a) productivity, trade integration and investment climate; (b) human capital; and (c) physical infrastructure.

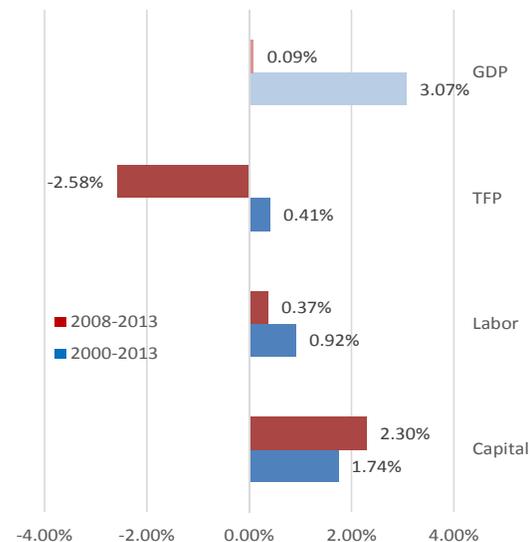
### *Productivity, Trade and Investment Climate*

103. Throughout the last decade, growth was led by factor accumulation rather than increases in total factor productivity (TFP). Using the Cobb-Douglas production function in the 2000-13 period capital<sup>50</sup> accumulation explains about 60 percent of growth in the period and increase in the labor force about a one third. The contribution of TFP was only slightly positive (Figure 52). There are at least two possible interpretations of this result. It may suggest that Montenegro, in contrast to other countries in Central and Eastern Europe, (a) may not have taken much advantage of recent technological and digital advances of global trade deepening to improve productivity; and (b) that there has been little reshuffling of factors of production from less productive to more productive sectors.

### Productivity and International Trade

104. After the crisis, productivity declined sharply and then rose unevenly, while growth slowed. Labor productivity is still below its 2008 level and the country still lags behind its SEE peers. From 2004 to 2008 labor productivity in Montenegro increased as in most countries in the region (Figure 53). While in other countries in the region productivity quickly returned to trend following a deceleration in 2009, Montenegro experienced a sharper decline in 2009 and despite a quick recovery in 2010 productivity has remained stagnant since, as the employment grew faster than real GDP. Most of the employment gains were in labor-intensive industries, like tourism and agriculture (also with the largest share of informality), while real estate and financial sectors took a lead with the highest growth of value added. Although global economic crisis disrupted that trend in 2011, wage growth was above productivity over the whole last decade (Figure 54), eroding the country's competitiveness.

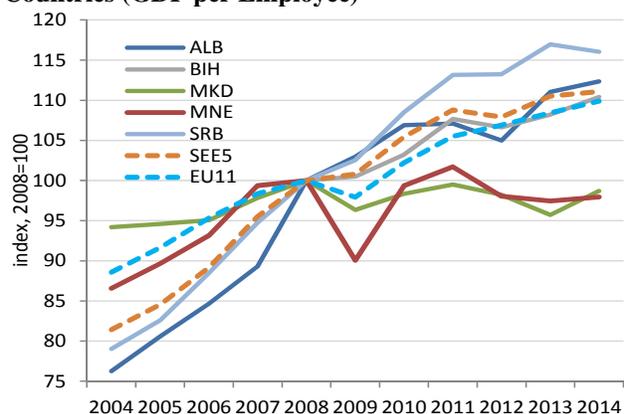
Figure 52. Factor-Input Sources of Growth in Montenegro, 2000-13



Source: MONSTAT, Popovic (2014).

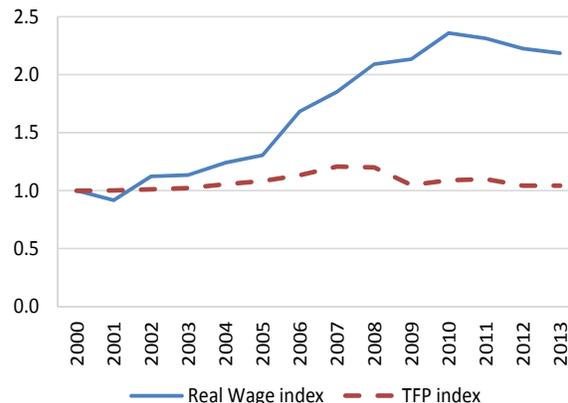
<sup>50</sup> Due to lack of data for both gross value and the net value of capital, the data were approximated by combining the perpetual inventory method, based on data available for realized investment, with an estimate of capital for 2007 and 2008 done by the Central Bank of Montenegro.

**Figure 53. Productivity in Montenegro and Peer Countries (GDP per Employee)**



Source: National statistical offices, Eurostat, World Bank staff calculations.

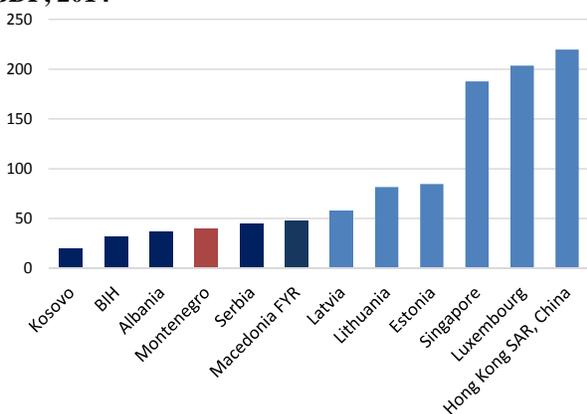
**Figure 54. Wage and Productivity Growth, Percent 2000=1**



Source: MONSTAT, Popovic (2014), World Bank staff calculations.

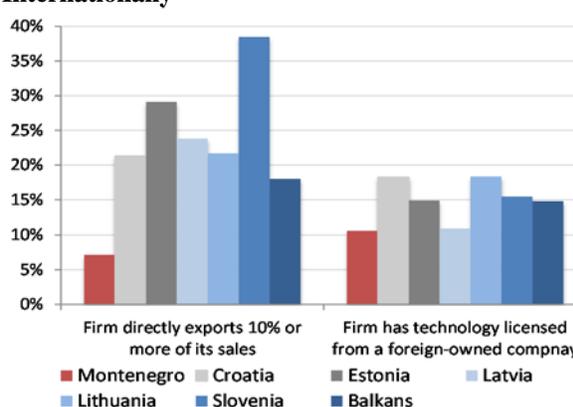
105. **Montenegro lags on openness and international trade too.** Coastline, proximity to EU markets and educated workforce present great potential for Montenegro to overcome its size limitations. But Montenegrin firms are relatively poorly integrated into the global economy (Figure 55). Only 7 percent of firms export their goods compared with 18 percent in the Balkans and 29 percent in Estonia, and they are less likely to have purchased a technology license from a foreign-owned company (Figure 56). In keeping with these findings, most firms tend to be almost entirely owned by Montenegrins. The proportion of firms in Montenegro in which 10 percent or more of the firm is owned by private foreign entity is much smaller than in the comparator countries studied.

**Figure 55. Goods and Services Exports, Percent of GDP, 2014**



Source: National statistical offices, WDI, World Bank staff calculations.

**Figure 56. Very Few Montenegrin Firms Trade Internationally**



Source: BEEPS 2013.

106. **The time and cost of trading across borders is often lower in Montenegro than the average in Europe and Central Asia.** Montenegro also does relatively well on the Logistics Performance Index: with a rank of 67, it is above the Western Balkans average. But there is still room to catch up with Western Europe, and so the need for improving trade logistics remains. That said, the fact that Montenegro does better than its regional comparators on logistics indicators but still underperforms in exports suggests that other factors, possibly low productivity, are also contributing to weak exporting (Table 8).

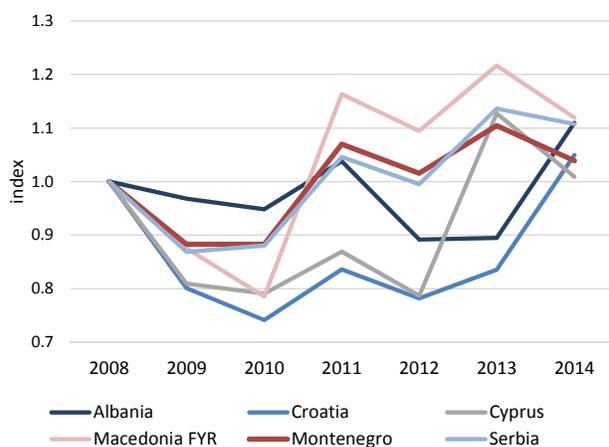
**Table 8. Logistics Costs of Trading Internationally**

	Montenegro	Europe & Central Asia
Time to export	13	59
Cost to export	US\$225	US\$363
Time to import	33	50
Cost to import	US\$406	US\$310

Source: Doing Business 2016.

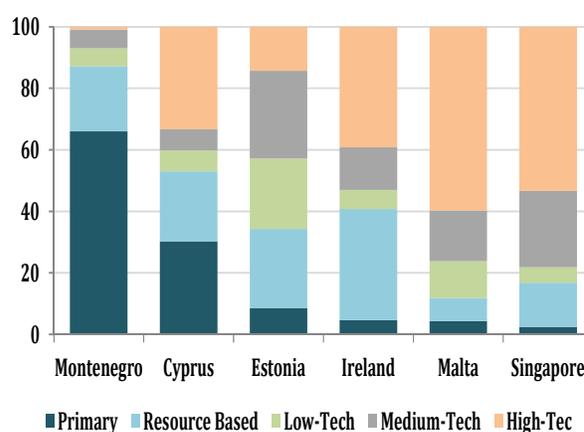
107. **To unleash growth potential, Montenegro requires more diversified composition of exports.** While Montenegro has one of the lowest goods export-to-GDP ratios in the world (9 percent), Montenegro’s services exports dominate goods exports at 34 percent of GDP in 2015 (lower than Slovenia at 68 percent, Estonia 75 percent and Malta 87 percent) (Figure 57). Merchandise exports have been highly concentrated on metal products with low technological content of merchandise exports (Figure 58). Compared to many of its peer countries, Montenegro’s commercial services exports are also relatively concentrated. Montenegro exports primarily three main service types; travel, transport and financial services together account for 90 percent of commercial services exports in 2015. According to the product space analysis undertaken in 2012<sup>51</sup> even if Montenegro could expand the current export structure significantly, it would not bring in much additional revenue or create many jobs. Existing merchandise exports have relatively little income potential. Products that are income-enhancing are not easily “reachable” in terms of the density of Montenegro’s exports. Moreover, exported products for which Montenegro has revealed comparative advantage (revealed comparative advantage>1) are sparse in the product space. Comparative advantage lies in the core of the product space: (i) agriculture, food processing (with limited export potentials, but can complement the tourism potentials), transport/logistics services, ICT (new); (ii) tourism, wine, energy (existing).

**Figure 57. Montenegro’s Commercial Services Export Growth Relatively Slow Compared to Peers**



Source: World Development Indicators.

**Figure 58. Merchandise Exports By Technological Content, 2006-11**



Source: Osorio-Roddarte and Bogetić (2012).

108. **Montenegro’s exposure to trade has shifted toward its closest neighbors.** Trade in goods with Serbia, Croatia and Slovenia accounted for two-thirds of total trade in 2015 which doubled since 2006. The slowdown in economic activity in the EU27 zone seems to have impacted Montenegro’s exposure to that block which contracted from two thirds in 2006/07 to slightly more than one quarter. A large portion of this is explained by the sharp contraction of exports to Italy. One of the biggest destination markets for Montenegro’s total services exports is Russia. The country’s top 10 export partners accounted for 37 percent of total services exports according to a new World Bank database on bilateral services trade. Yet Russia accounted for over 27 percent of services exports. While tourism exports are concentrated to select markets

<sup>51</sup> World Bank, Montenegro Country Economic Memorandum (2012).

(discussed below), the concentration of trade flows with Russia extend beyond just tourism, including foreign direct investment and large financial flows in real estate and other sectors of the economy.

#### **Box 5. The State of Two Strategic Sectors<sup>52</sup>**

**Tourism.** Montenegro's natural resources and position on the Adriatic coastline offer high potential for tourism. The country contains 288 km of sandy coast, as well as 40 lakes, rivers (in 2012 about 75 percent were good quality), forest (covering about 60 percent of the territory), and mineral springs. About 97 percent of overnight stays were connected to the coastal region. Tourism is the dominant sector in Montenegro's economy. From 2000–15 Montenegro recorded continuous growth of tourism. Travel exports represented about 66 percent of Montenegro's total services exports in 2015. Tourist arrivals by source are concentrated in regional markets. Russia accounted for nearly a fourth of Montenegro's tourism arrivals followed by Serbia at 21 percent and Bosnia and Herzegovina at 7 percent. The number of tourists from high-income countries such as France, Italy, and Germany is much lower.

Along with growing importance of tourism in generating economic gains, the pressure on nature and the environment, mainly in the coastal zone, has strongly increased. Critical issues are inadequate waste management, insufficient water quality, and chaotic urban planning. Connection to the sewerage network has risen in the coastal region, but there is still a significant problem with waste water. Effluents are discharged into the sea untreated or go into the ground from the leaky network of pipes. In many municipalities in the central and northern regions waste water is either pumped into streams and rivers or infiltrated into the ground. Stress on soils is also caused by the uncoordinated accumulation of domestic waste, especially during tourist season. There is also a significant impact on sea water quality at the beaches of Montenegro's coast. Many unique landscapes and natural assets along the coast and in the mountain region are being damaged by the uncontrolled building of holiday apartments and tourist infrastructure (UNECE 2007).

The Government recognizes tourism and tourism-based local economy as priorities for the country, as reflected in the Montenegro Tourism Development Strategy to 2020. The vision of the strategy is to create a tourism product based on an integrated approach that includes the coastal areas and the hinterland as a way to extend the tourism season beyond the short peak of summer months and provide impetus to developing the northern and central regions of the country. Supporting the tourism value chain will generate jobs and growth of local suppliers and SMEs supporting the tourism industry, including those in the agriculture sector.

**Agriculture.** Montenegro is still highly agricultural. Agricultural land represents 38 percent of total area, two-thirds of which is covered by pastures. Olive and citrus fruit production takes place in the coastal region, with early season vegetable production and extensive livestock breeding in the north. Agriculture is by far the largest activity of the rural population. 48,824 families obtain their income partly or entirely from agriculture. Food production and agriculture play a relatively important role in mostly rural part of the economy, with the primary sector alone providing around 8 percent of GDP, while agro-food processing contributing less than 1 percent of GDP.

Montenegro has an opportunity to increase agricultural income and job creation. Opportunities exist in particular in a number of niche sectors such as wine and olive oil, organic production, medicinal herbs and spices, honey, and mushroom and truffles harvesting. In 2013, the value of mushrooms and berries exported was US\$8.8 million, the fifth-highest commodity in terms of export value. These non-traditional products are labor intensive and often benefit mountainous, poorer regions. Agriculture may be more important than official statistics reveal. According to MONSTAT, the number of persons formally employed in agriculture was 2,347 in 2010. However, according to the 2010 Agricultural Census, the equivalent of 46,473 Annual Work Units were working in agriculture, indicating that only 5 percent of agricultural employment is formal (Figure 59). With agricultural exports increasing by around 4 percent annually during the last 8 years, agricultural imports have been increasing much faster (around 16 percent annually) leading to the worsening of agricultural trade deficit from US\$166 million in 2005 to quadruple by 2014. As a share of goods trade deficit, agriculture increased from 21 percent to 27 percent during the same period.

Montenegro agriculture suffers similar constraints that are seen in the region. These are: farmers education and willingness and ability to adopt modern technologies, size of land and related difficulty with enforcement of contract law in case of leasing of land, reluctance to join efforts in agricultural cooperatives that could improve the capacity in terms of storage, packaging, marketing and exporting, climate change which increases the risks of disastrous events such as floods, and to a lesser extent droughts, that in combination with the mountainous morphology of the terrain,

---

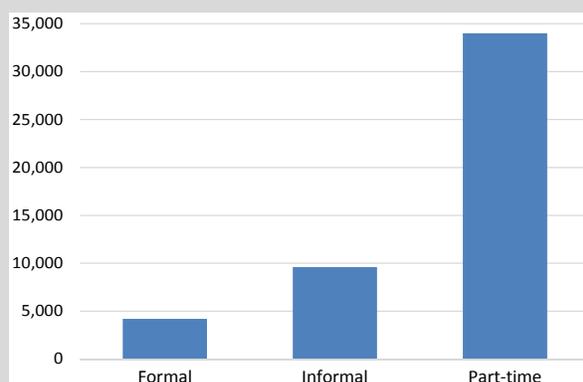
<sup>52</sup> “The Development Directions of Montenegro for 2015-2018” defines four strategic sectors of the economy: tourism, agriculture, energy and manufacturing, in which it aims to attract and invest over EUR1.1 billion in this period.

cause long term erosion. Comparing the agricultural value added per ha of the countries in the region, it seems that agriculture has still potential for growth (Figure 60).

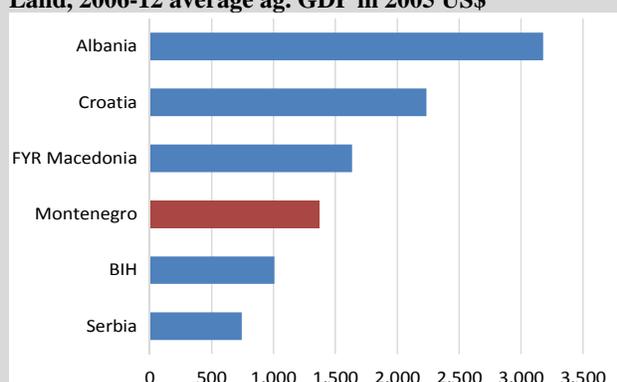
The main challenges for agriculture relate to competitiveness and integration. Generally, during the transition into an upper-middle-income country, primary agricultural production reduces its importance relative to agro-processing. This requires more sophisticated supply chains and quality compliance at both production and processing levels than currently exists in Montenegro. Further, the proximity to the EU market puts pressure on Montenegro's agricultural sector to compete both in domestic and in export markets. This pressure will only increase as Montenegro becomes an EU member.

To become competitive the agribusiness/agriculture sector has to modernize. The revealed comparative advantage (RCA) for food products is one of the lowest in the Western Balkans. The processing industry is almost non-existent, while the country struggles with small plots of land, lack of interest on the part of producers to adopt modern technologies, lack of aggregation, and poor post-harvest infrastructure. Competitive advantage will likely only be achieved with niche products (for example, olive oil, medicinal herbs, and specialized fruits). This niche development should be done with a view to complementing tourism sector development and diversifying tourism income. Supporting the tourism value chain, including ethno tourism and winter tourism, should be a priority for the government. This can generate jobs and growth of local suppliers and SMEs supporting the tourism industry.

**Figure 59. Agricultural Employment Data, 2010**



**Figure 60. Agriculture Value Added per ha of Arable Land, 2006-12 average ag. GDP in 2005 US\$**



Source: Tax Administration and Ministry of Agriculture and Rural Development registries, MONSTAT Labor Force Survey (LFS), and Agriculture Census. Please note that Part time is calculated based on the Annual Work Units minus the LFS data.

## Private Sector and Entrepreneurship

109. **The vast majority of firms are in services and located in the South and Center of the country.** Seventy-three percent of firms are in services, compared to 18 percent in manufacturing and 9 percent in construction and other sectors. Montenegro's tourism-oriented economy includes a sizable number of hotels and restaurants.<sup>53</sup> About 60 percent of firms are located in the central region (which includes the capital city). The northern region accounts for only about 10 percent of firms, with the remaining located in the coastal region of Montenegro. With micro firms accounting for about 25 percent of all employment, Montenegro is in the middle range. Small firms (10-49 employees) account for 28 percent of employment, the highest among all countries reported, although, it is not an outlier in EU. Even some high incomes countries such as Austria and Norway come close to Montenegro, with 24 percent of their total employment accounted for by small firms. Similarly, Montenegro does not stand out in terms of the share of employment in medium (50-249 employees) or big (250 + employees) firms.

110. **Montenegro is the only country in the Eurostat database where the share of big firms in total revenue is no higher than their share in total employment.** Generally, big firms (250 + employees) account for a disproportionately large share of total revenues compared to their share in total employment. For instance,

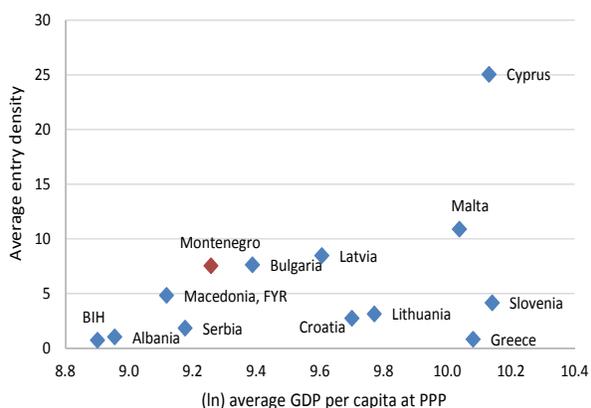
<sup>53</sup> The sector and location estimates incorporate BEEPS sampling weights to ensure national representativeness.

in Poland, big firms account for only 32 percent of total employment, but 44 percent of total revenue. Thus, on average, the biggest firms have the highest labor productivity, possibly because they use more capital per worker or have higher total factor productivity (TFP). In Montenegro, this is not case, likely due the presence of a few large, inefficient SOEs.

111. **The entrepreneurship dynamism appears strong.** Figure 61 displays the relationship between firm entry density (measured by the average annual number of new limited liability firms registered per 1,000 working-age people during 2008–12) and the level of economic development (measured by the average per capita income for the same period). Montenegro’s rate of entry density is substantially above what would be predicted by its income level. While this result contrasts with peers such as Latvia or Malta, there is evidence that the proportion of small and micro-sized firms in the economy is high relative to other countries in the Western Balkans or the Baltics.<sup>54</sup> This suggests that the problem is not with the entry of firms, but with their growing enough to become (and survive as) medium or large sized firms.

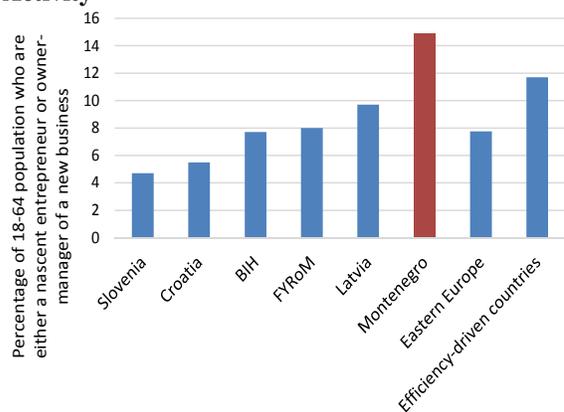
112. **Regarding most of the indicators of entrepreneurial activity, Montenegro outperformed its peers.** Global Entrepreneurship Monitor (GEM) research, in which Montenegro participated only in 2010, measures the attitudes of population, activities and characteristics of individuals participating in various phases of entrepreneurship as well as the aspirations these entrepreneurs hold for their businesses. Montenegrins reported high perceptions about good opportunities for entrepreneurship (36 percent of the population), and the capabilities to start businesses (71 percent), compared to Eastern Europe average of 29.9 and 50.6 percent, respectively. Favorable perceptions of entrepreneurship in Montenegro were matched with high intentions to start a business within three years (31.9 percent of the population), which was not the case for Eastern European countries (23.2 percent). Montenegro had nearly 15 percent of its population engaged in early-stage entrepreneurship (TEA) (Figure 62) and around 10.5 percent of female population that is above the Eastern European average. Montenegrin entrepreneurs usually receive high status in the country and public media are providing positive stories about their success, statements confirmed by more than two-thirds of surveyed population in the GEM and much above the region or Baltic average.

**Figure 61. Entry Density and GDP per Capita, 2008-12**



Source: World Bank Group Entrepreneurship Snapshots (WBGES).

**Figure 62. Total Early-Stage Entrepreneurial Activity**



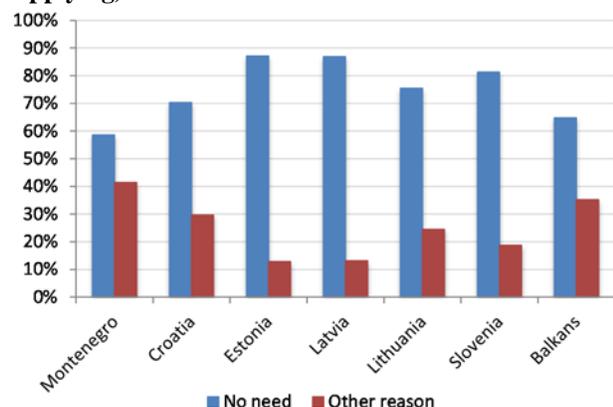
Source: Global Entrepreneurship Monitor (GEM), 2010.

113. **Montenegrin firms face constraints on access to credit.** A relatively high proportion of Montenegrin firms that did not apply for a loan in the past year report having needed one (Figure 63). Despite this evidence for credit constraints, the share of bank loans in the financing of firm working capital and fixed investments is high and Montenegrin firms are also less likely to source their working capital from internal funds (Figure 64). A high share of internal funds is typically interpreted as a sign of credit supply issues.

<sup>54</sup> World Bank Enterprise Surveys (BEEPS).

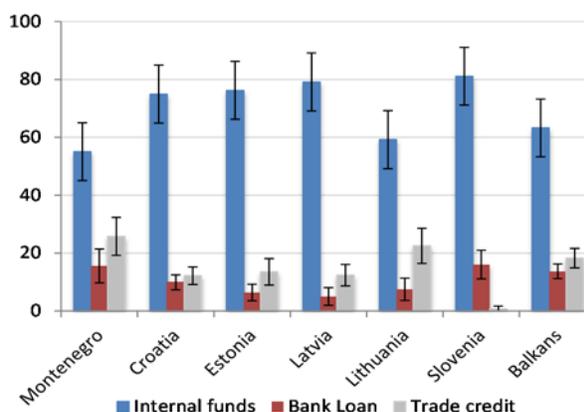
Hence, this evidence is puzzling. The data suggest that there is relatively high use of trade credit – the sum of credit from suppliers and advance payments from buyers – in Montenegro. Additional BEEPS data on the use of supplier credit hint that it is advance payments from purchasers that are driving this pattern.

**Figure 63. Line of Credit or Loan (Reason For Not Applying)**



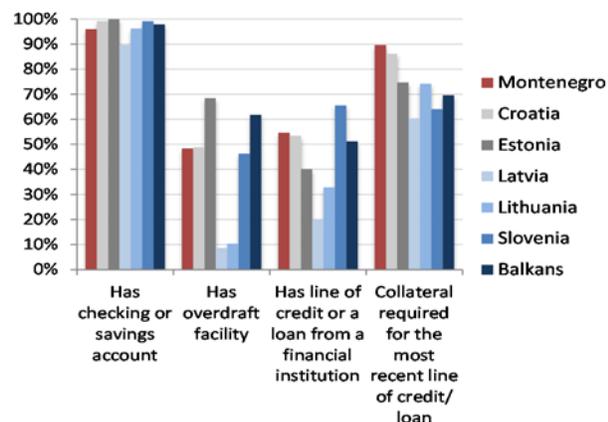
Source: BEEPS 2013.

**Figure 64. Source of Working Capital**



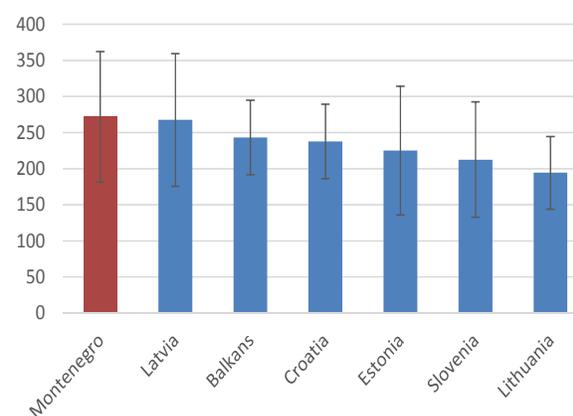
114. **The share of firms required to provide collateral for a line of credit or loan is slightly above comparator countries** (Figure 65). Conditional on requiring collateral, the mean collateral value as a percentage of the loan is also among the highest across comparators. When combined with the higher rate of loans requiring collateral, this suggests that there are relatively high collateral demands on firms in Montenegro (Figure 66).

**Figure 65. Access to Finance**



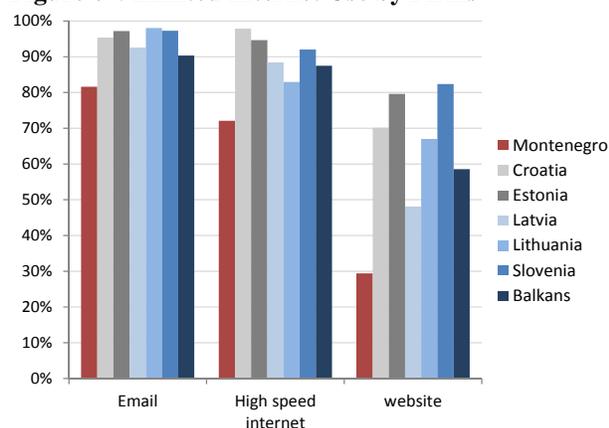
Source: BEEPS 2013.

**Figure 66. Collateral Value, as Percent of Loan Amount**



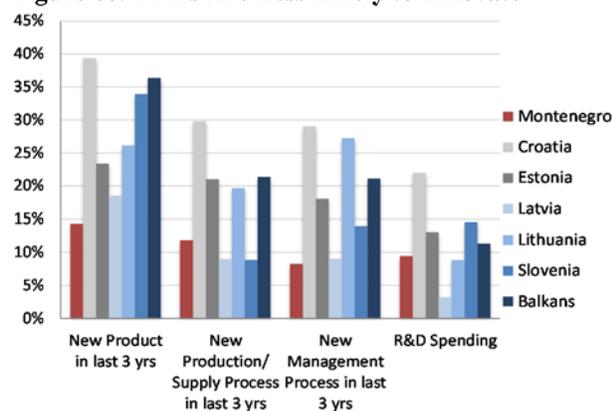
115. **There is limited usage of ICT among private firms and firms are less likely to innovate.** Barely 80 percent of firms use email to communicate with suppliers and clients, just over 70 percent have high speed internet, and fewer than 30 percent have a website (Figure 67). Fewer than 15 percent of firms have introduced a new product in the last 3 years, compared with over 36 percent in the Balkans. Fewer than 12 percent have introduced new production methods in the last 3 years, and fewer than 9 percent have introduced a new organizational/ management practice or structure over the last 3 years. And spending on R&D lags slightly behind the Balkans, at 9.5 percent, as compared with 11.3 percent (Figure 68). In fact, the overall R&D investment in the country amounts to only 0.45 percent of GDP, of which 75 percent comes from the government.

**Figure 67. Limited Internet Use by Firms**



Source: BEEPS 2013.

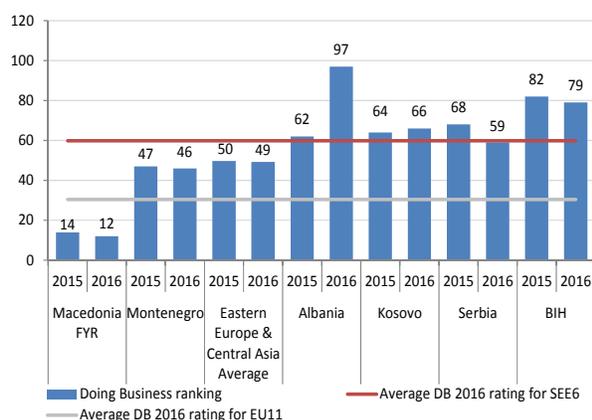
**Figure 68. Firms Are Less Likely to Innovate**



### Product and Labor Regulatory Environment

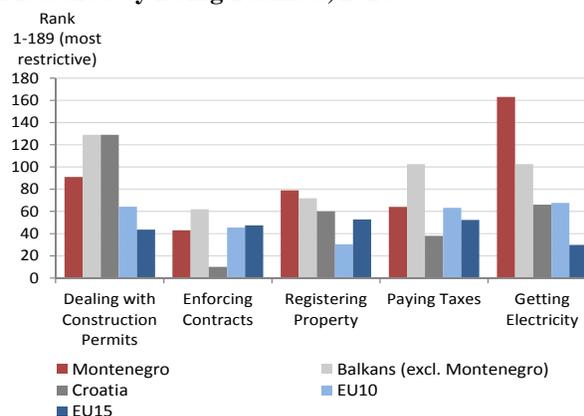
116. **Montenegro records a steady improvement in the ease of doing business.** Since 2008, Montenegro has seen a constant improvement in the overall ease of Doing Business, going up by more than 50 places. In 2016, Montenegro ranked 46<sup>th</sup> (of 189) globally, improving position from the 47<sup>th</sup> position in Doing Business 2015 (Figure 69) primarily thanks to a reform in the field of dealing with construction permits, where the activities aimed at reducing procedures from 158 to 154 days, and costs have been recognized. Montenegro also made an improvement in the area of paying taxes due to simplification of procedures for companies by introducing an electronic system for filing and paying labor taxes. There are, however, several areas in which Montenegro can do better (Figure 70) compared to the region, as well as the EU.

**Figure 69. Ease of Doing Business, 2016**



Source: Doing Business 2016.

**Figure 70. Mean Rankings in the Ten Areas Measured by Doing Business, 2016**



117. **Firm level data from the 2013 Enterprise Surveys (BEEPS) also suggest that although the regulatory environment has seen serious reform, there is still room for improvement, particularly in the implementation of reforms and in the transparency of procedures.** On average, about 12 percent of management time is still spent dealing with regulation and applications for permits and licenses. There is a relatively high incidence of corruption in the granting of licenses and permits. The share of respondents who believe that there is an expectation of unofficial payments when dealing with customs, taxes, licenses or regulations is relatively high, as are self-reported instances of being asked for informal payment when applying for licenses or permits.

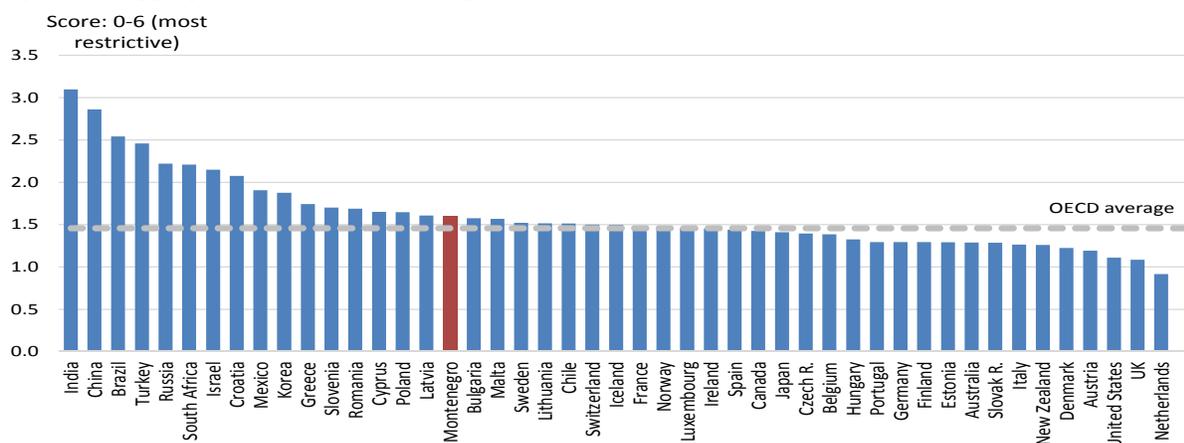
**Table 9. Business perception of “biggest obstacle” for firm growth**

	Montenegro	Croatia	Estonia	Latvia	Lithuania	Slovenia	Balkans
<b>Access to finance</b>	<b>9.2%</b>	<b>21.9%</b>	<b>10.9%</b>	<b>12.3%</b>	<b>13.5%</b>	<b>18.2%</b>	<b>10.8%</b>
Access to land	1.2%	0.1%	1.6%	0.3%	1.5%	5.7%	1.2%
Business licensing and permits	0.4%	1.2%	0.8%	0.1%	1.5%	0.8%	3.2%
Corruption	1.2%	4.6%	0.0%	1.0%	1.8%	4.3%	6.1%
Courts	0.2%	4.9%	0.0%	0.3%	0.0%	6.3%	4.3%
Crime, theft and disorder	2.6%	3.5%	2.2%	0.2%	1.2%	0.2%	3.3%
<b>Customs and trade regulations</b>	<b>9.1%</b>	<b>3.2%</b>	<b>0.8%</b>	<b>0.1%</b>	<b>3.5%</b>	<b>0.0%</b>	<b>4.9%</b>
Electricity	2.5%	0.5%	7.1%	0.2%	0.9%	0.9%	2.9%
Inadequately educated workforce	2.7%	3.5%	9.2%	13.1%	10.7%	0.9%	2.5%
Labor regulations	4.3%	5.6%	5.0%	2.5%	3.3%	6.5%	2.1%
Political instability	7.1%	8.7%	2.8%	9.9%	7.0%	16.0%	23.4%
<b>Practices of competitors in the informal sector</b>	<b>18.1%</b>	<b>10.6%</b>	<b>21.4%</b>	<b>6.2%</b>	<b>22.1%</b>	<b>7.1%</b>	<b>12.6%</b>
Tax administration	2.5%	3.2%	2.1%	7.3%	1.2%	12.1%	4.5%
<b>Tax rates</b>	<b>38.1%</b>	<b>27.9%</b>	<b>30.8%</b>	<b>44.1%</b>	<b>30.4%</b>	<b>19.7%</b>	<b>17.0%</b>
Transport	1.0%	0.7%	5.3%	2.5%	1.6%	1.3%	1.2%

Source: BEEPS 2013.

118. **Product market regulation lags behind the OECD and most small EU states.** State control and barriers to trade and investment remain high. There is high and widespread public ownership and low information access for foreign parties. Domestic regulations do not conform to international standards (Figure 71), which the harmonization with the EU *acquis* should help address over the medium term.

**Figure 71. Aggregate Product Market Regulation Score, 2013**



Note: PMR indicator includes indicators of: (i) State control; (ii) Barriers to entrepreneurship; and (iii) Barriers to trade and investment.

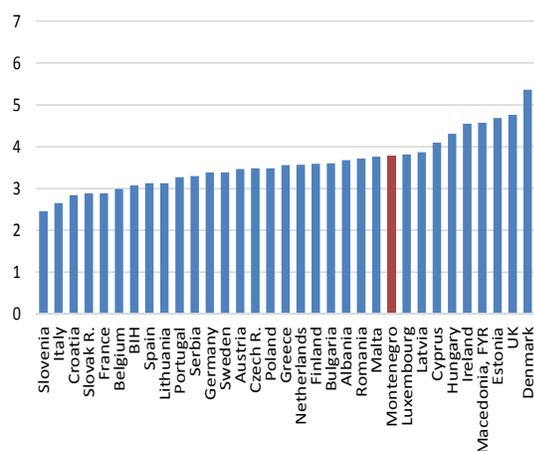
Source: OECD.

119. **Labor regulation could be more flexible.** Hiring and firing practices are impeded by regulations, but the impediment is considered moderate.<sup>55</sup> Montenegrin employers view labor regulations as less strict

<sup>55</sup> It is noteworthy that the subjective perceptions of the strictness of EPL are not necessarily consistent with the objective indicators. Employers may perceive labor regulations as onerous, while objective indicators suggest they are flexible (Bulgaria is an example). This may be because objective indicators are partial and do not cover all aspects of the regulatory environment. There may be important constraints to flexibility that are not reflected by the available objective indicators.

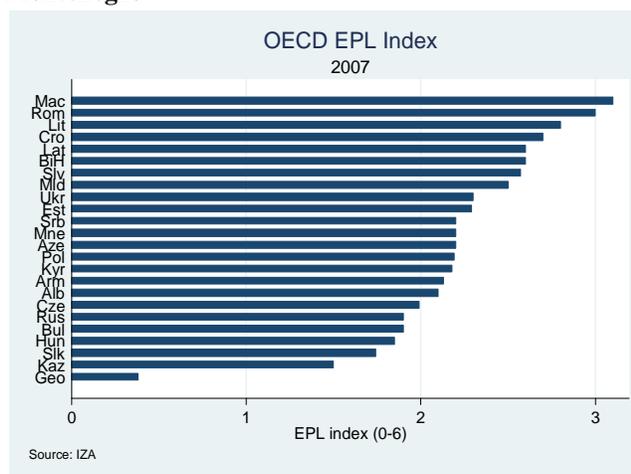
than their counterparts in Slovenia, Croatia, Bosnia and Herzegovina or Serbia, but they view them as stricter than employers in Ireland, FYR Macedonia, United Kingdom or Denmark (Figure 72). Most importantly, it is employers' perceptions of the regulations, rather than the "objective" situation that actually determine the hiring and firing decisions made by firms. Hence, subjective employers' perceptions are the most relevant indicator of the actual impact of EPL. According to estimates by the Institute for the Study of Labor (IZA), EPL in Montenegro is moderately strict, and the index lies in the middle of the ECA range (Figure 73).<sup>56</sup> However, the EPL index for Montenegro amounting to 2.2 is above the OECD average of 1.9. EPL in Montenegro is also stricter than in a number of transition economies, including the Czech Republic, Bulgaria, Hungary and Slovakia. Hence, there is still significant room to enhance labor market flexibility in Montenegro.<sup>57</sup>

**Figure 72. Hiring and Firing Practices**



*Note:* Results of executive Opinion Survey.  
*Source:* The Global Competitiveness Report 2015-16, World Economic Forum.

**Figure 73. Employment Protection Legislation (EPL) in Montenegro**



*Source:* Institute for the Study of Labor (IZA).

120. **There are high monetary but modest procedural costs of redundancy.** According to the World Bank Doing Business indicators, the monetary costs of redundancy are relatively high in Montenegro, whereas the procedural costs are rather low. Using the same business case as per the Doing Business methodology, Montenegrin employers have to pay 28 weeks of salary to workers made redundant, compared with 13 weeks in Poland and 8 weeks in Romania (Figure 74).<sup>58</sup> In a number of countries (e.g. BiH, Croatia, Hungary, Slovenia) the mandatory severance pay is still higher than in Montenegro. Redundancies, especially group lay-offs, are very costly in other ways. They may inhibit enterprise restructuring and limit hiring (severance pay represents an implicit labor cost). Procedural costs of dismissal are lower in Montenegro than in most other European countries (Figure 75). These costs include advanced notice of dismissal, consultations with trade unions, preventive measures, and potential approval of a third party (e.g. employment office). Thus, dismissing workers seems to be relatively easy in Montenegro, although it is more difficult than in a number of countries, including Bulgaria, Czech Republic and Hungary.<sup>59</sup>

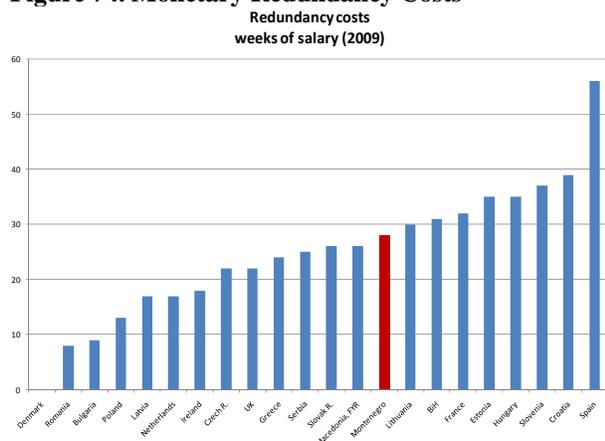
<sup>56</sup> IZA is a private independent economic research institute focused on the analysis of global labor markets.

<sup>57</sup> The index refers was calculated for 2007 and thus does not reflect the most recent revisions to the labor law.

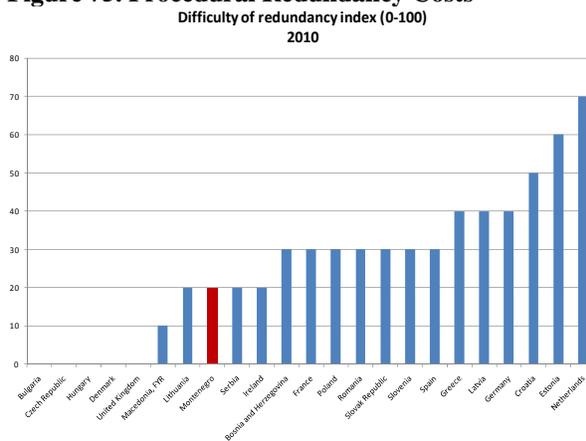
<sup>58</sup> The severance pay amounts to 1/3 of the average wage per year of service with the same employer.

<sup>59</sup> The index is only an approximate measure of the actual procedural costs of redundancy, as by its nature it does not take into account all factors that affect the costs (such as enforcement, the strength of trade unions, court decisions, firm ownership and size, political pressures, or social norms).

**Figure 74. Monetary Redundancy Costs**



**Figure 75. Procedural Redundancy Costs**

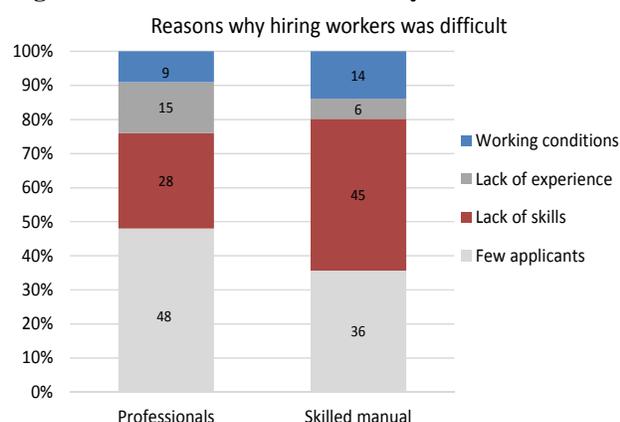


Source: World Bank Doing Business, 2010; World Bank staff calculations.

**121. Although hiring is easy, according to the Enterprise Survey, inadequate workforce skills are an obstacle to growth to new firms.**

This particularly refers to a relatively small segment of firms (about 10 percent) that are mainly modern and innovating firms (Figure 76). Otherwise, two recent firm surveys (2013/14) are consistent in reporting that the vast majority of Montenegrin employers do not see workers' skills as an obstacle to the activity of their firms, and they do not encounter much problems when trying to hire new workers. Employers demand not only job-specific technical competences, but also adequate socio-behavioral and cognitive skills which are equally important for employability. Young workers often lack some of the core employability skills. Skills that college graduates as well as secondary school graduates lack most often are other language, leadership and initiative, creative and critical thinking and advanced technical. The shortage of the global market-oriented competitive skills is also reflected in the low number of Montenegrin online freelancers as a share of its total population and their lower lifetime earnings, compared to SEE6.

**Figure 76. Difficult to Fill a Vacancy**



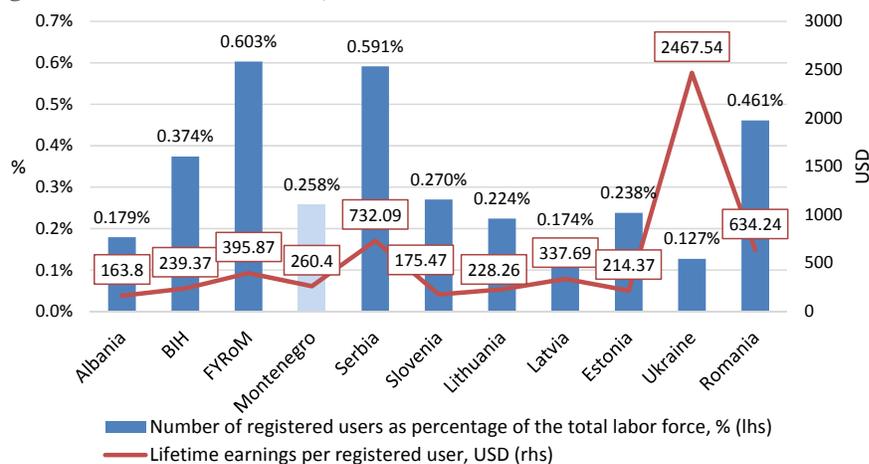
Source: Rutkowski (2014).

**122. The take-up of ICT-enabled freelance jobs in Montenegro could be further leveraged to become instrumental in addressing unemployment among the vulnerable groups such as youth, women, and rural unemployed.**

There are 649 users from Montenegro registered on the eLance online platform (or ~0.26 percent of the total labour force) (Figure 77). For comparison in Serbia the number of eLance users corresponds to 0.59 percent of the total labour force and in FYR Macedonia to 0.60 percent. ICT-enabled (online) work offers flexible work arrangements, opportunities to build new skills, and work in a multicultural environment. The World Economic Forum places Montenegro ahead of other countries in the region in terms of the quality of ICT skills. At the same time it should be noted that online jobs are not necessarily directly linked to IT (e.g. web-design, software programming, video editing, etc.) allowing for participation in a virtual job market for freelancers with a broad set of skills, including people with a lower skills set (transcription, translation of small chunks of text, tagging photos, etc.) or those who suffer from the occupational skills

mismatch due to the reorientation of the economy from industry to service-based.

**Figure 77. Online Freelancers, Percent of Labor Force and Their Lifetime Earnings, December 2014**



Source: WB staff calculations based on <https://www.elance.com/q/freelance-talent-report-2012>.

## Human Capital

### Demographics, Migration, Labor Force Participation and Gender

123. **Montenegro is a multi-ethnic small state.** Based on the 2011 census Montenegro has 620,029 citizens. The most populated cities are Podgorica (185,937), Niksic (72,443) and Bijelo Polje (46,051). In terms of its religious and ethnic structure, Montenegro is composed of Montenegrins (45.0 percent), Serbs (28.7 percent), Bosniaks (8.7 percent), Albanians (4.9 percent), Muslims (3.3 percent), Roma (1.0 percent), Croats (1 percent) and other ethnic groups (7.4 percent)<sup>60</sup>. The majority of the population is Orthodox (72.1 percent). Many languages are spoken, though Montenegrin is the official language.

124. **Montenegro has become a destination for migrant labor.** Throughout the 20<sup>th</sup> century Montenegro saw mostly emigration, with Montenegrins moving to the richer republics of Yugoslavia. Following independence, Montenegro became a country of net immigration. As a consequence of shortages for particular professions and sectors, there has been a significant inflow of seasonal, mainly low skilled workers during the last ten years. According to data from the national employment agency, these numbers reached its peak of 64,150 seasonal workers in 2008, dropping to 17,108 seasonal workers in 2009 when the country was hit by the global crisis. The majority of seasonal workers originate from Serbia (42 percent), Bosnia and Herzegovina (27 percent) and FYR Macedonia (23 percent). They work mainly in tourism and catering (29 percent), construction (28 percent), and agriculture (7 percent).<sup>61</sup>

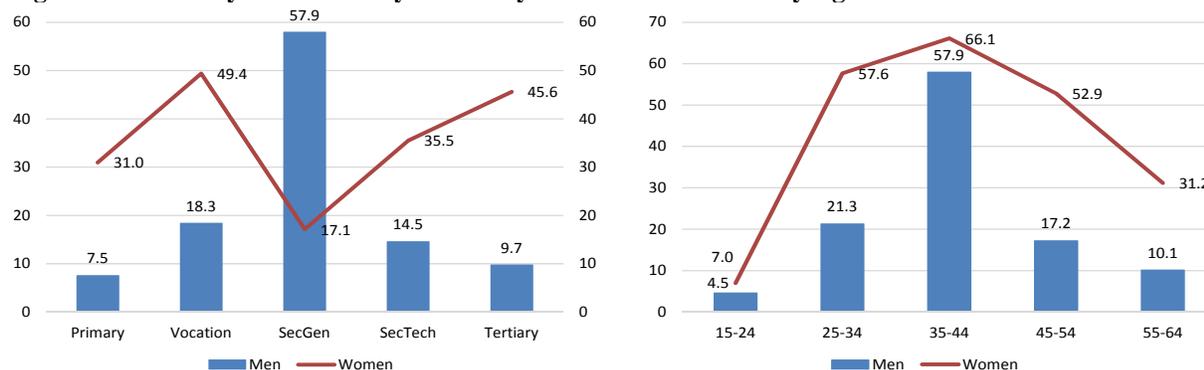
125. **Low fertility and increased life expectancy are resulting in a rapidly aging population.** Montenegro exhibits a below-replacement fertility rate of 1.7 and increasing age-specific life expectancies. In 2011, 12.8 percent of the population was 65 and older, 20.6 percent was younger than 15 years of age, and 66.6 percent was working-age (Figure 78). The country's old age dependency ratio (defined as the ratio of the population 65 years and older to those between 20 and 64) has increased from 12 percent in 1985 to close to 21 percent in 2013, and it is expected to deteriorate further to about 37 percent by 2050 (Figure 79). While in 2010 for every 10 people of working age population there were 1.8 people over the age of 65, in 2030 there will be 2.8. This makes the reduction in high youth unemployment and an increase in labor force participation pressing policy priorities, both in terms of: (i) preventing a dramatic drop in the labor supply; and (ii) financing

<sup>60</sup> MONSTAT, Census 2011. As noted earlier, the census likely underestimates the Roma population.

<sup>61</sup> Grecic and Kaludjerovic 2012.



**Figure 81. Inactivity Due to Family Duties: by Education Level and by Age**

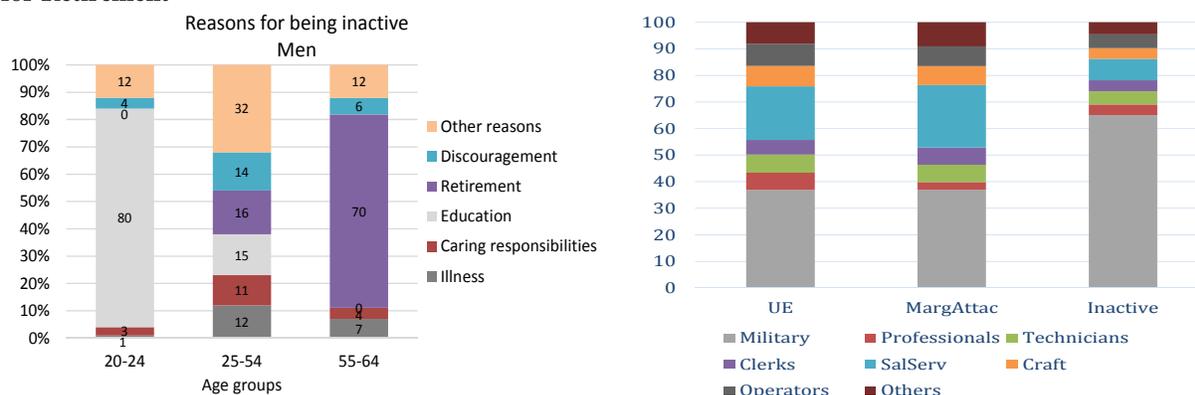


Note: People older than 64 are excluded.

Source: LFS (2013).

129. **Early retirement is the main reason for inactivity among older workers.** Retirees account for 70 percent of inactive men, and 55 percent of inactive women aged 55-64 (Figure 82). This means that many workers, especially men, retire before reaching the official retirement age of 65. This reflects the fact that there are still many routes to early labor force withdrawal while the Montenegro’s pension system itself provides incentives to early retirement.<sup>62</sup> The reasons for inactivity among prime age (25-54) workers are less clear. One out of three inactive prime age men and one out of four inactive prime age women are inactive for no identifiable reason. One can only presume that some of these people are employed informally, but do not reveal their employment status. This seems quite likely given that the size of informality is severely underestimated in the Montenegrin labor force survey.

**Figure 82. Men Leaving the Labor Market too Early for Retirement** **Figure 83. Sector of Occupation in the Last Job**



Source: LFS, World Bank staff calculations.

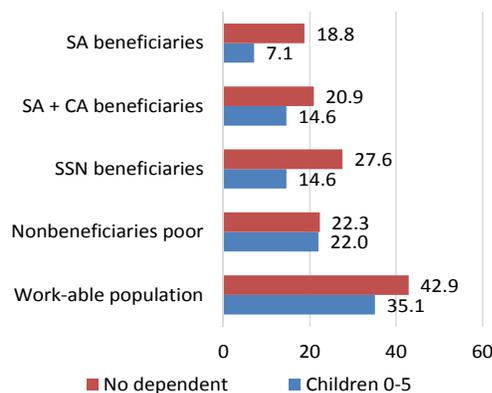
130. **Discouragement figures prominently as a reason for inactivity among prime age workers.** People withdraw from the labor force because their job search efforts proved futile. They no longer believe that jobs are available. This refers to both men and women. As many as 14 percent of prime age men, and 10 percent of women are economically inactive because they are discouraged by the lack of job opportunities available to them. Stronger labor demand and an increase in job offers is thus a necessary condition for a higher labor force participation rate. According to sector of occupation in the last job, more than half of unemployed or marginally attached (not looking for a job, but would like to work) came from military or sale

<sup>62</sup> World Bank (2012).

service jobs. About 67 percent of inactive population worked in military service (Figure 83).

131. **There is also underutilized reserve labor among women.** Greater caretaking duties for children are associated with significantly lower employment rates, especially among women who benefit from social assistance and the child allowance. The recent amendments to the Law on Social and Child Care that provide for a lifetime benefit for mothers of three and more children, equal to 70 percent of average net salary in Montenegro (a condition being having 25 or 15 years of service for mothers of three and four plus children), are likely to further deteriorate the female employment and participation rates. One would expect immediate withdrawal from the labor force of all eligible women at the time when Montenegro needs to proactively address the aging phenomenon. The employment rate of female social safety net (SSN) beneficiaries is much lower in the presence of young children aged 0–5 (15 percent) than among beneficiaries with no dependents (28 percent) (Figure 84). On the other hand, the presence of young dependents is not associated with lower employment rates in the case of male SSN beneficiaries. The relationship between the presence of dependents and reduced employment appears to be much weaker for women in the general population and even for non-beneficiary poor women. Individuals with higher incomes may have access to more support services, including formal childcare, than in SSN beneficiary households. Almost half of prime age women indicate that caring responsibilities are the main reason for inactivity, as do 23 percent of older women. This implies that a key to higher labor force participation by women is the development of child-care, and long-term care institutions. Such a development would have a double effect on the one hand freeing of female labor, and creating new jobs on the other.

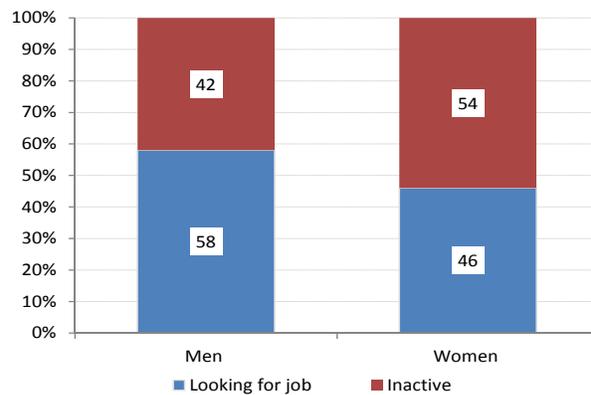
**Figure 84. Employment Rate of Female Living With a Person in Need of Care in Montenegro, 2011**



*Note:* SA=social assistance. CA=child allowance. SSN=social safety nets (includes SA, CA, disability benefits, and scholarships). “Work-able” includes all individuals of working age (15–64) who are neither disabled nor in education or training. “Poor” refers to individuals in the bottom 20th percentile of the total consumption distribution.

*Source:* Montenegro HBS data 2011.

**Figure 85. Youth Not in Education or Employment (NEET)**



*Source:* LFS 2013, World Bank staff calculations.

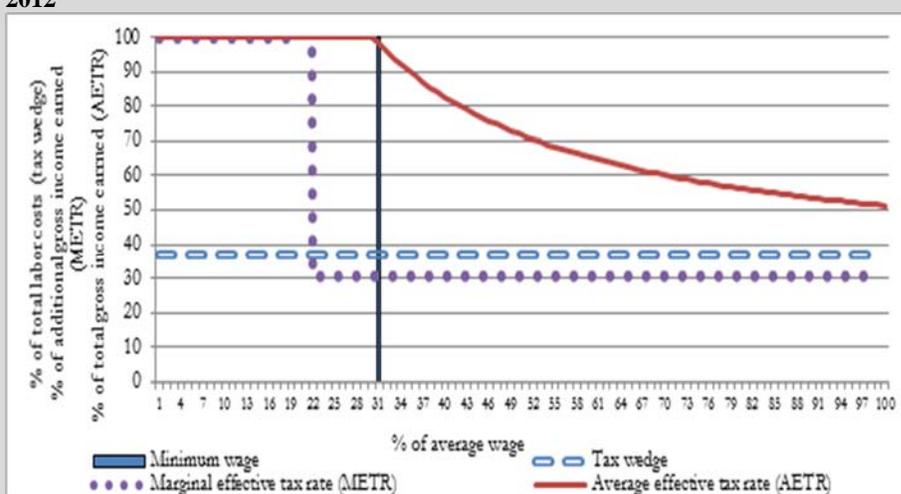
### Box 6. Social Assistance Disincentives Characteristics

There are implicit work disincentives in the design of the social assistance programs, while the high marginal effective tax rates are unlikely to have a significant impact on employment decisions. Just as in many other countries in the Eastern European and Central Asian region, the social assistance program is designed so that each additional euro earned by a beneficiary is subtracted from the benefit amount. The benefit is calculated as the difference between a certain income threshold and net income of beneficiary families. As a result, below the threshold there is no financial incentive for a family to earn more income because it will be automatically reduced from the benefit they receive. This

design has a 100 percent marginal effective tax rate (METR)<sup>63</sup> Figure 86 shows that the marginal effective tax rate is 100 percent for a one-earner family with two children until about 20 percent of the average wage, when such a family is no longer eligible for social assistance. For a one-earner family with two children, social assistance is withdrawn at a level that is less than the full-time minimum wage.<sup>64</sup> This is also the case for other household types. It is therefore unlikely that these high marginal effective tax rates have a significant impact on employment decisions, but, in theory, they could weaken incentives to take up part-time, temporary, or seasonal employment at levels below the social assistance threshold. Disregarding such earnings partially or fully for the purposes of the social assistance income test could significantly improve attachment of social assistance beneficiaries to the formal labor market. In the absence of such a possibility, they are most likely to take such employment in the informal sector.

Unemployment insurance is not a significant disincentive to working. Work disincentives are measured by the “unemployment trap,” the implicit tax on returning to work for unemployed persons receiving unemployment benefits. In Montenegro, the average effective tax rate for moving from unemployment to work is consistently lower than in other countries in the region and EU10<sup>65</sup> and EU15<sup>66</sup> averages. Recent reforms to the unemployment benefit have significantly reduced the generosity and duration of the benefit for most unemployed (ISSP 2012).

**Figure 86. Tax Wedge and Effective Tax Rates for a One-Earner Couple with Two Children in Montenegro, 2012**



Note: Minimum wage corresponds to a value of approximately 30 percent of the average wage, which is the legal minimum for a person working full-time. The tax wedge is defined as the proportional difference between the costs of a worker to their employer (wage and social security contributions, i.e. the total labor cost) and the amount of net earnings that the worker receives (wages minus personal income tax and social security contributions, plus any available family benefits). The METR is defined as  $(1 - \Delta ne / \Delta ge)$  where  $\Delta ne$  is equal to the change in net earnings, and  $\Delta ge$  is the change in gross earnings experienced by the household, where the marginal change is 1 percent of the average wage. The AETR is defined as  $(1 - \Delta ne / \Delta ge)$  where  $\Delta ne$  is equal to the change in net earnings, and  $\Delta ge$  is the change in gross earnings experienced by the household, where the total change is from 0 to x percentage of the average wage (from 1 to 100 percent, as indicated on the x axis).

Source: World Bank (2013a).

132. **There is also a substantial proportion of Montenegrin youth who are neither in education nor in employment.** The so called NEET rate is 17 percent, meaning that one out of six young (15-24) people are idle. The NEET rate in Montenegro is 5 percentage points higher than the EU average of 12 percent, indicating

<sup>63</sup> The METR is defined as  $(1 - \Delta ne / \Delta ge)$  where  $\Delta ne$  is equal to the change in net earnings, and  $\Delta ge$  is the change in gross earnings experienced by the household, where the marginal change is 1 percent of the average wage.

<sup>64</sup> The minimum monthly (176 working hours) wage of full-time employed person cannot be lower than 30 percent of the average wage in the previous semiannual period. This is different from the minimum price of labor (minimum pay standard), which is €55.

<sup>65</sup> The EU10 comprises the following 10 countries: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia.

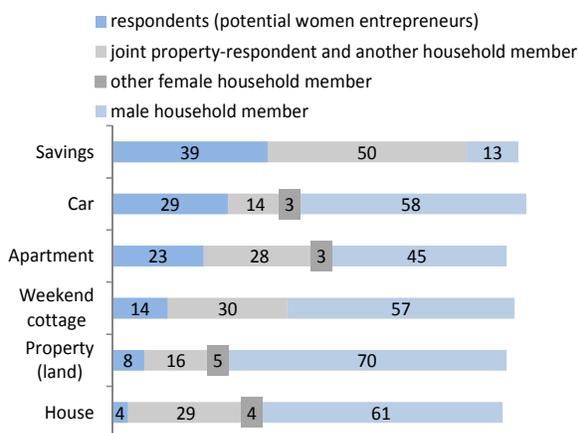
<sup>66</sup> The EU15 comprises the following 15 countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

that youth idleness is a greater problem in Montenegro than in most EU countries. Interestingly, the NEET rate is virtually the same for women as for men (one could have expected a higher rate among young women given that some of them care for their children). Less than half of young people who are not in employment or education are looking for work. More than half of NEETs are economically inactive. However, there the gender difference is significant. While 58 percent of young NEET men are looking for employment, only 46 percent of young women do (Figure 85). The difference is most likely explained by child caring responsibilities of some young women. In any case, there is substantial scope for activating young people in Montenegro, both men and women.

133. **Women face barriers to self-employment.** Female participation in self-employment programs organized by the Employment Agency of Montenegro (EAM) is 44 percent. The percentage of loans extended to women might be higher if women did not face barriers to providing collateral owing to a tradition of male property title inheritance. Access to land can lift a woman's security, status and enhance her bargaining power in families and communities, boosting well-being at the household level.

134. **Women in Montenegro tend not to own land and property.** Women are owners of 4 percent of houses, 8 percent of land and 14 percent of holiday houses (Figure 87). They are represented in entrepreneurship significantly less than men, as evidenced by data that only 9.6 percent of women are business owners, which places Montenegro behind the EU and the countries in the region. This data includes women who are only formal business owners while the management functions and entrepreneurial activities are performed by their male relatives.<sup>67</sup> The reason for this dismal result is that for a large number of women entrepreneurship is not the primary goal in life, but they get into it mainly out of necessity.

**Figure 87. Ownership of Household Assets, Percent**

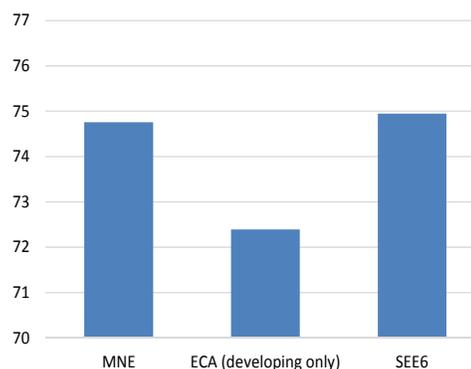


Source: UNDP (2011), survey based.

## Health

135. **Basic health coverage is good, but inequality persists in health outcomes, service access, and service quality.** Coverage of some essential services is equitable: social health insurance is nearly universal, and 99 percent of poor women deliver in health facilities. Between 2000 and 2012 out-of-pocket spending accounted for about 31 percent of total health expenditure, which is relatively low compared to similar countries in the region. Out-of-pocket health spending is lower in Montenegro than in other Western Balkan countries, but the poor spend a higher percentage of their income on health care (mostly for purchasing drugs) than the wealthy and informal payments remain prevalent. Thus financial access remains one of main obstacles, as well as the fact that poorer people are less likely to seek medical care when in need.

**Figure 88. Life Expectancy, 2013**



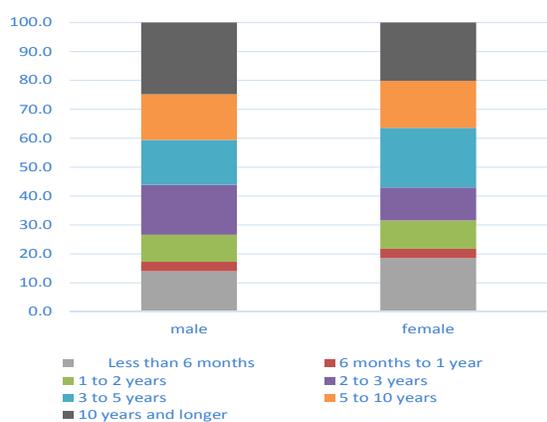
Source: MONSTAT, World Bank.

<sup>67</sup> UNDP (2011) and Montenegrin Employers Federation (2013).

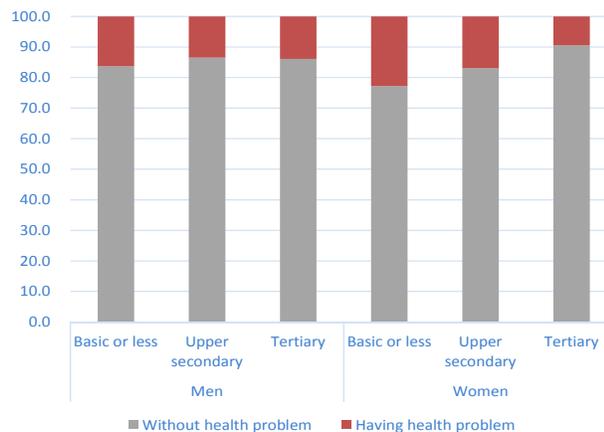
136. **Life expectancy has been increasing slowly in Montenegro, but is still behind the EU average, while infant mortality rate is declining to the EU level.** At 74.8 years in 2013, life expectancy in Montenegro is higher than the ECA average of 72 but lower compared to the SEE6 and EU11 average of 75 (76) (Figure 88). Life expectancy at birth increased by only 0.3 years in the last two decades, with only Kosovo among SEE6 countries performing worse. A drop in the infant mortality rate from 12.5 in 2000 per 1,000 live births to 4.9 in 2013 (same as for EU11), marked Montenegro as a country with the lowest level of infant mortality among SEE6 countries, though large disparities exist within the population. Child malnutrition has also declined: in 2013, 9 percent of all children under age five suffered from chronic malnutrition, with much higher rates among Roma children (27 percent).<sup>68</sup>

137. **Due to aging population and increased lifestyle-related risk factors, the causes of death moved to the non-communicable diseases (NCDs).** Transition from infectious to NCDs has already taken place in Montenegro, like in other European countries. Up to half are certified as cardiovascular disease, one in six as cancer and one in eight as stroke. The standardized death rates from diseases of the circulatory system for the population less than 65 years of age is similar to Romania, but three to four times higher than in Germany, France, or Slovenia. Risk factors for NCDs are increasing. Moreover, a third of children aged 12-24 months are overweight, which increases future risks for chronic diseases. Thirty-one percent of adults smoke, with equal rates among men and women, and higher rates among older adults. Alcohol consumption is predominantly a male problem and has increased since 2008, which increases health risks and road accidents. Among Montenegrin adults, 45 percent of females and 39 percent of males experience psychological distress, clearly incomparably high rate. Sick leave rates and disabilities are high and also lead to lower labor productivity. The problem is larger given the incidence of long-term health problem is very high (Figure 89).

**Figure 89. Duration of Health Problem**



**Figure 90. Adults 15+ Reporting Health Problems**



Source: World Bank staff calculations.

138. **Poverty is both a cause and a consequence of poor health.** Vulnerable groups, the elderly, and Roma females are more at risk of having poor health or poor nutrition, which in turns perpetuates poverty. Health problems affect significantly more low skilled workers, especially women (Figure 90). Access to quality health services is more limited for those with lower household income. Only two-thirds of poor mothers have four or more antenatal care visits, compared to 91 percent of the wealthiest quintile, and the quality of ANC service is worse for poor women and Roma. In 2013, 88 percent of all children (24 to 35 months) were fully immunized, compared to 78 percent for the poorest quintile, and only 12 percent for Roma.<sup>69</sup> Self-assessment studies of health conditions showed that one in five Roma considered their health to be poor (compared to 1 in 10 for non-Roma). Over half of Roma women marry before age 18 (56 percent),

<sup>68</sup> UNICEF and MONSTAT, Multiple Indicator Cluster Survey (MICS) 2013.

<sup>69</sup> MICS 2013.

and nearly one-third have their first child before 18 (compared to 3 percent for the overall population), which puts them at greater risk for health problems and poverty.

139. **Roma have lower child vaccination rates, difficult physical access to medical services, and affordability concerns.** According to UNDP/WB/EC regional Roma survey<sup>70</sup> the overall regional data prove a high disparity between Roma and their non-Roma neighbor<sup>71</sup> in accessing the most frequently provided medical interventions. In Montenegro, 99 percent of non-Roma neighboring adults reported medical insurance coverage compared to 10-percentage points lower share of Roma coverage, thus performing above the region average. Low Roma awareness of health issues results in a higher incidence of disabilities, long-standing illnesses, and greater numbers of in-patient visits. These outcomes are usually result of socio-economic deprivation (particularly the isolation from the educational system and formal labor markets) and unhealthy lifestyles. In addition, access to health services is more limited and inequitable outside of the capital. As such, Roma, refugee and disabled children are the worst affected. From 2004, the financial affordability, measured by access to essential drugs, has increased in the region with the most positive shifts for the Roma respondents in Montenegro, where cases of unaffordable medicines decreased from 66 percent in 2004, to only 19 percent in 2011. The reported lack of access to medicines in Montenegro among non-Roma neighbors stood at 8 percent, significantly lower than in other countries.

## Education

140. **Education has had a significant impact on economic growth in Montenegro.** Isolating from the total factor productivity (TFP) the impact of improvement in the education of the labor force and the advance of applied or technical/vocational knowledge on labor force efficiency, educational structure seems to be quite a robust growth predictor (Table 10). Once the contribution of efforts to maintain the educational level of a growing labor force and the contribution of “raw” labor are added to improvement of the educational structure, the total contribution of labor is much larger than in the simple growth diagnostics (Figure 52); absolute contribution of education to economic growth is 1.3 percent, while its relative contribution is about 40 percent. Impact of labor force education improvement is much stronger (0.9 percent per year) than impact of efforts to sustain existing level of education of growing labor force (0.4 percent per year) due to increasing trends to invest in education, and, increasing wage premiums on higher levels of education (despite increasing supply of educated labor).

**Table 10. Contribution of Education and Knowledge to Growth in Montenegro, 2000-13**

	2000-2013			2000-2008			2008-2013		
	Growth rate	Contribution to growth	%	Growth rate	Contribution to growth	%	Growth rate	Contribution to growth	%
Physical Capital – C	4.4%	1.7%	56.7%	3.5%	1.4%	28.0%	5.8%	2.3%	2521.2%
Raw Labor	0.9%	0.5%	17.2%	1.2%	0.7%	14.5%	0.3%	0.2%	213.1%
Education: To sustain existing level of ED	0.7%	0.4%	12.7%	0.9%	0.5%	10.8%	0.3%	0.2%	197.7%
Education: Improvement of labor ED level	1.4%	0.9%	27.8%	1.3%	0.8%	15.9%	1.6%	1.0%	1046.9%
Educational Total Contribution	2.1%	1.3%	40.5%	2.2%	1.3%	26.7%	1.9%	1.1%	1244.5%
N T F P (New Total Factor Productivity)	-0.4%	-0.4%	-14.3%	1.5%	1.5%	30.8%	-3.5%	-3.5%	-3878.8%
G D P	3.1%	3.1%	100.0%	5.0%	5.0%	100.0%	0.1%	0.1%	100.0%

Source: MONSTAT, World Bank staff calculations.

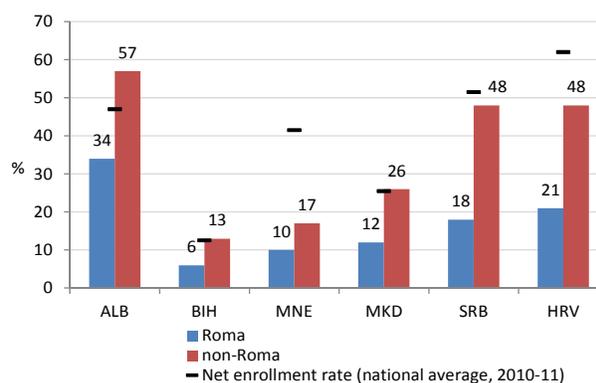
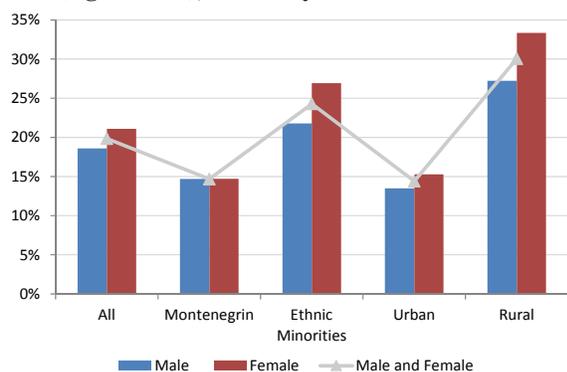
141. **Enrollment rates in primary and secondary education are comparable to other European and**

<sup>70</sup> UNDP (2012).

<sup>71</sup> Living in areas with higher density (concentration) of Roma populations.

**OECD countries, though ethnic minorities lag behind.** Almost all children are, according to official statistics, enrolled in primary education, which places Montenegro favorably in the midst of higher-income countries. The share of individuals 15 and older with at most primary education for the bottom 40 percent (12.4 percent) is almost the twice the share for the top 60 percent; however, it is among the lowest compared to other South Eastern European countries and even to the EU11 average. Enrollment is particularly high in secondary education, with an overall net enrollment rate of 86 percent, above the OECD average of 84 percent, and with little difference between the male and female enrollment rates. Adjusted net primary enrollment rates show that enrollment is 1.3 percentage points lower for girls than boys in Montenegro. However, a significant number of Roma children is not enrolled in compulsory primary education. One of the reasons for this is the absence of classes in their native language and the difficulty of providing them with basic lessons in Montenegrin before starting primary school. About 15 percent of ethnic Montenegrins complete only primary education or less, while 27 percent of non-Montenegrin women have a primary education or less (Figure 91) and non-Montenegrin men have a lower completion rate of 22 percent. Thirty percent of those in rural areas have a primary education or less. According to the 2013 MICS survey, 58 percent of Roma children are enrolled in primary school, but net enrollment in secondary school is only 5 percent for Roma.

**Figure 91. Population With Primary Attainment or Less (Ages 15-64), Ethnicity and Location** or **Figure 92. Pre-School Attendance, 2011**



Source: LFS, World Bank staff calculations.

Note: Share of children aged 3 to 6 who attended pre-school, kindergarten, or nursery.

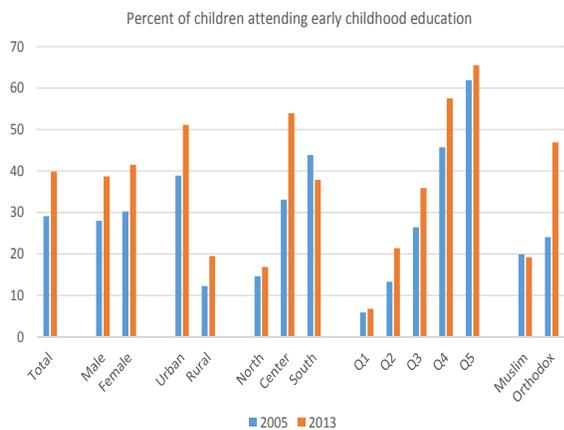
Source: UNDP/WB/EC Regional Roma Survey 2011.

142. **The social inequities start early--enrollment rates in pre-primary education are low, with geographic and income inequities.** In Montenegro about 40 percent of children 3 and 4 years old attend pre-primary education up from 31 percent in 2005 (Figure 92). This places Montenegro amongst the countries in the region with the lowest enrollment rate. There is almost no difference between boys and girls, but there is a substantial difference across urban (52 percent) and rural (20 percent) areas and across regions, with the Center region having the highest percentage (55 percent) and the North region the lowest (18 percent). There are large disparities across the income distribution: 66 percent of children from the richest households attend pre-primary education compared to only 8 percent in the poorest (Figure 93).

143. **Low pre-school enrolment rates severely reduce chances of school completion and increase the probability of dropping out of school early.** In Montenegro, 94 percent of Roma were early school leavers (not finishing the secondary education), compared to only 29 percent for non-Roma living in close proximity (Figure 94). Furthermore, many Roma children live in isolated areas or in refugee camps, so it is not easy for them to get to school. Simple regression analysis shows that having tertiary education is associated with a reduced probability of belonging to the bottom 40 percent by, for example, 19 percentage points in Montenegro<sup>72</sup>.

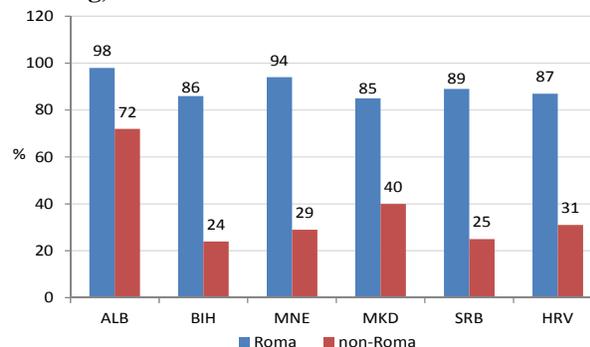
<sup>72</sup> Ceriani and Davalos (2014).

**Figure 93. Within Country Differences in Pre-School Attendance, 2005 and 2013**



Source: MICS 2013.

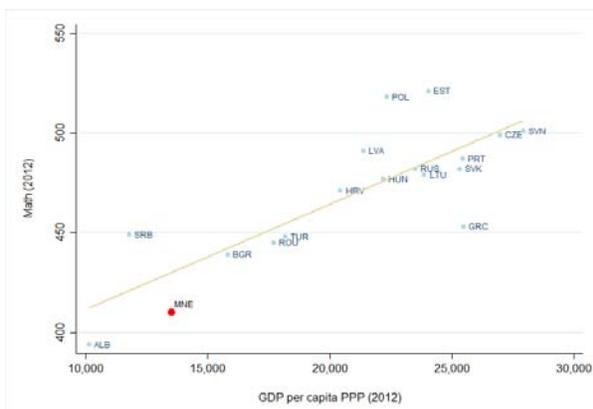
**Figure 94. Early Leavers from Education and Training, 2011**



Note: Share of population aged 18 to 22 which is not attending school and has not completed education higher than lower secondary or short-term upper secondary.  
Source: UNDP/WB/EC Regional Roma Survey 2011.

144. **Montenegro is underperforming in terms of education outcomes, but returns to schooling are positive.** At 4.5 percent of GDP, Montenegro spends as much on public education as other countries in the region and very close to the OECD recommended 5 percent of GDP, but these spending levels have not yet resulted in comparable education outcomes. Montenegrin students underperform on the PISA (Figure 95), showing inadequate levels in reading, mathematics, and science among 15-year-olds, though scores have improved over the past three rounds of PISA (Table 11). This highlights the importance of improving the quality of basic education, but low enrollment rates in pre-primary education likely also contributes. Returns to schooling are positive for all secondary education, with vocational education showing a 18 percent higher mean wage, secondary general and technical a 30 percent and tertiary an 80 percent increase.

**Figure 95. PISA Scores and GDP per Capita in ECA, 2012**



Source: World Bank staff calculations.

**Table 11. Montenegro PISA Performance Over Time**

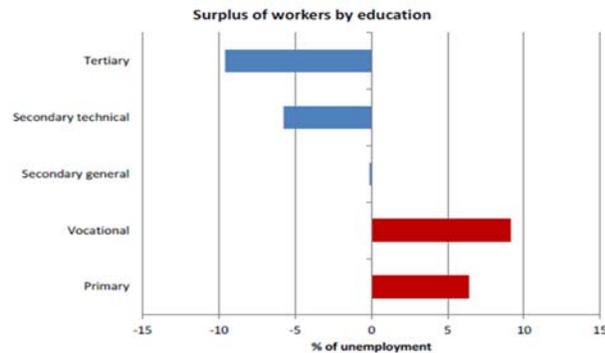
	Math	Reading	Science
<b>2006</b>	399	392	412
<b>2009</b>	403	408	401
<b>2012</b>	410	422	410
<b>OECD Average (2012)</b>	494	496	501

Source: OECD.

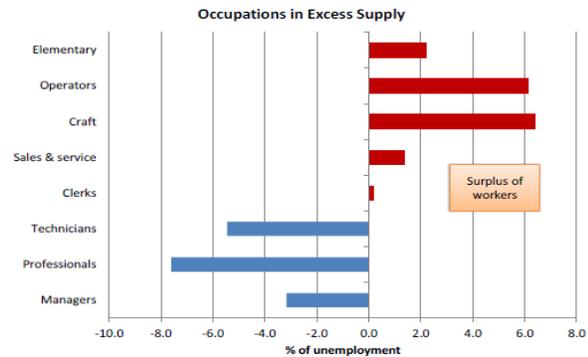
145. **Poor education outcomes lead to skills mismatches that may also explain poor employment outcomes in Montenegro.** Many of the unemployed and the inactive do not have the skills necessary to find employment, including part-time and freelance employment opportunities offered online. Relative to demand, there are too many unemployed with primary education and vocational training (Figure 96); altogether at least

15 percent of the unemployed will not benefit from job growth due to insufficient educational attainment<sup>73</sup>. While 90 percent of youth are enrolling in secondary education, two-thirds of them are in the VET system that offers excessive specialization, early diversification at the age of 14, an obsolete program content and lack of collaboration among schools and employers. Manual workers – machine operators, assemblers, craftsmen – will find it particularly difficult to escape unemployment because of the falling demand for their skills. Altogether, some 20 percent of the unemployed are likely not to get a job because they the occupational mismatch in Montenegro have an occupation that is no longer in demand. The occupational mismatch is more severe than the educational mismatch because occupational categories are narrower and more skill-specific than the educational ones (Figure 97).

**Figure 96. Skills Mismatch by Education, 2011**



**Figure 97. Skills Mismatch by Occupation, 2011**



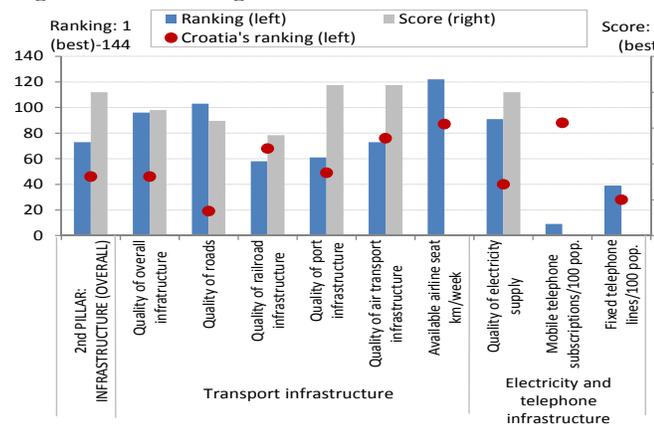
Source: Montenegro Labor Force Survey 2011, World Bank staff calculations.

### Physical Infrastructure

146. **Transport, energy, and ICT are central to connectivity, and can contribute to the expansion of trade, and enhance business productivity.**

According to the Global Competitiveness Index 2015, Montenegro ranks 73 out of 140 in the Infrastructure pillar. The quality of roads, electricity supply, and airline connections were suboptimal compared to EU peers (Figure 98). While Montenegro has improved some of its transport infrastructure, especially the airport in the capital and some key roads, infrastructure still lags significantly behind what a dynamic economy needs.

**Figure 98. Montenegro's Scores in the Infrastructure Pillar**



Source: World Economic Forum, 2015-16.

### Transport

147. **Transport infrastructure is central to Montenegro's regional integration and a prerequisite for a vibrant tourism sector as well as for trade and productive activities.**

An efficient and integrated transport system (roads, railways, ports and airports) facilitates trade and factor mobility. Better transport linkages would also improve access, help correct regional imbalances in development particularly in the north of the country and also remove bottlenecks (North-South).

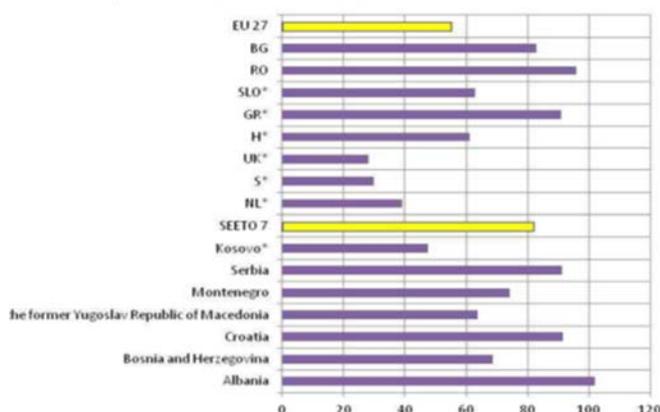
148. **Lack of, or low, quality infrastructure is one of the key problems in further development of entrepreneurship.** That includes poor roads, high prices and market entry barriers. While the EU Progress

<sup>73</sup> Based on the Employers' Survey and the LFS 2011.

report indicates that the track access charges for all types of trains are at EUR3 per train km of a 1,000 t-train, which would be indeed high as an average, the Montenegrin authorities have indicated that steep slopes of 2.5 percent are the reason for these high rates but that the overall average value is less than EUR2 per train km if empty trains are taken into account. Publishing the track access charge for empty trains would help clarify this point. Relatively large losses due to breakage or spoilage during shipment indicate that road quality is insufficient.

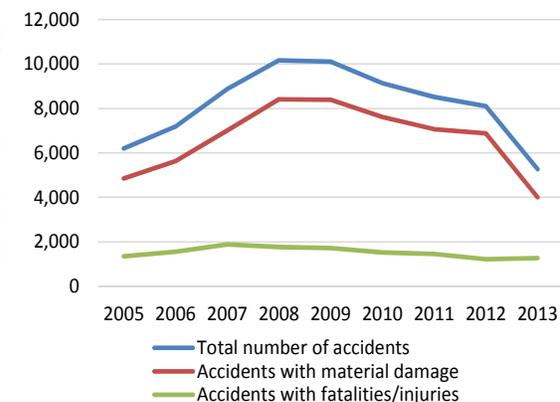
149. **Montenegro fares reasonably well on road safety performing better than the SEETO average for 2012** (Figure 99). The fatality rate per million inhabitants was 74, compared to the EU27 average of 55. The progress was remarkable given that the number of Montenegro’s road fatalities per million in 2008 was 160, more than twice the number for 2012. The number of road accidents increased sharply from about 6,200 in 2005 to about 10,200 in 2008 then started dropping gradually to reach about 5,300 in 2013. These trends indicate that the safety programs introduced around 2008 were effective in terms of reducing road accidents.

**Figure 99. Road Fatalities per Million of Population in Montenegro and Select Countries, 2012**



Source: SEETO Road Safety Strategy Survey 2014, March 2014.

**Figure 100. Road Accident Rates in Montenegro from 2005 to 2013**



Source: Data from MTMA.

150. **The road sector needs rehabilitation.** The rehabilitation backlog equals to EUR299 million (8.4 percent of GDP or 0.6 percent of GDP per year to address rehabilitation backlog over the next 15 years). Currently, half of the roads are considered to be in poor conditions (Table 12). Periodic maintenance expenditure must quadruple to maintain the network in sustainable condition. The annualized periodic maintenance needs of the network amounts to around EUR9.7 million per year of 1,882 km of roads (146 km per year). In contrast, the average expenditure from 2006 to 2013 was EUR2.5 million per year (40 km per year). The average expenditure for regular maintenance (winter and non-winter routine maintenance) from 2006 to 2013 was around EUR5,000 per year per km (or EUR10 million per year), considered reasonably funded according to international experience.

**Table 12. Condition of State Roads**

Condition of State Roads	2003 Montenegro Road Survey	2006 World Bank Estimate	2013 EBRD Road Survey for a Small Portion of Network	Our Estimate (2014)
Good	0.18	15%	15%	29%
Fair	0.33	39%	35%	18%
Poor	0.49	37%	40%	53%
Very Poor		10%	10%	

Source: World Bank.

151. **Compared to international benchmarks, Montenegro has underinvested in the road sector.** Montenegro’s total investment as a percentage of GDP (1.1 percent) is 65 percent of the average of the two

benchmarks used and if one would consider Montenegro's economy to be closer to those of the Mediterranean countries (MED11), the lag in road expenditures would be even higher (Table 13). This is a direct result of not allocating sufficient resources to asset preservation over the past ten years and the resulting backlog in rehabilitation.

**Table 13. International Benchmarks for Transport Infrastructure Investment as a percent of GDP**

	OECD*	MED 11	Average of ITF and MED 11	Montenegro (average from 2006 to 2013)
Road Maintenance	0.5%	0.9%	0.7%	0.7%
New and Upgrade Roads	0.6%	1.4%	1.0%	0.4%
Total	1.1%	2.3%	1.7%	1.1%

Source: International Transport Forum, 2012, Transport Infrastructure for MED11 Countries, Network Reports 108/12.

152. **Road user charges may be used for road maintenance to reduce the burden on the budget and the crowding out that may result from the new highway construction.** Montenegro imposes vehicle registration fees paid at the time of purchase and vehicle license fees paid annually, tolls and fuel excise tax. Like many countries, these income sources are not earmarked to road maintenance and construction. Table 14 shows that the revenues generated by the road sector are 3-5 times expenditures on construction, rehabilitation, and maintenance. Registration and license fees make up about 17-19 percent of the total revenues generated by the road sector, and have in fact exceeded total expenditures in the road sector in 2012 and 2013 by over 50 percent. Typically, these charges in Western European countries are significantly higher than in Eastern European countries indicating that there is often room for increasing the revenues from vehicle registration and use over time.

**Table 14. Road User Payments to the Montenegro Government, 2006-2013 in Million Euros**

	2006	2007	2008	2009	2010	2011	2012	2013
Gasoline Excise	24.7	29.5	30.0	30.2	31.9	29.0	23.8	22.4
Diesel Excise	28.5	34.0	46.0	54.2	54.6	47.3	42.1	45.1
Gasoline VAT	10.9	13.0	13.2	13.3	14.0	12.8	10.5	10.7
Diesel VAT	15.4	18.3	24.8	29.2	29.5	25.5	23.5	23.6
Import duties on road user items	32.4	50.9	49.6	17.6	18.1	17.7	n/a	n/a
VAT on road user's items imports	24.6	41.3	42.1	15.3	16.3	16.3	n/a	n/a
Vehicle registration, use and related fees	n/a	n/a	n/a	n/a	n/a	n/a	33.7	35.1
Tolls	n/a	n/a	n/a	n/a	n/a	n/a	2.1	2.2
<b>Total (excluding registration, license fees and tolls)</b>	<b>136.5</b>	<b>187.0</b>	<b>205.7</b>	<b>159.8</b>	<b>164.4</b>	<b>148.6</b>	<b>n/a</b>	<b>n/a</b>
<b>Road Sector Expenditures</b>	<b>14.1</b>	<b>25.3</b>	<b>34.9</b>	<b>45.1</b>	<b>55.5</b>	<b>51.2</b>	<b>29.3</b>	<b>20.5</b>

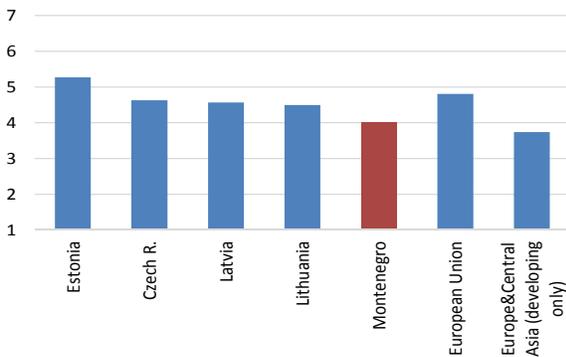
Note: n/a: not available.

Source: MTMA, MoF and MIPA.

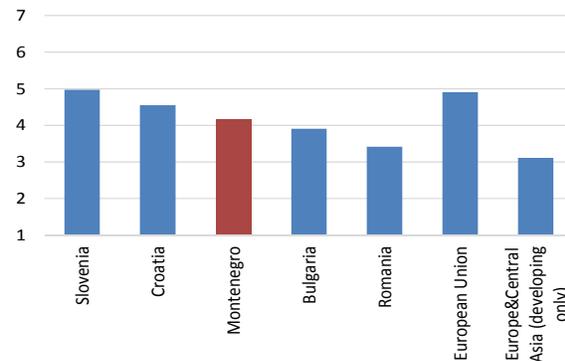
## Ports and Logistics

153. **Service delivery in customs clearance and port infrastructure offer important entry points for endearing investors to Montenegro.** Montenegro exhibits lukewarm performance in the provision of logistics services and customs clearance (Figure 101). In customs clearance, Montenegro scored a 4 out of 7 in 2015, significantly behind most EU countries. Performance has improved only slightly from 2007 when Montenegro scored a 3. In "burden of customs procedures" Montenegro is comparable to only the bottom three EU11 countries: Romania, Poland, and Bulgaria. While the quality of port infrastructure is lower than the EU average, Montenegro's port infrastructure is comparable to Croatia, Bulgaria, and Poland (Figure 102). Only five EU11 countries are ahead of Montenegro. Nevertheless, by international standards, Montenegro's ports are not as efficient as they should be.

**Figure 101. Burden of Customs Procedure, 2015**



**Figure 102. Quality of Port Infrastructure, 2015**

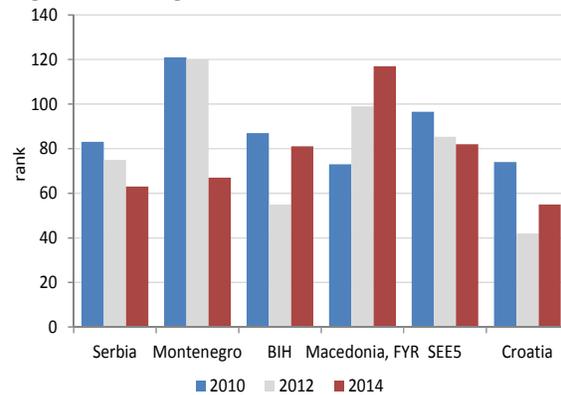


Note: (7=well developed and efficient by international standards).

Source: World Economic Forum, 2015-16.

154. **Nonetheless, Montenegro significantly improved its logistics performance in 2014.** It has moved from 120<sup>th</sup> in 2012 to 67<sup>th</sup> in 2014, mostly due to higher efficiency in border management, better quality of trade and transport related infrastructure, timeliness of shipments, and ease of arranging competitively priced shipments. Although only Serbia among neighbor countries was ranked better in 2014, Montenegro can still improve to catch up with EU countries (Figure 103). This requires consistent actions in improving logistics performance in Montenegro. Better risk management, further procedural simplification, closer interagency cooperation and enhanced use of ICT with regard to cross border clearance procedures, post clearance audit for customs, and risk-based trade controls for the inspection agencies involved in international trade will bring the country closer to meeting the requirements of the WTO Trade Facilitation Agreement.<sup>74</sup>

**Figure 103. Logistics Performance Index (LPI)**



Source: World Bank.

## Electricity

155. **While coverage of electricity is good, quality is inconsistent.** One hundred percent of Montenegro's population has access to electricity. The World Economic Forum ranks Montenegro 91<sup>st</sup> out of 140 on quality of electricity supply (Figure 98). Montenegro's ranking is close to that of its neighboring countries (Bosnia and Herzegovina and Serbia, ranked 85<sup>th</sup> and 76<sup>th</sup>, respectively), but well below Croatia (ranked 40<sup>th</sup>). The average number of outages per month in Montenegro is comparable to that of other countries that experienced power outages in the last year, as is the percentage of annual sales lost due to outages. Combined with the higher rate of power outage, this suggests that the total loss from power outages is relatively high in Montenegro (Figure 104).

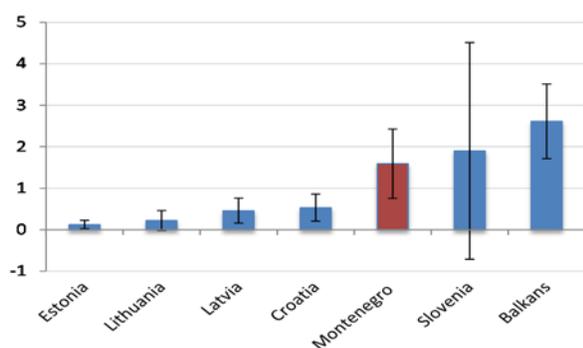
156. **Energy connectivity needs to be improved both internally and within the region.** The government believes that with strengthened tariff policy and institutions, new investments and expanded

<sup>74</sup> IFC, Western Balkans Trade Logistics Project. Other areas identified in the course of a 2014 WTO TFA self-assessment workshop comprised of public and private sector stakeholders and facilitated by USAID and IFC where Montenegro is not aligned and needs support are: making information available on the internet, establishment of a WTO TFA enquiry point, notifications for enhanced controls or inspections, publications of fees and charges, pre-arrival processing, establishment and publication of average release times, developing appropriate rules for the treatment of perishable goods, and the development of a Single Window system.

supply, energy could over the long term also become an important export industry. That said, Montenegro is facing multiple and pressing energy challenges.

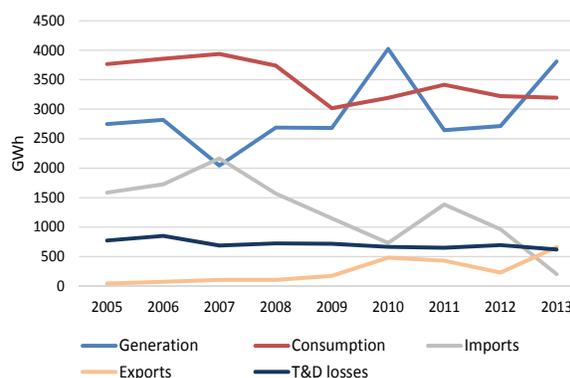
157. **The power sector is aging.**<sup>75</sup> The inherited industrial structure relies on high energy consumption and high household demand and inefficient consumption (particularly with respect to electricity for heating purposes) results in the combination of high energy intensity/low energy productivity. The system presents high transmission and distribution (T&D) losses due to an under-maintained grid, significant non-payment and theft of electricity, and sizable (around 19 percent) technical and commercial losses from the T&D network (transmission losses of about 4 percent and distribution losses of about 15 percent) compared to average T&D losses of 6 to 8 percent.

**Figure 104. Incidence of Power Outages and Their Reported Losses**



Note: lines indicate confidence intervals.  
Source: BEEPS 2013.

**Figure 105. Electricity System**



Source: MONSTAT, World Bank staff calculations.

158. **Having a state-owned monopoly electricity provider inhibits the efficient allocation and mobilization of resources for future investments and growth.** A market dominated by a single entity, of which the government is the majority shareholder, no longer efficiently serves the public interest. Electricity needs call for a structural reorganization and full commercialization of the electricity company (Elektroprivreda Crne Gore AD Niksic—EPCG). Though the country has significant potential for the development of renewable energy sources (including biomass, new hydro, wind and solar), almost no construction has occurred. In recent years intensive effort has been made towards the creation of a conducive regulatory framework for investments in the RE sector. Progress can be seen in the tendering of a number of small hydro-power plants locations, and in preparations for construction of the country's first wind park.

159. **Montenegro depends on electricity imports, while the usage of renewable energy resources is low** (Figure 105). From 2005 to 2013, Montenegro met 29 percent of its electricity needs through imports<sup>76</sup>. Exceptions were 2010 (year with extremely good hydrological conditions) and 2013, both years with reduced

<sup>75</sup> The only thermal plant in Montenegro, lignite-fired thermal power plant (TPP) Pljevlja, provides critical base-load generation capacity and was commissioned more than 30 years ago, and is planned for retirement in 2025 (Energy Community 2013). Also reflecting its age, TPP Pljevlja has a significant negative impact on the environment and human health - Montenegro ranked on first place in the Energy Community comparing average estimated external costs of SO<sub>2</sub>, NO<sub>x</sub> and dust emissions among all Contracting Parties (26.7€/kWh). In order to comply with the Large Combustion Plant EU Directive, investment costs for the environmental upgrade needed at TPP Pljevlja, with the aim of reducing emissions in Montenegro, are estimated to EUR 60 million. Some of the hydro power plants (HPP) are also aging; the largest power plant in the country, hydro power plant (HPP) Piva, is operating in the power system of Montenegro since its commissioning in 1976. More importantly, hydropower is susceptible to variation in hydrology and as HPPs account for 75 percent of country's generation capacity (or 65 percent of average generation) there are significant variations in annual output.

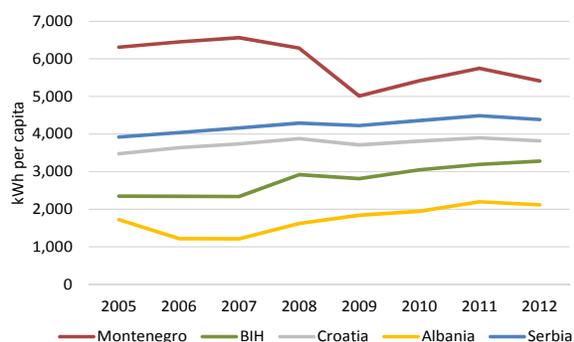
<sup>76</sup> MONSTAT.

demand of main industrial electricity off-takers, resulting in ability of country’s power system to fully cover domestic needs the only two times since 1990. Total installed generation capacity is only 876 MW. Support for utilization of renewable energy (RE) sources needs to be continued in the future to fully exploit the abundant natural potential for increased RE generation. Apart from the abundant technical hydropower potential (around 4,000 GWh), Montenegro energy strategy<sup>77</sup> envisages the construction of TPP Pljevlja II (225 MW), a replacement of existing thermal plant.

160. **The topology of existing transmission grid creates overloads and overall system instability**<sup>78</sup>. In order to increase security of supply, enhance interconnectivity with neighboring countries, further reduce losses (currently at 3-4 percent) and accommodate new generation facilities, significant investments into the transmission grid, estimated at more than EUR240 million<sup>79</sup>, are required until 2025. A major step forward would be the completion of the 500 kV undersea cable to Italy (1,000 MW), whose construction recently started on the Italian coast. In addition, the Energy Community identified the 400 kV interconnection between Montenegro, Serbia and BIH as one of the “Projects of Energy Community Interest” (PECI), with commissioning planned for 2020. Finally, regardless of the recent improvements, additional investments are required in the distribution grid as well in order to reduce the significant technical losses (19 percent in 2011).

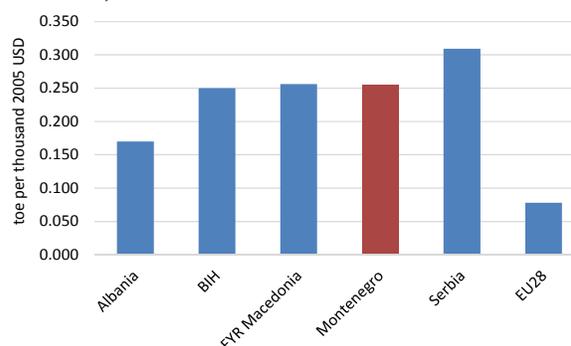
161. **Power demand in Montenegro is likely to increase in the future** – the country’s energy strategy<sup>80</sup> foresees electricity demand increase by more than 50 percent from 2010 level by 2030. Montenegro’s per capita electricity consumption (Figure 106) is the highest in the Balkans, but well below EU levels<sup>81</sup>. Significant drop in 2009 is due to reduced overall consumption in the country caused by reduced offtake by main industrial consumers (KAP Podgorica and Niksic steel mill). Consumption per capita in 2011 almost returned to the 2005 level.

**Figure 106. Electricity Consumption Per Capita**



Source: World Development Indicators.

**Figure 107. Energy Intensity in 2012 Measured in Total Final Consumption (in toe) per Unit of GDP (in 2005 USD)**



Source: IEA World Energy Statistics and Balances.

162. **The Montenegrin economy has high energy intensity measured as energy used per unit of gross domestic product.** This is primarily due to significant consumption in the aluminum smelting process, which is using outdated and far from energy-efficient technology. But energy consumption is also inefficient among households, many public buildings, and in the services sectors, especially with regard to heating—a very high share of electric energy is used for space heating, mainly because of low electricity prices. Although energy intensity in 2012 at 0.255 toe per thousand USD was 30 percent lower than in 2005, it still remains 3.3 times

<sup>77</sup> Ministry of Economy (2014). “Energy strategy of Montenegro until 2030”.

<sup>78</sup> In case of unavailability of the 400 kV grid, as the main 400 kV and 220 kV lines are running in parallel with different transmission capacities (1,330 MVA vs. 300 MVA).

<sup>79</sup> Ibid.

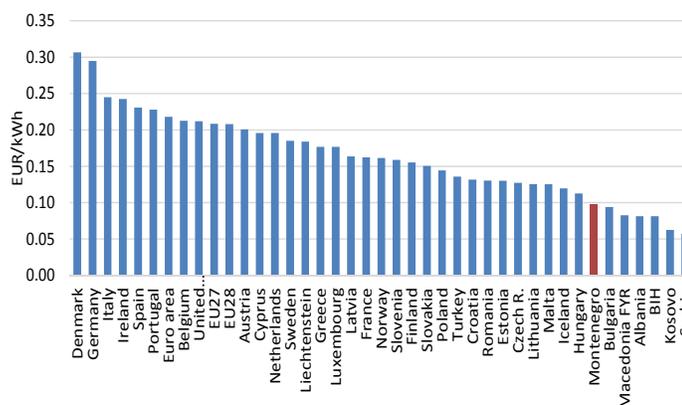
<sup>80</sup> Ibid.

<sup>81</sup> World Development Indicators.

higher than the EU28 average<sup>82</sup> (Figure 107).

163. **Electricity prices will increase in the future, raising energy affordability concerns.** Electricity prices for domestic consumers (including all taxes and levies) remain at 47 percent of the EU28 average<sup>83</sup> (Figure 108), while at 9.82 €-cents/kWh in the first half of 2015, Montenegro's price is significantly higher than that of Bosnia and Herzegovina and Serbia (8.12 and 5.75 €-cents/kWh). Electricity prices will likely converge gradually. A combination of energy efficiency interventions as well as social safety net programs for energy poor are the most effective ways to address energy affordability of citizens.

Figure 108. Electricity Prices

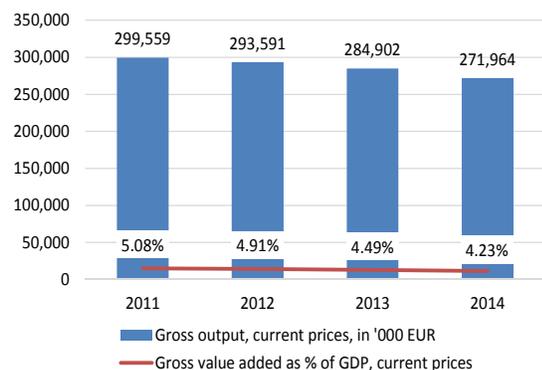


Source: Eurostat (2015).

### Information and Communication Technologies

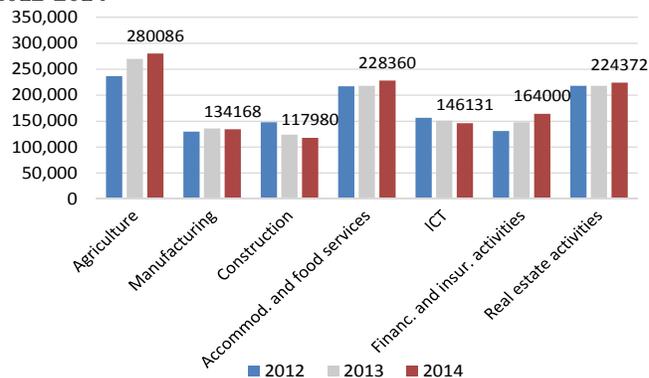
164. **Montenegro has not performed well in integrating ICT into service delivery.** On the Global Innovation Index, Montenegro ranks low compared to the EU countries. Similarly, Montenegro scores the lowest in general infrastructure provision. It is outperformed by all EU11 countries. ICT offers huge opportunities for a small country like Montenegro fostering a higher level of connectedness with economies in the region and beyond, by enabling higher intensity movement of goods, services, finance, and people through increased data and communication exchange.

Figure 109. Sector Output and Gross Value Added, 2011-2014



Source: MONSTAT.

Figure 110. Gross Value Added by ICT and Other Sectors, 2012-2014



Source: MONSTAT.

165. **The ICT sector share in GDP remains within the EU average, despite declining sector output and value added since 2011.** The output shrank by 9 percent in 2014 as compared to 2011 (Figure 109). In EU28, ICT to GDP ratio was 4.4 percent<sup>84</sup> in 2014. The ICT sector produces a higher value added when compared to manufacturing, construction or financial and insurance services. Such performance designates ICT as a sector with a major potential to become one of the growth engines of the economy (Figure 110).

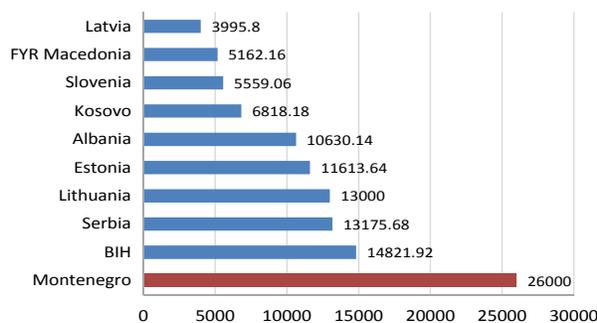
<sup>82</sup> IEA World Energy Statistics and Balances.

<sup>83</sup> Eurostat (2015).

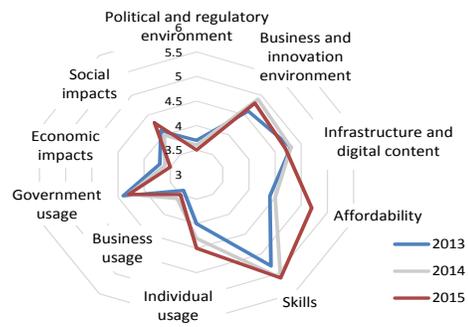
<sup>84</sup> Eurostat.

166. **There is a growing IT industry characterized by small firms paying high wages.** Montenegrin IT and programming specialists are in demand on the online IT outsourcing market. From 2010-14, the average number of employees in the sector was under 5,000. At the same time, ICT net wages were third highest on the market, after financial sector and electricity, gas steam and air conditioning supply, at around EUR660 in 2014. Local IT specialists earn more than their peers in Albania, Bosnia and Herzegovina or the Baltic states, which is indicative of the higher volume of online work orders completed to date by Montenegrin specialists<sup>85</sup>. Yet, local IT specialists are underperforming compared to FYR Macedonian or Serbian IT outsourcing specialists that signals a room for growth. ICT can help strengthen the country's competitiveness, improve investment climate, and increase innovative capacity of its private and public sectors, thus transforming Montenegro into a vibrant innovation hub linking Montenegrin businesses and the Balkans, as a whole, to the rest of Europe and to the global value chains of tourism, manufacturing, and other sectors. Smart investments in the local ICT infrastructure, especially in broadband, open data, and e-government, as well as in targeted ICT skills development can have huge payoffs in terms of productivity growth, job creation, and improvement in public service delivery.

**Figure 111. Number of Households per Internet Service Provider** **Figure 112. Global Competitiveness in ICT**



Source: Telegeography GlobalComms Database, [www.telegeography.com](http://www.telegeography.com)



Source: World Economic Forum, 2015.

167. **Mobile broadband adoption in Montenegro is among the highest in the region; however, the take-up of high speed connections is lagging behind.** The portion of low-speed connections in Montenegro is the highest among six Western Balkan states (the portion of speeds up to 4 Mbps presents 80 percent of all connections),<sup>86</sup> which denotes lower adoption of high-speed broadband service and lower possibility to harness the power of ICT on an individual and firm level. According to the survey on ICT usage in enterprises 2014, of the companies that have access to the internet, 96.5 percent use DSL or some other type of fixed broadband connection, but 51.7 percent have a maximum download speed of 2Mbps to 10Mbps, and only 13.9 percent reach speeds of 30Mbps to 100 Mbps.<sup>87</sup> Adoption of high-speed connections is likely constrained by limited fixed broadband competition (Figure 111). Mobile broadband take-up, at 11.7 percent in 2012 (accounted by the data cards/modem), surpassed the EU average (9 percent in 2012) and is nearly three times the second highest value in the region (Serbia, at 4 percent in 2012). Overall, mobile broadband take up in Montenegro accounted by all mobile devices with data connectivity (35.5 percent in 2013) is close to the regional average (29.4 percent in 2013). Seeking to increase adoption of the broadband, government is taking steps to address the affordability concerns<sup>88</sup> (Figure 112).

<sup>85</sup> [www.eLance.com](http://www.eLance.com), 2014.

<sup>86</sup> Cullen International (2014) and Enlargement countries monitoring report 4 (December 2012).

<sup>87</sup> <http://www.monstat.org/userfiles/file/ICT/2014/ICT%20USAGE%20IN%20ENTERPRISES%20IN%202014.pdf>

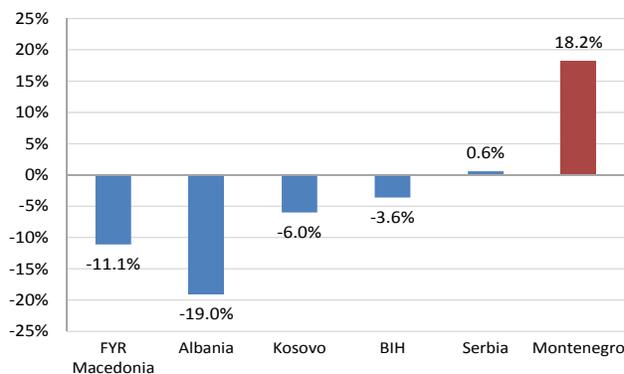
<sup>88</sup> Until November 2014, Montenegro had the most expensive retail internet packages in Europe. The cheapest basic ADSL package (up to 1Mbps/128Kbps; 1GB) currently provided by the largest Internet service provider in Montenegro - Crnogorski Telekom, costs around 14 euro per month (excluding the cost of ADSL modem which varies from EUR17.5

168. **Rural areas are particularly disadvantaged in terms of access to information and communication technologies.** According to the 2014 ICT Usage in Households Survey conducted by Statistical Office of Montenegro, only 69 percent of urban and 53 percent of rural settlements in Montenegro have access to the internet. The northern part of the country has the lowest percentage of households with internet access (52 percent), in particular rural areas (46 percent). The southern part of the country has the highest rate of households with internet access (72 percent), especially in urban areas (79 percent).<sup>89</sup> Among the reasons for lack of internet access are poor internet infrastructure, lack of knowledge of the benefits from internet use, and expensive internet access and equipment. The current Montenegro's ICT sector strategy (2012-2016) identified following priority areas: (i) improvement of the broadband internet access infrastructure across the country, with particular focus on rural areas; (ii) decreasing (in a sustainable way) the retail prices of the Internet access; (iii) cyber security, whereby Montenegro established national Computer Emergency Response Team (CERT) and is looking towards further strengthening its cyber environment; and (iv) improving efficiency of the e-Government infrastructure through the preparation of the proper analysis of the current ICT solutions used throughout the government institutions.

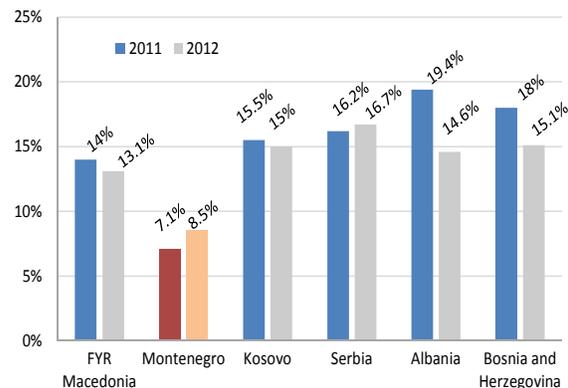
169. **Connecting the vulnerable segment of population to economic opportunities coupled with skills development would eventually allow to overcome geographical and digital divide of the region.** Efficient ICT skills development for jobs can achieve strong impact in terms of eventual employment. An analysis of recent ICT skills programs conducted shows that programs are achieving a 70–75 percent placement rate while maintaining its focus on disadvantaged low-income populations. At the same time there is a need to strengthen household Internet connectivity in the most disadvantaged regions of the country, e.g. the North region which is significantly lagging behind in connectivity indicators with some municipalities not even reaching 10 percent of household penetration (Andrijevića, Šavnik or Plužine).

170. **Investment in electronic communications is rising, led by the investments of the incumbent operator into the fibre network infrastructure** (Figure 113). However, overall investments as percentage of revenues in Montenegro has been the lowest in the Western Balkans at 8.5 percent in 2012 (Figure 114) and the country lags behind in infrastructure upgrade compared to the region.

**Figure 113. Investments in Electronic Communications, EUR terms, percentage change, 2012 over 2011**



**Figure 114. Investments in Electronic Communications Sector, Percent of Revenues**



Source: Enlargement countries monitoring report 4, Cullen International, 2014.

to EUR52.5), whereas in other monitored countries the price for this type of package ranges from only EUR5-10. On November 5, 2014, the government reduced the retail prices of internet access by 35 percent on average, while the wholesale prices of internet access went down by an average of 25 percent, according to the regulator's (AKIP's) decision. At the moment, the government is considering establishing its own Internet service provider.

<sup>89</sup> <http://www.monstat.org/userfiles/file/ICT/2014/ICT%20USAGE%20IN%20ENTERPRISES%20IN%202014.pdf>

## ***Emerging Priorities***

171. **Montenegro should focus on facilitating private sector job creation through increasing productivity and flexibility and ensuring connectivity with the big EU block.** Montenegro has attracted capital and should maintain its business environment appealing to investors. Looking ahead, economic growth will largely depend on total factor productivity rather than on factor accumulation. With the growing volatility of foreign capital inflows and large external debt, it is highly unlikely that capital accumulation will be a dominant factor of growth in the future. Moreover, the aging population calls for mobilizing the existing labor force and moving people from inactivity to the labor market by addressing incentives for work and labor demand. More efficient use and utilization of existing capital and labor can strongly support a more sustainable and less vulnerable growth model. However, job creation may not be sufficient to reduce poverty. The country is faced with large unemployment, especially amongst the youth. The composition and not only the level of growth matters, as the inclusiveness of growth depends on the demand for low skilled jobs. Thus, social protection programs may be needed to ensure that the worse off benefit from increased growth.

- (i) *Strengthening private sector job creation.* Montenegro has been very successful at attracting foreign capital and is still, given current international circumstances, receiving significant capital inflows. Staying the course of reform to improve the business climate has certainly had a noticeable reward.
  - *Unblocking the financial system.* The most challenging domestic constraint to recovery is the unwillingness of commercial banks to lend to the private sector. This state is a remnant of the financial crisis of 2008 and its aftermath; it characterizes not only Montenegro but the European economy as well. Whether this unwillingness to lend reflects perceived commercial risks, the current level of non-performing loans or international circumstances has to be addressed. Strengthening supervision and enforcement system would prevent future reoccurrence of such risks.
  - *Maintaining an inviting environment for private investment.* The country is among the top 50 countries in the world per the ease of doing business. The effort needs to be devoted to attract investments in productive sectors and in particular in labor intensive ones. Modernizing systems for paying taxes, land and business registration and custom services through use of information technology to limit opportunities for contact with public officials, and thus reduce instance of bribery would be welcomed.
- (ii) *Addressing the high inactivity and unemployment.*
  - *Improving school-to-work transition.* The high level of youth unemployment and its long-term duration call for interventions attempting to facilitate the process of transition from school into stable employment, in particular for the least educated, who can struggle with the process for years. The most important key deficits (lack of work-relevant experience, lack of information and connections, limited opportunities for entry-level work, etc.) need to be identified for specific groups in designing interventions.
  - *Strengthening education and skill acquisition.* While school-to-work transition interventions can be used to address the issues faced by the current youth, a more long term approach requires strengthening the education system starting from early childhood education and ensuring equal access. As the nature of the economy is changing, there is a need to ensure that the next generation is fully equipped with the skills required to enter the labor market. A priority should be to expand access to quality of education for all, in particular marginalized groups, and to reduce inequity and increase workforce productivity by improving skills and learning outcomes.
  - *Disincentivize inactivity.* Reviewing the elements of disincentives in the social protection system, including through revisiting early retirement, disability certification and social assistance marginal tax rate could increase availability of the labor force. Mapping this with the activation

- policies and formalizing undeclared work could do well for poverty reduction and fiscal sustainability.
- (iii) *Deepening integration with the region and the rest of the world.* This is a cross-cutting theme: design of institutions, commercial policy, the regulatory framework for business activity, and coordination of physical infrastructure (electricity grid and power generation, roads, ports and airports, ICT). Further infrastructure integration is critical to reduce the price of energy and increase the export of electricity and to develop complementary infrastructure to support private investments in the tourism sector.

## VI. INSTITUTIONAL CONSTRAINTS TO GROWTH

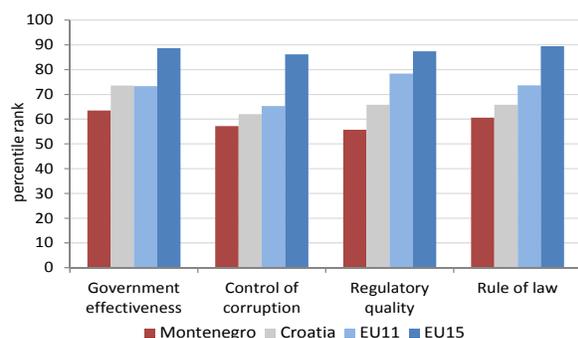
As Montenegro moves towards EU accession there is need to focus more strategically on strengthening its governance institutions to improve service delivery and strengthen public trust in the state. Governance issues that matter for reducing poverty and increasing opportunities for shared growth in Montenegro would need to focus on three pillars: (i) legitimacy of the state (governance issues that are critical for the stability of the state), e.g. trust and accountability; informality; (ii) investment climate drivers (governance issues that are critical for private enterprise), e.g. corruption, rule of law, regulatory quality; and (iii) service delivery (governance issues that are critical for citizen satisfaction), e.g. access to justice and service delivery.

### *The Legitimacy of the State, Transparency and Accountability*

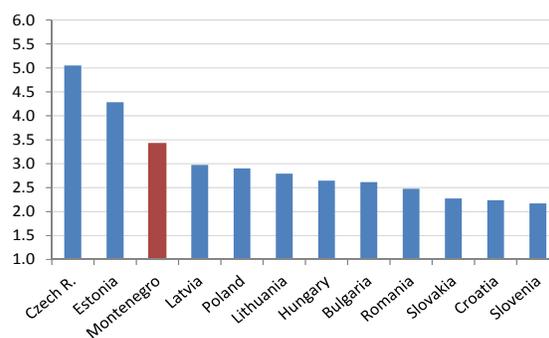
172. **Montenegro is a small young sovereign state.**<sup>90</sup> The transition from a state part of a federation to a sovereign nation required creating government capacities that had not been necessary theretofore. Public goods and services such as security, well defined property rights, and a stable economic environment up until then supplied, at least in part, by the federal government had to be, thereafter, provided by national institutions. The cost of developing and running national institutions and governments was augmented by the incapacity to exploit economies of scale in provision of public goods and services.

173. **The decision to join the EU and adopt the euro as national currency can be understood as part of the strategy to address these challenges.** Initiating the process of joining the EU provided an anchor to reforming core political and regulatory systems and probably shortened the time that would have been required to develop these institutions on their own. Adopting the euro as the national currency amounted to outsourcing monetary policy to the European Central Bank; this kind of outsourcing of government services and institutions is characteristic of small states all around the world<sup>91</sup>. Adopting a regulatory system and institutions well established in high-income European countries does not imply that the quality of government services and institutions will automatically reach the level of highly developed countries. There is a difference between establishing an institutional framework and making it work. The first step is mostly done; making it work is the challenge now.

**Figure 115. Selected World Governance Indicators, Figure 116. Efficiency of Public Spending 2014**



Source: World Bank.



Source: Global Competitiveness Index, 2015-16.

174. **Montenegro has been improving on various dimensions of governance which are largely better**

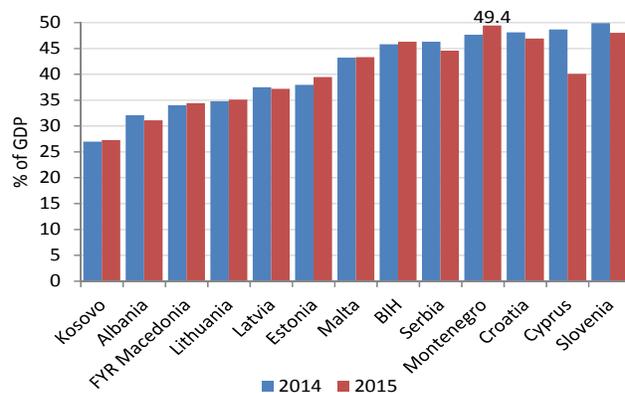
<sup>90</sup> Small states are defined as sovereign nations with population below 2 million. The population threshold selected is somewhat arbitrary and only posited to facilitate presentation of stylized facts.

<sup>91</sup> Favaro, 2008.

**than in the rest of the Balkans, but continue to lag behind EU member states.** The gap remains the largest when it comes to government effectiveness, regulatory quality, control of corruption and the rule of law (Figure 115). Nevertheless, there is evidence that Montenegro is making improvements in making the government more effective over the past five years, according to the Governance Indicators. Montenegro also performs fairly better than the EU11 countries in terms of transparency of government policy making. Only two countries--Estonia and Lithuania, are rated better than Montenegro in this indicator. This means that businesses believe that it is fairly easy to get information on changes in government policies and regulations affecting their activities. This is particularly important given the relationship between perceptions of transparency and efficiency: the more governments are perceived to be transparent, the lower the perception of wastefulness in spending. According to the Global Competitiveness Report 2015-16, while there are several administrative constraints, there are pockets of efficiency that provides an opportunity for scaling up to better serve citizens and the private sector. For instance, compared to EU11 countries, Montenegro emerges as the least wasteful, with the only two countries Estonia and Czech Republic performing better (Figure 116).

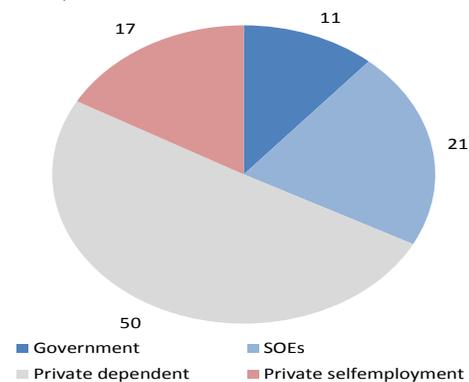
175. **While Montenegro has made enormous strides in addressing the transition challenges there is more to do and more legacy costs to be absorbed.** For example, Montenegro has a large public sector. Public sector spending in Montenegro is constantly high; in 2015 it reached almost 49 percent of GDP (Figure 117). Croatia and Serbia were the only countries whose spending on public sector exceeds the Montenegrin one in the region.

**Figure 117. General Government Spending, Percent of GDP**



Source: MoF, EUROSTAT, MONSTAT, World Bank staff calculations.

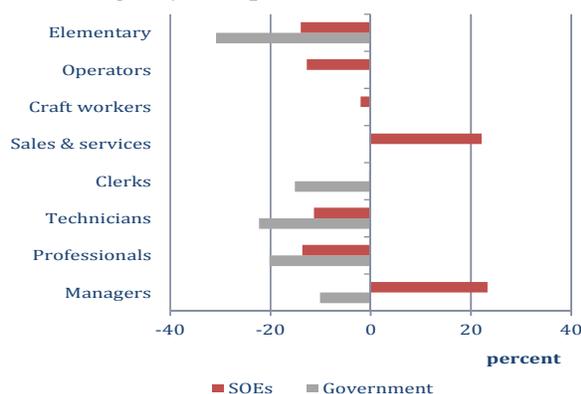
**Figure 118. Montenegro: Employment by Sectors, 2014**



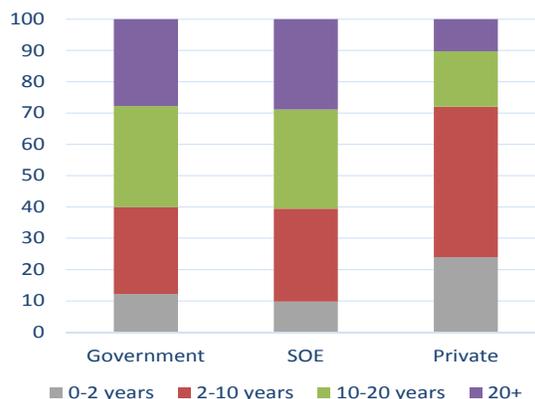
Source: LFS, World Bank staff calculations.

176. **Public sector acts as a safety net.** Employment in public sector in Montenegro is also high compared to other countries (Figure 118). The share of employed in government equals to 11 percent of total employment, with additional 21 percent of all employed are employees of state owned enterprises. However, there is no evidence on public sector wage premium, except for some occupations in state-owned companies. In fact, private sector pays more but jobs are less secure (Figure 119 and Figure 120). While one quarter of all employees in government sector spent 20 years or more in the same job, in private sector half of all employees spent two to 10 years in the same job.

**Figure 119. Public Sector Wages Relative to Private Sector Wages by Occupation, Percent Differential**



**Figure 120. Employment by Job Tenure and Sector, 2013**



Source: MONSTAT, staff calculations.

### Voice and Accountability

177. **Public participation in government decision-making has been modest.** This is not surprising given that citizen engagement does not have a strong tradition in Montenegro.<sup>92</sup> Existing NGOs operate in areas such as human rights, anti-corruption, gender, rights of disabled people, LGBT issues, civil society development, education, social protection, and environmental issues. However, their influence on formal decision-making is often modest. Some NGOs provide essential services to vulnerable groups, and increasing their involvement in policy design and implementation would significantly improve outcomes. The EC Progress Report (November 2015) notes the importance for Montenegro of providing opportunities for the development of an empowered civil society, including the necessary legal space and material means for this to occur.

178. **Given their pressure on government, relations between NGO and government have remained largely acrimonious, but some of the issues that the civil society has advocated on have been turned into government policies.** For instance, the law of an access to information provides an opportunity for citizens broadly, and civil society in particular to scrutinize government decisions. In addition to the public interest civil society groups, other groups representing the business community have emerged to push for important policy reforms- especially those related to the investment climate and business. This category of civil society includes the Chamber of Commerce. This diverse relationship between the government and the public interest civil society groupings on the one hand, and its relationship with the private sector on the other is important for two reasons: first, it provides the state with an opportunity to bring its agenda to the public and foster debate among a diverse public. Secondly, by engaging the business community through their organizations, the public sector has the opportunity to positively shape the perceptions of firms about government policies--and indirectly, influence the investment climate. NGO representatives are also members of the working groups for preparation of regulatory frameworks, consultative and advisory bodies such as: Anti-Discrimination Council, Council for Children's Rights, Council for Care for Disabled Persons, Commission for Allocation of the Part of Revenues from Games of Chance, Commission for Monitoring the Results of the Fight against Organized Crime and Corruption, etc.

179. **Montenegro needs to continue strengthening its 'check and balances' institutions to ensure accountability.** Public Internal Financial Control (PIFC) and the State Audit Institution (SAI) came a long way in its development in the past several years. Nevertheless, further development actions need to be addressed with the Chapter 32 on Financial Control opened in June 2014 in the process of EU negotiations. The reoccurrence of arrears at the central and the local government levels are imposing transparency concerns

<sup>92</sup> The Government of Montenegro got engaged in the Open Government Partnership Initiative in September 2011.

and question the enforcement of laws, including of the most recent fiscal responsibility framework. Further, the fiscal rule introduced through the Budget and Fiscal Responsibility Act in 2013, which aims to keep public debt to GDP ratio below 60 percent of GDP, has yet to be enforced. This and other numerical fiscal rules introduced need to be aligned with the EU directive on requirements for budgetary frameworks, while their application needs to be regularly assessed and measures taken to enforce them.

180. **Acknowledging achievements of the reforms of public financial management system in Montenegro, there are areas, which require attention and additional reform efforts in short to medium term.** Public finance and debt management are public sector areas which deserve attention. The Public Expenditure and Financial Accountability (PEFA) assessment for Montenegro<sup>93</sup> identified certain areas for attention and improvement. One of the key areas relates to transforming to more efficient public finances by considering strategic and medium-term aspects. There is a need for more meaningful medium-term budgeting framework and multi-year contracts should be considered in relation to revenue and expenditure estimates. Sector strategies should be costed and capital investments should be undertaken after thorough cost-benefit analysis. Overall, ensuring rigorous public investment management and evaluation is critical to ensure value for money.

181. **Tax collection needs substantial improvements in order to yield maximum revenue and disable unfair competition.** Tax arrears in the order of assessed 5 percent of GDP represent unfair competition vis-à-vis regular taxpayers. However, an additional 3 percent of GDP could be collected by tapping into the informal economy. More clarity is needed with regard to disclosure and application of accounting standards used, as well completeness and quality of financial statements. Currently, financial statements are prepared in line with relevant regulation and are broadly in line with cash basis IPSAS; however, accounting standards are not clearly disclosed and legislative framework itself does not provide sufficient clarity in this area. Financial statements do not present sufficient information on assets and liabilities and consideration of shift from cash to accrual basis of accounting is one of the items on the Government's reform agenda.

182. **Furthermore, major efforts are needed in the development of an independent, professional and efficient public administration system in line with European standards, including at the local level.** Montenegro has adopted comprehensive strategic framework for public administration reform<sup>94</sup> that covers the state administration, local government and publicly-owned bodies and agencies. The areas it addresses include civil service reform; public-sector wage reform; improving the quality of legislation and strategic planning, including the introduction of regulatory impact assessments; modernization of administrative procedures for better service delivery; reform of the inspection supervision system; and local-level organization and administration, including financing and public financial management. The effective policy coordination and lack of a concept of accountability of the work of public institutions and officials need to be ensured.

183. **While the legal, regulatory, and supervisory frameworks for the banking and insurance sector have markedly improved over the last ten years<sup>95</sup>, further progress is required.** Banking sector oversight by the central bank needs to be strengthened, cross-border arrangements with home supervisory and resolution authorities need to be bolstered, while risk-based supervisory approach and gradual introduction of Solvency II into the insurance sector should be introduced. Montenegro is taking active steps to enhance its AML/CFT framework and reach a better understanding of its money laundering and terrorist financing risks (ML/TF). Banks have increased reporting on such transactions in 2015 by over 73 percent compared to 2013. However, significant deficiencies nevertheless remain among others related to the scope of the reporting requirements remaining too narrow and information on the beneficial ownership of legal persons created in Montenegro not appearing to be accessible to competent authorities in a timely manner.

---

<sup>93</sup> World Bank, October 2013. Montenegro did not participate in the Open Budget assessment initiative so far.

<sup>94</sup> Government of Montenegro (2011). "Strategy of Public Administration Reform in Montenegro 2011-2016".

<sup>95</sup> Since the 2006 Financial Sector Assessment Program.

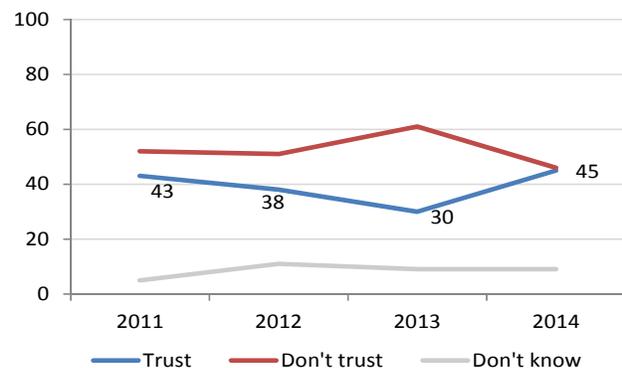
184. **On the corporate side, financial reporting and auditing needs further strengthening.** Promoting the high quality of corporate financial reporting and auditing supports business environment, facilitates access to capital markets, direct investments, and competitiveness. Credible corporate financial reporting is critical for access to finance since financial sector relies upon reliable credible financial information for business enterprises, prepared in accordance with international standards and audited in accordance with European Union statutory audit requirements. Corporate Financial Reporting is also a central part of the EU *acquis communautaire* for a well- functioning internal market.

### Trust and Informality

185. **Economies as well as citizens need trust to survive in a multi-ethnic society such as Montenegro.** Montenegro is ranked at position 42 out of 140 in the Global Competitiveness Report on the indicator “ease of protecting investors”, implying a strong endorsement of trust in the Montenegrin state by investors. This high level of confidence in the investment climate is visible in the volume of foreign direct investment into Montenegro. According to the Global Competitiveness Report, 2015-16 Montenegro is ranked 10<sup>th</sup> out of 140 countries in the size of Foreign Direct Investment Net Inflows.

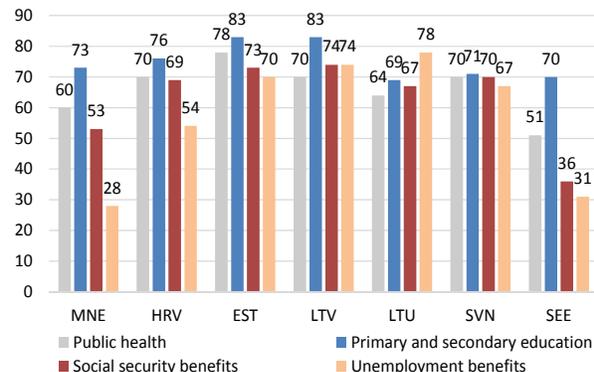
186. **Nevertheless, this seemingly strong trust by the private sector has yet to translate into trust by citizens.** According to *Eurobarometer Surveys*, citizen trust in the Montenegrin government has improved from 43 percent in 2011 to 46 percent in 2014, while the proportion of citizen that does not trust government has declined from 52 percent in 2011 to 46 percent in 2014, still high share of population (Figure 121). Usually, citizens only trust their governments when they believe that government is performing its functions properly, and in the best interest of the citizens. Thus, trust in government can be an indicator of the satisfaction of citizens in their government. Citizens’ satisfaction with public service delivery is above the SEE average, except those receiving unemployment benefits who are the least satisfied (Figure 122). This could be a problem given the size of unemployment in Montenegro.

**Figure 121. Trust in Government**



Source: Eurobarometer Surveys.

**Figure 122. Percent of Respondents Satisfied with Service Delivery**



Source: LiTS, 2011, World Bank, EBRD.

187. **One of the key challenges for Montenegro is the reduction of informal employment.** Based on the survey of citizens,<sup>96</sup> the overall scale of the informal employment in Montenegro is at 29.3 percent of employed, out of which half are workers having partial taxes and contributions paid, and almost half are workers with no taxes paid. The key factors that influence informal employment are: the belief that financial benefit from avoiding payment of taxes and contributions exceeds the financial loss from sanctioning, given the perceived inefficiency of inspection services, and the low valuation of pensions and other insurance benefits. The tax revenues lost due to informal employment are estimated at 2.8 percent of GDP annually. Nevertheless, only 11 percent of the firms surveyed view informality as a major constraint to business (Table

<sup>96</sup> UNDP report on informality, forthcoming.

15), which is half of both the regional and global average. This may suggest the kind of informality experienced in Montenegro is one deeply embedded in the social structure of the country and may be difficult to tackle.

**Table 15. Enterprise Survey**

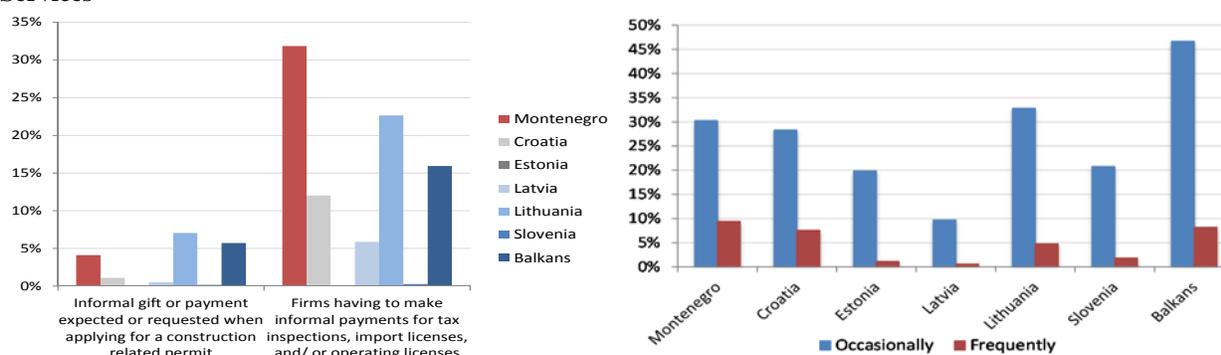
	Montenegro	Europe and Central Asia	All Countries
Percent of firms competing against unregistered or informal firms	52.4	39.0	54.4
Percent of firms formally registered when they started operations	99.9	97.8	88
Number of years firm operated without formal registration	0	0.4	0.8
Percent of firms identifying practices of competitors in the informal sector as a major constraint	11.2	20.5	28

Source: UNDP Enterprise Survey, 2015.

## Corruption

188. **The immediate danger of unbridled informality is in the fight against corruption and entrenchment of rule of law.** Montenegro exhibits high tolerance of corruption. Only a small number of respondents reported corruption to authorities and a surprisingly large percent are willing to pay bribes to obtain services.<sup>97</sup> According to the Doing Business Survey, over half of the firms compete against unregistered informal activities by firms almost double the average for Europe and Central Asia, and only slightly lower than the average for all countries.

**Figure 123. Corruption in Dealing with Public Services** **Figure 124. Frequency of Informal Payments**



Source: BEEPS 2013.

189. **Montenegrins identify corruption as the second most important problem facing their country after poverty and low standard of living.** Similarly, businesses view corruption as among the top five problems.<sup>98</sup> In the 2014 Corruption Perception Index, Montenegro ranks 76 out of 175. Public opinion research on corruption in education<sup>99</sup> showed that half of the citizens believe corruption is present in high education, both private and public institutions, related to academic advancement, enrollment and access to student homes. Compared to 2011, the corruption perception in higher education has increased. Citizens also believe that nepotism and use of party connections are widespread in Montenegro's education system (61 percent of respondents). Firms report cases of corruption in the granting of licenses and permits. The business survey suggests that firms expect to make unofficial payments when dealing with customs, imports, and courts (Figure 123). The share of firms who report having to make informal payments frequently in official transactions is high (Figure 124).

190. **Small businesses are particularly vulnerable to corruption.** They are harassed more, and are more

<sup>97</sup> UNODC (2013).

<sup>98</sup> UNODC (2011).

<sup>99</sup> Center for Civic Education, 2015

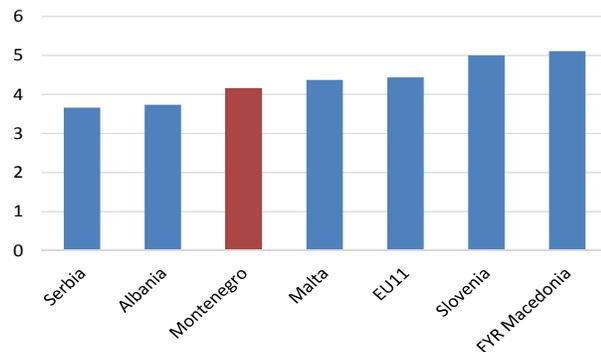
likely to pay a bribe than large businesses, and is more common in the transportation and storage and accommodation and food service sectors than elsewhere.<sup>100</sup> Certain public offices are more associated with corruption: Customs, Land, Municipal, Tax and Inspection.<sup>101</sup> About 45 percent of businesses surveyed report that the main reasons for paying bribes are for public services. This includes paying bribes to speed up business related procedures, finalize procedures, reduce the cost of procedure, and receive information.<sup>102</sup>

191. **Bribes are also paid to get better prices, win contracts, and agree on public tenders.**<sup>103</sup> Montenegro completed the Strategy for Development of the Public Procurement System for the period 2016-2020 with the Action Plan for its implementation. A new Public Procurement Law which would be compliant to the new EU Directives 23, 24 and 25 of 2014 needs to be drafted. In addition to that, Montenegro is also at the beginning of the introduction of e-procurement which should improve transparency of public procurement and contract award, but also lower the cost of procurement.

## Justice and Rule of Law

192. **The justice system is not equipped to tackle corruption.** There is a lack of transparency, and ineffective investigations into and prosecutions of corruption. Insufficient staffing and financial expertise hinders the corruption-fighting capacity of the police, prosecution offices, and courts. There yet needs to be a track record of investigations, prosecutions, and convictions in corruption cases. Corruption in courts themselves is also a concern: judicial decisions can be influenced, as evidenced by the World Economic Forum ranking for irregular payments for favorable judicial decisions (Figure 125).

**Figure 125. Irregular Payments for Favorable Judicial Decisions (7 as best)**



Source: WEF Global Competitiveness Report, 2015-16.

193. **Compliance with EU standards is the key driver for reform of the judicial system.** The European Commission is pursuing

a more rigorous approach to Chapter 23 of the *Acquis Communautaire*<sup>104</sup>. The new approach, endorsed by the Council in December 2014, means that countries need to tackle issues such as judicial reform and the fight against organized crime and corruption early in accession negotiations. This maximizes the time countries have to develop a solid track record of reform implementation, thereby ensuring that reforms are deeply rooted and irreversible. Montenegro started Chapter 23 negotiations in 2013 and has produced a detailed action plan with interim benchmarks. Progress has been positive in some areas, including improvements in court efficiency and the passage of legislation to align with EU requirements, such as constitutional reforms in 2013 which led to the appointment of key judicial and prosecutorial positions. Progress has been limited in the implementation of laws and in tackling corruption. The gap between the laws on the books and the law in practice remains wide.

<sup>100</sup> The majority of Montenegrin companies are in the following five sectors: Manufacturing, Electricity, Gas and Water Supply; Building and Construction, Whole Sale and Retail; Transportation and Storage; Accommodation and Food Service.

<sup>101</sup> UNODC, p.55.

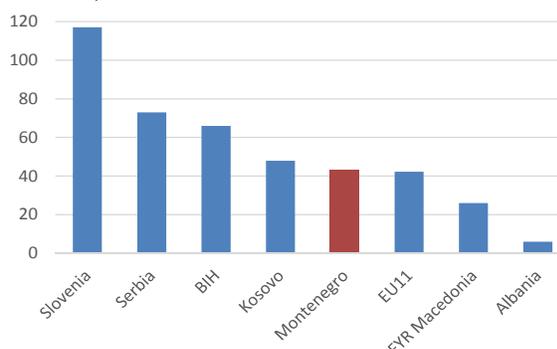
<sup>102</sup> UNODC, p. 26.

<sup>103</sup> UNDP, p. 35.

<sup>104</sup> European Commission (2013). "Enlargement Strategy and Main Challenges (2013-2014)"

194. **Enforcement of court decisions remains weak.** Montenegro is slightly below the EU11 average for time, cost, and procedures to enforce contracts.<sup>105</sup> According to the 2016 Doing Business Report, contract enforcement takes 545 days, costs 25.7 percent of the value of the claim, and requires 49 procedures. Montenegro ranks 43<sup>rd</sup> out of 189 countries for contract enforcement, worse than Croatia, Albania and FYR Macedonia, but still better than other regional neighbors, including SEE and ECA averages (Figure 126). Recent reforms will transfer most new enforcement cases to a newly created profession of private bailiffs.<sup>106</sup> This is expected to significantly reduce the workload on the courts. However, the reform created systemic risks of corruption and arrangements for reporting and oversight are not yet robust. The profession should be monitored closely. To date, there is neither an organized profession of bailiffs nor clear procedures. Data also needs to be collected and monitored on recovery rates, costs, duration of proceedings etc. to ensure that the transition of cases from court to private bailiffs resolves the enforcement problem, rather than merely displacing it or creating new ones.

**Figure 126. Ease of Contract Enforcement (out of 189 countries)**



Source: Doing Business 2016.

195. **More broadly, the efficiency of case processing in courts is a concern.** The clearance rate in courts has fallen from 102.5 percent in 2012 to 98.6 percent in 2013 and has since remained stagnant.<sup>107</sup> Few measures have been put in place to reduce backlogs. The disposition time for non-criminal cases is 616 days.<sup>108</sup> This is more than double the CEPEJ average, triple the median, and far behind FYR Macedonia and Slovenia. Service of process is a key bottleneck that causes protracted delays and frustrates users and courts alike. Service is required for each stage of proceedings and is easy for parties to avoid, so the majority of services fail, causing a ricochet effect through the system.

196. **There is little use of streamlined procedures or alternative dispute resolution mechanisms.** Montenegro has one of the smallest monetary values (EUR 500) for what constitutes a ‘small claim’, and even then the ‘simplified procedures’ for small claims could be much further streamlined. As a result, SMEs with relatively minor debt recovery actions are required to pursue their claims using the full, and often cumbersome, civil procedure.<sup>109</sup>

197. **The quality of laws and decision-making in courts is uneven.** Businesses report that contradictory laws exist in key areas pertinent to their operations, such as mergers and acquisitions. Even recent reforms that attempt to align Montenegrin legislation with EU requirements have seen laws passed that are poorly drafted and overlap with existing legislation in an incoherent manner.<sup>110</sup> Further, there is little in the way of training for judges and court staff beyond ad hoc donor-funded training events and the Judicial Training center needs strengthening to fulfill its growing mandate. The result is weak quality and unpredictable decision

<sup>105</sup> See Doing Business Report 2016.

<sup>106</sup> As at November 2014, 21 out of the planned 32 bailiffs had been appointed.

<sup>107</sup> Montenegro EU Progress Report 2014, at page 37.

<sup>108</sup> CEPEJ Evaluation Report, 2014 (based on 2012 data), Table 9.2. The European Commission for the Efficiency of Justice (CEPEJ) monitors data on judicial systems from the 47 member states of the Council of Europe and benchmarks these in its biennial publication.

<sup>109</sup> For a discussion on options to fast-track the resolution of minor disputes in EU countries, see <http://blogs.worldbank.org/europeandcentralasia/resolving-minor-disputes-matters-big-time-poor>.

<sup>110</sup> See also, Montenegro EU Progress Report 2015, at page 35.

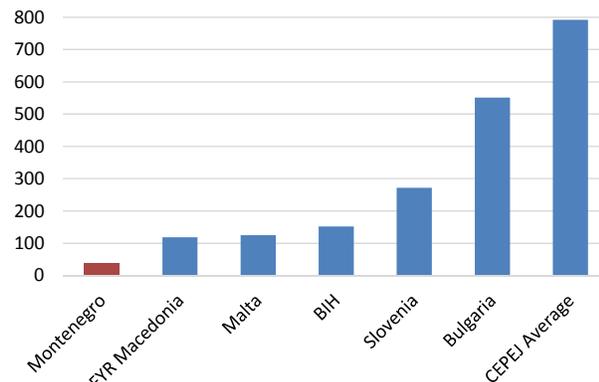
making in courts, which leaves businesses unable to operate with reasonable expectations. Complex and ambiguous laws may create wide discretion and thus opportunities for malfeasance, as lawyers exploit loopholes and judges extract bribes for favorable interpretations.

198. **The current system of recruitment and career development for judges and prosecutors leaves much room for politicization and undue influence.** Reforms are afoot to create a single recruitment system and period of professional assessment but these have yet to be implemented and it is unclear what criteria would be used for such assessments.<sup>111</sup> There are few checks on conflicts of interest, and there is no random allocation of cases to judges, nor any standards for the workloads of judges or predicted timeframes for proceedings. Such governance and management reforms will be necessary to promote a culture of transparency, professionalism and performance. As far as judicial independence, Montenegro dropped from a ranking of 75 out of 148 countries in 2013-14 to 90 out of 144 countries in 2014-15 but improved to a rating of 88 out of 140 countries in 2015-16 according to the WEF Global Competitiveness Index.<sup>112</sup>

199. **Discrimination against vulnerable groups persists.** Amendments to anti-discrimination laws were adopted in 2013 but the scope remains limited and sanctions are weak. Awareness among judges, prosecutors, and court staff of the new laws and international standards is low, and continued training will be necessary to embed cultural change. The number of incidents of ill-treatment by police is a concern, as the processing of these cases is slow and the number of officers punished is extremely low. Montenegro adopted an action plan in relation to LGBT treatment in 2014, but the LGBT community remains subject to violent attacks that go unpunished.

200. **For the bottom 40, access to basic justice services is constrained by the absence of a functioning legal aid system.** In 2012, Montenegro granted legal aid in only 49 cases per 100,000 inhabitants – the smallest number of all the 45 countries that submitted data to the CEPEJ, and more than 20 times lower than the CEPEJ average (Figure 127).<sup>113</sup> Legal aid to marginalized groups is especially rare, including for asylum seekers (due to linguistic barriers) and for victims of domestic violence due to the absence of targeted approaches. To enable access to basic services for the bottom 40 and marginalized groups, it will be important for the justice system to promote the use of legal aid and resource it adequately.

**Figure 127. Number of Legal Aid Cases Granted (per 100,000 inhabitants)**



Source: Doing Business 2015.

201. **The lack of an effective system for misdemeanor cases presents a serious issue for the poor.** The bottom 40's most likely interface with justice is in misdemeanor cases, but these cases are handled by misdemeanor bodies rather than judges. Misdemeanor bodies are appointed by the Executive, lack tenure, are prone to undue influence, and have long had a poor reputation regarding equal treatment. Reforms are underway to bring misdemeanor cases within the judiciary, with misdemeanor judges being selected. Reforms will need to be combined with training and a package of initiatives to imbue a culture of due process, strengthen service delivery and improve public

<sup>111</sup> In 2012, there was only one disciplinary proceeding brought against a judge (which resulted in a reprimand rather than a sanction) and two proceedings brought against prosecutors (resulting in minor fines). Of the thirty-five disciplinary charges filed against lawyers, only five proceedings were initiated.

<sup>112</sup> This is indeed better than some EU11 countries, such as Croatia and Bulgaria, and on par with Slovenia, but lower than FYR Macedonia or Malta.

<sup>113</sup> CEPEJ Evaluation Report, 2014 (based on 2012 data) *supra* note 7.

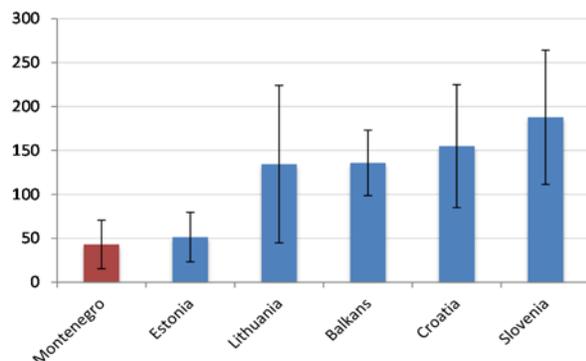
perception of justice.

202. **There is increasing concern for freedom of expression in Montenegro.** Journalists (especially those conducting investigations into corruption and undue influence) have been subjected to threats and violence to themselves and media property, and cases are rarely investigated by the police or prosecuted in the courts. A Commission for monitoring the competent authorities in cases of threats and violence against journalists has been established, but the recommendations have yet to be implemented. An environment of intimidation and self-censorship thus prevails, and the justice system will need to be more proactive to reverse this concerning trend.

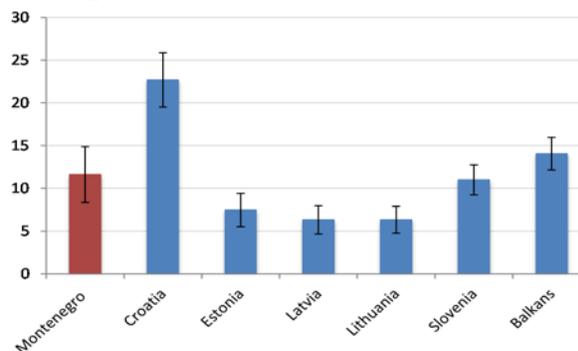
### Regulatory Barriers

203. **There are mixed messages on regulatory barriers.** In line with the reforms passed in recent years, the time to deal with permits and licenses is not, in general, markedly higher than in comparators, and in some cases, notably time to get construction permits, Montenegro does quite well (Figure 128). However, this performance varies and there is still room for improvement. For one, the overall share of management time spent on dealing with regulation and applications for permits and licenses is at the Western Balkans average, which is still high relative to the Baltic countries (Figure 129). In addition to this, application time for operating and import licenses is relatively high. Given that the Western Balkans average for regulatory delays remains higher than that for Baltic comparators, there is room for improvement in the efficiency of granting other licenses and permits.

**Figure 128. Days to Obtain a Construction Permit**



**Figure 129. Share of Management Time Spent Dealing with Regulations**



Note: lines indicate confidence intervals.

Source: BEEPS 2013.

### Public Service Delivery

204. **The Montenegrin public administration system cannot cope with demands for improved service delivery unless modernized.** In addition to weak capacity arising from lower levels of workforce with tertiary education, other factors have also been identified. For instance, the government has named as an issues “an insufficient number of creative young staff with the required professional qualifications” and “absence of organized and competent institutions that would monitor the reform process from the professional and methodological viewpoint and act as logistics support”.<sup>114</sup> In recent years, the government has intensified training for public administration officials and supported the reorganization of public sector to improve efficiency. In the interim period, there have been mixed results in a range of public service delivered by government (e.g. education, health, water and sanitation, electricity and infrastructure), and overall government efficiency.

<sup>114</sup> Government of Montenegro (2011). “Strategy of Public Administration Reform in Montenegro 2011-2016”.

## Social Services

205. **The delivery of social services can be made more efficient and sustainable by reviewing benefit packages and moving toward financing systems based on outputs and outcomes.** There are several priorities to improve the efficiency and fiscal sustainability the pension system, health, education, unemployment insurance and social protection service delivery<sup>115</sup>:

- (i) *First*, pensions represent one of the largest expenditure items in the budget (11 percent of GDP), and outlays have increased significantly in recent years, posing a significant risk to overall fiscal sustainability. Key priorities include adjusting benefit indexation; valorization of pension point benefits, constraining inflows of new beneficiaries, including reducing scope for early retirement, and tightening the disability criteria.
- (ii) *Second*, education spending is higher (4.5 percent of GDP)—but educational outcomes lower—than in regional comparators. Priority reforms include enhanced monitoring and focus on improving education outcomes; reviewing the spending norms in the tertiary sector; capping per student expenditures; and rebalancing the composition of education spending. Higher education financing reforms are being proposed which should result in major shifts in assessing the efficiency of the sector, with a more outcome-driven approach.
- (iii) *Third*, public health spending is relatively high (6 percent of GDP), but overall health outcomes are relatively good. Efficiency of spending needs to be increased, particularly for hospitals, and fiscal sustainability is a growing concern. Reforms in primary care (including introduction of chosen primary care doctors and adjusted capitation financing) need to be further consolidated and further reforms introduced to improve efficiency of the hospital network and introduce output-based financing.
- (iv) *Finally*, government can increase the socio-economic impact of social assistance by linking it to provision of social care and employment/activation services. At only 0.5 percent of GDP, family material support does not pose a fiscal risk and is reasonably well targeted, but the coverage and spending on child protection could be increased – as last resort social assistance reaches less than one-fifth of the poorest quintile, while seeking savings through tightening eligibility criteria for disability benefits. The recent policy of lifetime benefit for mothers of three and more children, however, is considered as a step in a wrong direction in terms of fiscal as well as impact on female labor force participation.

206. **Pension system. Montenegrin policymakers have actively engaged in pension reforms in the last two decades to respond to aging phenomenon.** Since 2004, Montenegrin pension system is formally a multi-pillar system. It comprises public pay-as-you-go (PAYG) pillar, second private mandatory funded component (which has never been put in place), and third voluntary funded pillar with private voluntary pension funds. Parametric reforms to the PAYG system, introduced in 2004 and 2010, aimed to strengthen the fiscal sustainability of the system and align it with aging process and labor market requirements. The reform of 2004 introduced point formula, widened calculation period, increased retirement age to 65, and abolished early retirement. The 2010 reform raised retirement age further to 67, but also reintroduced early retirement and weakened the system stabilization efforts.

207. **Introduction of early retirement option in 2010 and recent ad-hoc early retirement options enabled the early exit from the labor force.** In addition to penalty-free retirement with 40 years of service (for women gradually increasing from current 35 service years to 40 by 2033), the 2010 Law introduced a general early retirement at 62 with 15 years of service, which did not exist previously. Early retirement for special categories (police, military that retires with 50 years of age and 20 years of service) was extended for miners who can now retire with 30 years of service, of which 20 in jobs with extended service calculation.

---

<sup>115</sup> World Bank (2012a) and World Bank (2015).

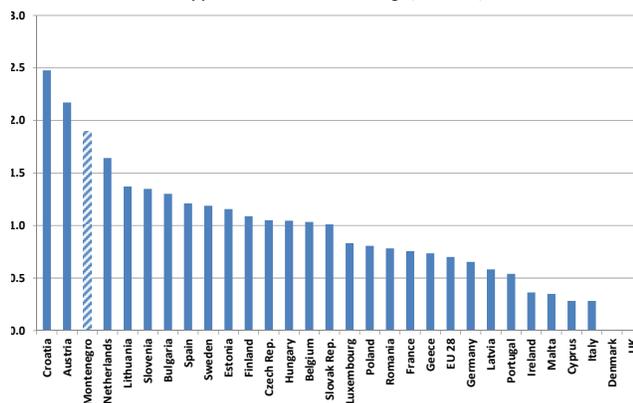
Ad-hoc early retirement window opened between March to July 2015 for metallurgy workers and employees in bankrupt companies with majority state ownership,<sup>116</sup> allowing penalty-free retirement with 30/25 years of service for men/women, distort not only Montenegrin pension system but also act as a disincentive for already low labor force participation.

208. **Given the aging society and the low participation rates, policymakers in Montenegro should refrain from ad-hoc early retirement windows creating 50-year old and still work-abled pensioners.** EU has been advocating for reducing the early retirement period to 2-3 years and raising the early retirement decrement (penalty) above actuarially neutral level in order to stimulate longer stay in the labor force as well as eliminating privileged retirement rules. Montenegro's introduction of a 5-year early retirement option at actuarially neutral decrement,<sup>117</sup> maintaining service-related retirement conditions and introducing lighter condition for non-hazardous occupations, go in opposite direction, weaken the effects of the retirement age increase and do not address early exit from the labor force. The available data confirm that--since 2010 the number of new early old-age pensioners in Montenegro has been growing by about 1,000 every year, and reached 3,354 in December 2014.

209. **Montenegro has eliminated most of merit (or privileged) pensions and pension rules for special occupations.** Retirement rules for military, police, and national security forces were equalized with general retirement rules in December 2012, and for aluminum and steel producing workers in 2013. Prior to equalization, these occupations were eligible for lower retirement age, occupation-specific vesting period, special pension formula, and/or a supplement to regular pension formula.<sup>118</sup> Although current special pensions' burden is not that high – 6 percent of beneficiaries – equalization of eligibility rules is a fundamental step towards creating universal labor market conditions for all occupations and eliminating the occupational lock-in effect.<sup>119</sup> However, the law left miners with the opportunity to retire with 30 years of service, of which 20 in mining, and parents with disabled children, who can retire with 20 years of service. Unless a higher contribution is paid, miners should have longer service periods to earn their pension, or receive actuarially fair pension cut instead. In case of parents with disabled children, it is not clear why this social category is regulated in the pension law through early retirement. Instead, parents with disabled children could be encouraged to work full or part time as long as possible and receive direct transfers and help for the care needed.

210. **Disability expenditures in Montenegro still absorb a relatively high share of GDP.** At 2.1 percent of GDP, expenditures on disability pensions are almost three times higher than the EU28 average and compare to the levels in countries with highest disability pension share (Figure 130). Following the tightening of the temporary disability definition in 2004 reform, the inflow of new

**Figure 130. Disability Pensions in Montenegro**  
Disability pensions in EU and Montenegro, % of GDP, 2013



Source: EU Aging Report 2015.

<sup>116</sup> Amendments to the Pension Insurance Law, Official Gazette 10/2015.

<sup>117</sup> A decrement in Montenegro of 4.2 percent is set close to its actuarially neutral level.

<sup>118</sup> The rules included, for example, 50 years of age and 10 years of service on positions with accelerated service period as authorized personnel (authorized to carry firearms), 20 years if they are not authorized personnel, shorter calculation period (last calendar year), and pension based on total accrual to the calculation period salary

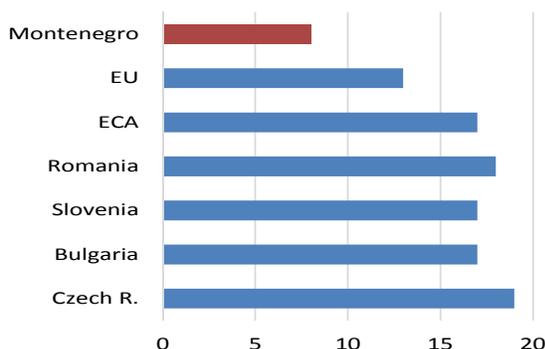
<sup>119</sup> This, for example, means that eligible military and army personnel would not retire at 50 with 10 years of service or more, and special formula, but at 67 (mandatory age for full pension), 62 (early retirement), or with 40 years of service. Accelerated service period for these occupations will count as for other occupations with accelerated service period. Furthermore, their pension will be computed according to the general pension formula.

disability pensioners has been largely reduced, and their share in total number of pensioners and total pension expenditures has been steadily declining from 27 percent in 2003 to 19 percent in 2013. However, disability criteria as well as process of disability certification remain vulnerable to abuse and corruption. In order to curtail disability expenditures quicker, the Government should consider introducing modern disability assessment methodologies and procedures.

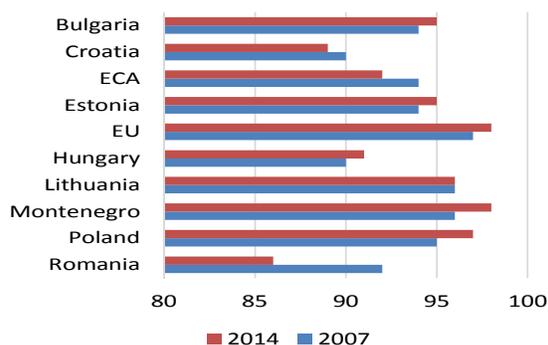
211. **The current fiscally strained situation is likely to reverse rapidly.** Despite pension reform efforts in 2004 and 2010, pension expenditures in Montenegro grew above 11 percent of GDP in 2014, with a current deficit of almost 4 percent of GDP. However, Montenegro is applying one of the least generous valorization and indexation patterns in Europe. A current combination of a 75-percent price and a 25-percent wage growth, is expected to reduce future pension expenditures, eliminate deficit by 2030, but also result in strongly declining replacement rates and eroding future pension adequacy. In order to respond to the challenge of current fiscally strained pension system turning into socially unsustainable one, Montenegrin policymakers should revisit key system parameters including early retirement conditions, pension formula, disability criteria, and ultimately general retirement age. Short-term slippages such as ad hoc early retirement windows for some occupations would distort the reform process and should be avoided in the future.

212. **Education. Service delivery in education has not kept pace with the demands of Montenegro’s economy.** Low transition rates to secondary and tertiary education are reflected in the relatively lower proportion of Montenegrin labor force with secondary and tertiary education. Compared to other EU11 countries, Montenegro is only ahead of Romania, Slovak and Czech Republic whose starting points are low. Pre-primary education also lags behind and some minority groups are particularly disadvantaged, with less than 10 percent of Bosnian kids attending compared to almost 50 percent of Montenegrins. Promoting equal opportunities starts with an emphasis on children and their healthy and cognitive development. Addressing early childhood development gaps by promoting adequate parenting skills and improving the availability or affordability of quality education and child care services could go a long way in enhancing opportunities well into adulthood. Demographic aging and decline mean that ensuring equal opportunities is an economic necessity given declining working age population.<sup>120</sup>

**Figure 131. Pupil Teacher Ratio (Primary), 2014**



**Figure 132. Net Primary School Enrolment**



Source: World Bank.

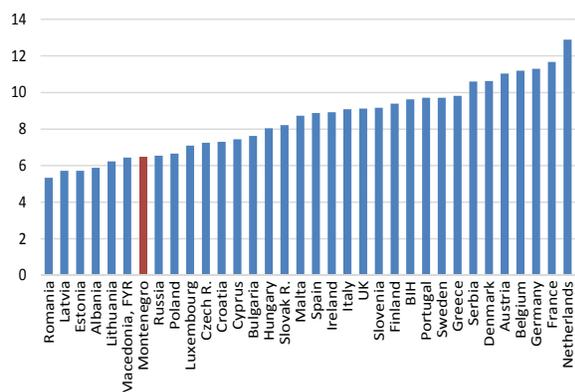
213. **Montenegro records the lowest pupil-teacher ratio in primary schools compared to EU11 countries** (Figure 131). However, this service seems to suffer from low up-take as the enrollment patterns in Montenegro are nearly as high as those in EU11 countries. In terms of school enrollment, Montenegro compares favorably with top performers among the EU11 countries (Figure 132). With a net primary school enrollment rate of 98 percent, it suggests that nearly all primary school children are enrolled. Moreover, it shows that the rate of enrolment has increased from 96 percent in 2007 to 98 percent in 2014. However, the high number of enrolled children and the low pupil- teacher ratio suggest the presence of inefficiencies in the

<sup>120</sup> Murthi, M. (2015). “Equal opportunities for Europe’s Roma: an economic imperative in an ageing Europe”.

spending on teachers: there are more teachers that are needed, and these resources could better be expended elsewhere to provide other services.

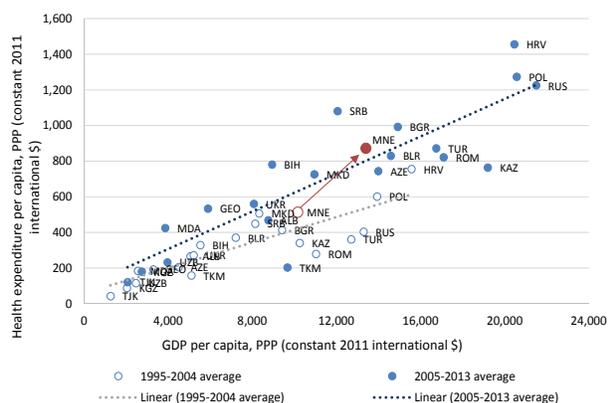
214. **Health. Montenegro's per capita expenditure in health is lower than the EU average but higher than the ECA average.** In 2013, Montenegro spent USD461 per person, compared to USD3,460 in the EU and USD413 in ECA. The total health expenditure in GDP was relatively high (at 6.5 percent on average) compared to similar countries in the region and despite the public spending being below the EU28 average (3.7 percent of GDP) (Figure 133), per capita health expenditure was high for Montenegro's income level (Figure 134). However, out-of-pocket accounts for only about 33 percent of total health expenditure on average between 2000 and 2013, which is lower compared to similar countries in the region.

**Figure 133. Public Health Expenditure in 2013, Percent of GDP**



Source: World Bank Development Indicators.

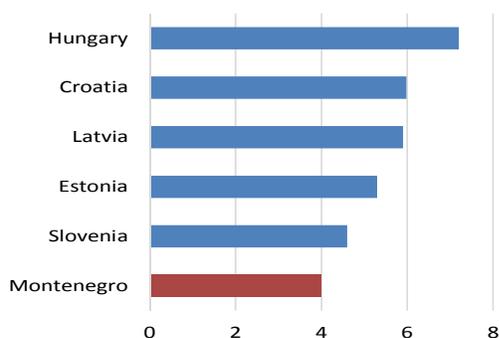
**Figure 134. Total Health Expenditure and GDP per Capita in ECA (1995-2013)**



Source: World Development Indicators.

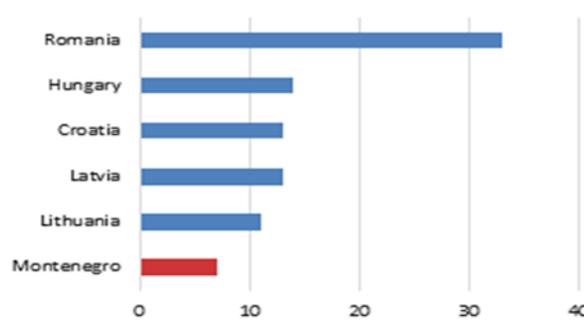
215. **Despite lower spending in health, few hospital beds and physicians serving the population, Montenegro has achieved good outcomes in maternal and child health.** Montenegro has fewer hospital beds compared to other EU11 countries, averaging only 4 beds and 2 physicians for every 1,000 patients (Figure 135). Nevertheless, compared to EU11 countries, Montenegro registers among the lowest levels of maternal mortality rates (Figure 136). Similarly, Montenegro seems to maintain the same pattern as EU11 countries, of progress in the proportion of children immunized for measles. Like a number of EU11 countries, Montenegro has nearly maintained the size proportion of measles immunization of children between ages 12-23 years. Thus, unlike in education where significant investment to increase the number of teachers is not producing results, health sector service delivery is producing good outcomes respect to maternal and child health.

**Figure 135. Hospital Beds**



Source: WDI 2014.

**Figure 136. Maternal Mortality Rate, 2013**



Source: World Bank.

216. **The efficiency and equity of health spending could be improved, however particularly to cope**

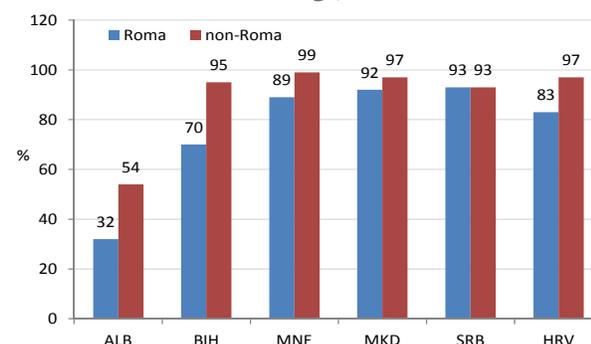
**with the growing burden of noncommunicable diseases.** Montenegro made important progress in moving toward capitation financing of primary health care; these reforms were undercut, however, by negotiated salary increases for all health personal. Hospitals are still financed through line-item budgets rather than based on outputs or quality, and the hospital network has yet to be rationalized, contributing to inefficient spending and hospital deficits. Pharmaceutical spending is relatively high, as are drug prices. The health insurance benefits package has continued to expand, including high cost procedures and medicines, without sufficient attention to financial sustainability, which results in rationing (e.g., growing waiting times for procedures) or budget pressures that may compromise quality or provision of primary health care.

217. **Also, there are some Roma adults who do not have medical insurance coverage.** Around 99 percent of non-Roma adults<sup>121</sup> reported medical insurance coverage compared to 10-percentage points lower share of Roma coverage, thus performing above the region average<sup>122</sup> (Figure 137). Lower awareness of health issues results in a higher incidence of disabilities, long-standing illnesses, and greater numbers of in-patient visits. These outcomes are usually result of socio-economic deprivation (particularly the isolation from the educational system and formal labor markets) and unhealthy lifestyles. In addition, access to health services is more limited and inequitable outside of the capital, while sexual minorities also face a lack of access to and quality of health services.<sup>123</sup>

218. **Social Assistance. Social assistance targets the poor well, but coverage remains low.** Montenegro spends slightly less on all social assistance programs than the ECA average (1.5 percent of GDP in 2010 against an ECA average of 1.6–1.8 percent). However, spending on the last resort social assistance program was among the highest in ECA, at around 0.5 percent of GDP in 2010. Up to 70 percent of all spending on social assistance reaches the poorest population quintile (according to the 2011 Household Budget Survey), but it covers only 5.4 percent of the total population and 19 percent of the poorest quintile. The coverage of the last resort social assistance program was even lower: 4.6 percent of the total population and 17 percent of the poorest quintile. At the same time, it accurately targeted the poor, with over 77 percent of the budget for this program going to the poorest quintile.

219. **Generosity, measured as the share of the respective benefit in post-transfer consumption of the poorest quintile, was among the highest in ECA in 2011:** over 42 percent of all social assistance and over 39 percent for the last resort benefit. The eligibility criteria favored the concentration of several benefits to the same household, and this increased the risk of creating benefit dependency and work disincentives. The recently adopted Social Welfare and Child Protection Law addresses these risks, with changes in benefit design along with incentives and administrative requirements for the activation of able-bodied benefit

**Figure 137. Adults (age 16 and above) Reporting Medical Insurance Coverage, 2011**



*Note:* Based on the question: Do you have medical insurance, either in your own name or through another member of your household? (Positive response). Comparing “Roma” and “Non-Roma neighbors” who are living in same community.  
*Source:* UNDP/ WB/EC Regional Roma Survey 2011.

<sup>121</sup> Living in areas with higher density (concentration) of Roma populations.

<sup>122</sup> The 2011 UNDP/WB/EC regional Roma survey, which compared living standards of Roma and their non-Roma neighbors in the same community.

<sup>123</sup> There is a general belief that health workers have insufficient knowledge about LGBT issues and specific/needs-based care or information. Also, sexual minorities reported being asked intrusive questions unrelated to their treatment, and receiving suggestions for various treatments to ‘fix them’. Majority had never been tested for HIV/AIDS, Hepatitis B, Hepatitis C or other sexually transmitted diseases (Juventas, 2012)

recipients. It offers three main innovations: (i) open access to programs to able bodied (thus reducing disincentive effect to labor force participation); (ii) activation as a right and principle in social assistance; and (iii) social service provision by local government). It shifts the focus from cash handout to one of activation. While the law is a step in the right direction, its implementation presents challenges, mostly related to capacity, in particular of the north where more focus should be placed.

220. **Almost half of all last-resort income support program (FMS/MOP) recipients are of prime age (19-65) and over one third are able-bodied and of working age.** The average stay in the program is long and beneficiary turnover low. FMS/MOP provides regular income for an unlimited period of time and is subject to light conditions for continued receipt. There is no significant attrition of FMS/MOP beneficiaries due to non-compliance with the work availability test or required monthly re-registration with the employment office. The FMS/MOP is relatively generous when measured as share of transfer value in post-transfer consumption of beneficiaries, and as share of the minimum wage or other minimum pay standard. It guarantees access to health care and serves as an entry point for access to other cash benefits and rights. Through activation, the FMS/MOP can be made more efficient and effective in protecting the poor, preventing poverty and destitution, and promoting human capital development by reinforcing financial incentives for pro-activity (moving out of dependency and investing in employability).

221. **The capacities of local administrations to deliver social services are still very limited,** as is the implementation of social accountability principles such as transparency and participation. As noted by UNDP's 2009 National Human Development Report, new lines of accountability and reporting will need to be introduced together with a systematic dialogue on citizen engagement, including with municipal governments, civil society organizations, community groups, and the private sector, to determine in a participatory manner local priorities and accountability mechanisms.

#### **Box 7. Capacity in the Welfare System**

The welfare system in Montenegro is centralized in terms of design and financing, while implementation is delegated to the local level. The system of social and child protection in Montenegro is centralized, with the MLSW responsible for policy making, provision of finance, and supervision of Centers for Social Work (CSWs) as institutions that implement social and child protection at the municipal level. The CSWs make decisions about the rights to social and child protection, according to the Law on Social and Child Protection. Montenegro has 13 CSWs covering 23 municipalities. Although there is good communication between the CSWs and MLSW, the connection between various CSWs as well as between CSWs and other local institutions is rather limited. Despite the MLSW's centralized financing and coordinating role, the CSWs vary greatly in how they operate. There is a regulation that governs organization of the centers' work, the number and structure of employees in CSWs. Although discretion of CSWs in this area could lead to better matching of the needs of the community, it could also reflect lack of client service standards and lead to unequal access to services in communities with lower capacity.

The territorial organization of CSWs does not give citizens in all municipalities equal access to social services. CSWs and linked SSWs (Services for Social Work), which serve as branches for CSWs, are often located far from each other, especially in the central region where one CSW covers a quarter of Montenegro's total area. Such territorial dispersion and lack of funds complicates the realization of field work. In some field offices, field work is organized in such way that one car from the main CSW is used for field visits when there are a larger number of cases. This practice points to an untimely and routine approach because visits are not responding to the current needs of the beneficiaries but rather to those of the field office (UNICEF 2011).

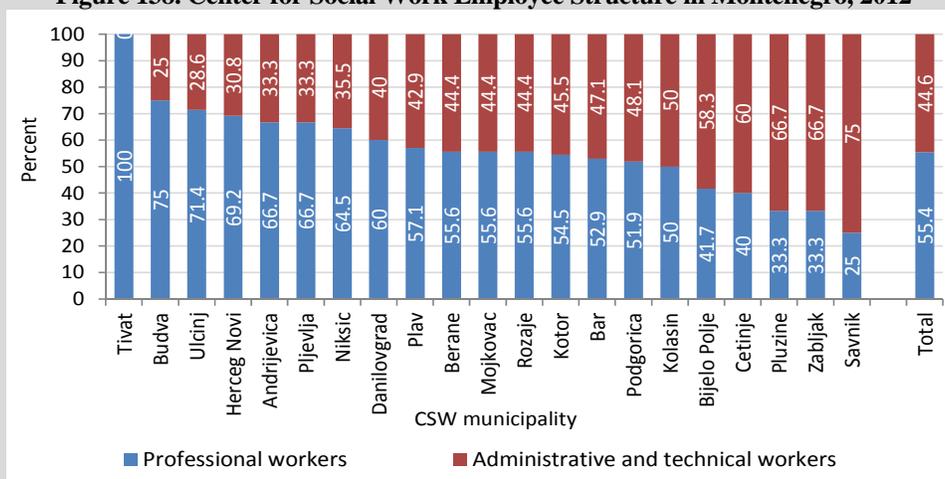
Cooperation between CSWs and other stakeholders, such as local governments, is limited. The lack of institutional links between CSWs and local governments inhibits their cooperation despite overlapping responsibilities. In recent years, local governments established different institutions that provide social services, such as home assistance for the elderly, day-care centers for children with disabilities, and so forth. CSWs are not involved in setting up those services, but in some cases they participate in managing boards of the service providers. Similarly, CSWs do not have cooperation agreements with other offices in their communities.

There is no unique database of beneficiaries, although a development of the social card aims to introduce standardized rules for keeping files and records in CSWs. At the national level, the MLSW manages the database of FMS/MOP

and child allowance beneficiaries based on the data from CSWs. CSWs maintain a database about beneficiaries of other benefits and services, but the databases are not unified and coordinated among CSWs and local governments.

Insufficient numbers of professional workers in some CSWs affects the quality of social services in those municipalities. Furthermore, among all professional employees, almost a quarter are lawyers. As a result, the number of professional staff members who work directly with beneficiaries as social workers is low.

**Figure 138. Center for Social Work Employee Structure in Montenegro, 2012**



Source: World Bank 2013.

Caseloads vary significantly across CSWs, leading to unequal capacity to offer personalized support to beneficiaries. The number of FMS/MOP beneficiaries per case worker varies significantly across CSWs. In general, the number of social beneficiaries per social worker often goes beyond the average, which points to lower quality of work. According to MLSW and CSW data, the average ratio of professional workers to FMS/MOP beneficiaries in Montenegro is 1 to 285, however the situation is significantly worse in some CSWs.<sup>124</sup> As a result, the capacity of CSWs to provide personalized service to SSN beneficiaries varies greatly across the country and is poorer in areas with worse economic conditions.

Source: World Bank 2013 “Activation and Smart Safety Nets in Montenegro: Constraints in Beneficiary Profile, Benefit Design, and Institutional Capacity”.

222. **Employment services. Employment services, administration of social assistance, and provision of social services are not integrated in Montenegro.** Public employment services are provided by the Employment Agency of Montenegro (EAM) while administration of social assistance is the responsibility of the CSWs, which are also responsible for the provision of social services. These two institutions operate largely separately, but both under the supervision of the MLSW. Employment services are responsible for keeping records of unemployed persons and providing intermediation services, assistance for training, and professional orientation. They provide health insurance for the registered unemployed. They are also responsible for designing and implementing the ALMPs. The employment services and social centers do not provide one-stop-shops for helping social assistance beneficiaries who are harder to employ compared to other job seekers. They are not being profiled to identify their barriers to work and needs for support services. Personalized interventions and individual action plans for employment are not common.

223. **Even at its peak, spending on ALMPs was moderate by international standards.** Spending on ALMPs taking into account the number of unemployed and GDP per capita was low by international standards. Spending on ALMPs averaged about 0.5 percent of GDP between 2005 and 2010. In 2011, that share dropped to just 0.25 percent and stayed at that level since. In 2013, real spending per unemployed was

<sup>124</sup> The worst ratio is in Rozaje, where one professional worker provides social services for 410 families (or 1,330 FMS/MOP beneficiaries), while the best ratio is in Herceg Novi, where one professional worker provides services to 21 families (or 55 FMS/MOP beneficiaries).

just a fifth of what was spent in 2008 and lower than what was spent per unemployed in any year since 2005.

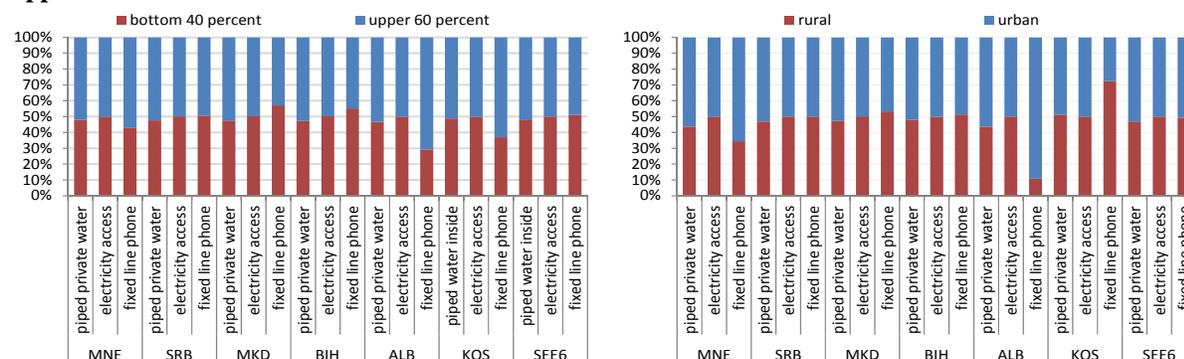
## Infrastructure Services

224. **Success rates in providing access to access to electricity, water and sanitation facilities across all population segments should be replicated in other public services.** Montenegrin citizens enjoy significantly higher access to electricity than regional comparators. Nearly all households have access to electricity. The provision of electricity is uniform both in terms of the overall population as well as with respect to the share of urban and rural population with access to electricity. The fact that coverage tends to be uniform for both rural and urban areas points to the government’s sensitivity to ensuring equity across horizontal groups.

225. **Similarly, households also enjoy comparatively higher access to improved water and sanitation facilities.** Since 2006, Montenegro has maintained a consistently high percentage of its population with access to improved water source. On average, about 98 percent of Montenegrins have access to improved water source, while 76 percent is connected to the public water supply system, comparable to EU11 counterparts such as Estonia, Latvia and Croatia. More importantly, it is ahead of some EU11 countries, boasting better coverage than Lithuania and Romania. Nevertheless, rural population is not as advantaged as the rest of the population. About 5 percent of rural Montenegrins still remain without access to improved water source.

226. **The bottom 40 percent in Montenegro has almost equal access to piped private water and electricity as the upper 60 percent.** Exception is access to fixed telecommunication lines which ranks Montenegro below the SEE6 average, as well as Albania and Kosovo which marked the largest gap between bottom 40 and upper 60 (Figure 139). Access to drinking water through in-residence pipes and fixed phone line in Montenegro varies between rural and urban areas. The urban advantage is evident at a glance (Figure 140).

**Figure 139. Access to Public Services, bottom 40 and upper 60 percent**      **Figure 140. Access to Public services, Rural and Urban**



Source: HBS.

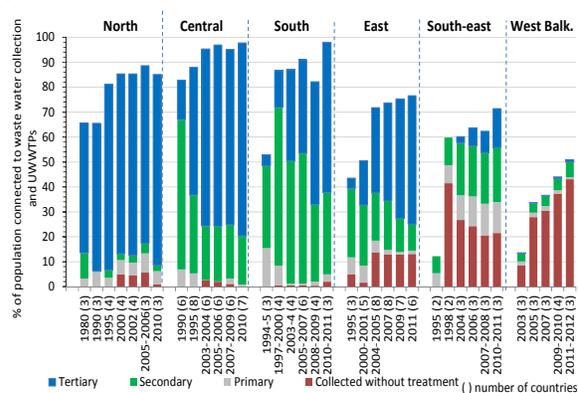
227. **Low waste water treatment standards are a serious impediment to further sustainable development of tourism.** Approximately 60 percent of the urban population discharges waste water in public sewage networks, or 43 percent of the total population of Montenegro. This is far from satisfactory, but is similar to other countries in the region and comparable or moderately lower than regional EU member countries (Figure 141). Waste water treatment is extremely low, with 18 percent of all collected waste water treated according to standards. In the coastal area, waste water is mostly discharged directly into the sea. This area also has potential to absorb EU funds through co-investments with the private sector or IFIs and develop the municipal infrastructure. While 99 percent of Roma have access to improved water sources, 20 percent lack access to adequate sanitation.

228. **The water utility sector in Montenegro is not unique with regard to the challenges it faces in providing safe and reliable, quality water supply and sewerage services to its customers, at a fair price in terms**

of the standard of living of its customers. The main issues that the sector faces are following:

- *Access to service:* There is relatively high level of access to water, but large differences between rural and urban areas remains. Sewerage and in particular wastewater treatment are significantly lagging behind with the sewerage development in the coastal area becoming a serious issue for sustainable development of the tourist industry;
- *Lack of full cost recovery:* Water utilities do not generate sufficient revenues to achieve full cost recovery. In a number of situations, subsidies from central and local government are needed to cover the routine operations and maintenance costs which also faces maintenance backlog;
- *High rates of non-revenue water:* Non-revenue water, which is the difference between the volume of water produced and provided to the system, and the volume of water sold to the customers of the system, is very high in Montenegro. The causes of such situations are different and can result from leaks in the systems (technical losses) or from a variety of “administrative losses” such as non-registered connections, illegal connections, faulty customer meters, etc.;
- *Overstaffing of utility companies:* Publicly owned and operated utilities have often suffered from pressures to take on workers as a means of “job creation”. Over time, this resulted in overstaffing of water utilities, which created an unnecessary labor cost burden;
- *Lack of financial reserves for capital repair and replacement:* A major element associated with the previously mentioned lack of full cost recovery is the lack of serious consideration of capital maintenance, creating maintenance backlog.

**Figure 141. Population Connected to Wastewater Collection and Wastewater Treatment Plants**



Source: European Environmental Agency, <http://www.eea.europa.eu/#tab-datamaps>

229. **Spatial planning and low levels of efficiency in the delivery of municipal infrastructure and service at local level need to be addressed.** Poor mid-term budget planning at municipal level is matched by poor spatial planning. As a result of limited capacities to prepare and implement spatial development plans at local level, although improving, unplanned and unregulated urban expansions and constructions are still an issue, especially in the coastal area. The environmental sustainability of urbanized areas is also greatly compromised. Inadequate planning and poor enforcement of plans result in the undersupply of public services, especially for vulnerable groups. This has important implications for the Montenegrin poor, the majority of whom are located in urban areas, as of 2011. Moreover, the local government’s ability to provide services through capital expenditures was severely hit during the crisis with capital expenditures dropping from 5 percent of GDP in 2008 to 1.6 percent of GDP in 2011<sup>125</sup>. Given the unplanned urban development and land use, unplanned (or poorly planned) urban expansion pose challenges and additional costs for infrastructure and service delivery, reducing efficiency. Since lower-income people/migrants often live in marginal areas in the urban periphery, exhibiting poor social conditions and sub-standard access to services and infrastructures (e.g. reliable water supply, sewer, access roads, street lights, etc), impact of poor spatial planning and unmanaged urban growth affect mostly the urban poor.

<sup>125</sup> World Bank (2015) “Montenegro: Options to Restore Fiscal Sustainability and Improve Spending Efficiency at Subnational Level”.

### ***Emerging Priorities***

230. **Strengthening governance and the rule of law is a necessary condition for strengthening growth and shared prosperity.** Several emerging priorities come out:

- *Accountability and integrity of the judiciary.* The independence and the professionalism of the judiciary needs to be strengthened, along with its efficiency. Montenegro still needs to develop an initial track record of investigations, prosecutions and final convictions in cases of corruption and organized crime, with the newly established Anti-Corruption Agency yet to become fully operational. The many anti-corruption laws currently in the books, including those on political party financing, conflict of interest, and asset declaration need to be implemented. Similar actions could be taken with regarding the tendering process for large government contracts to reduce opportunities for collusion among businesses.
- *Quality of government services and institutions.* Montenegro still has bloated public sector which delivers moderately good services. Given the fiscal sustainability pressures, there is a need to increase the efficiency of public service delivery, including of the higher quality (eg. water and waste water, education, health, social protection). This is happening at the time of the political transition to EU which requires professional and accountable administration. Modernizing public sector and strengthening the checks and balances institutions are priorities for improved service delivery for shared prosperity.

## VII. PRIORITIES AND OPPORTUNITIES

231. **The analysis presented thus far in the SCD discussed several opportunities and constraints Montenegro is facing in achieving the goals of eliminating poverty and boosting shared prosperity.** This chapter identifies those that are seen as having the biggest impact in accelerating Montenegro's progress toward these goals. It is important to highlight how all of the issues discussed in this section and in the SCD more broadly are being addressed in some form (with greater or lesser priority) by the Government of Montenegro. The SCD aims at identifying areas where more focus and resources may be placed. Moreover, the prioritization exercise in no way mean that the challenges or opportunities not mentioned are not important. All the issues discussed in this document are important to ensuring sustainable, shared growth and poverty reduction. The purpose of the SCD prioritization is to use the analysis as a way to identify those challenges that are likely to have the greatest bearing on the twin goals. Lastly, the prioritization is independent of whether the specific challenges are ones in which the World Bank has specific expertise and is likely to engage.

232. **The analysis presented in the SCD highlights how increasing resilience to external shocks and facilitating private sector job creation are essential to Montenegro's strategy of poverty reduction and inclusive growth going forward.** The vulnerability of Montenegro's small, open economy to external shocks, along with the pro-cyclicality of its most important sectors and underlying tax system, presents a challenge to sustainability. The EU has not emerged from the crisis and thus external demand is lingering. The use of monetary policy is extremely limited as is the fiscal space available for managing volatility. Montenegro faces the prospect of prolonged weak demand and the challenges of an unfinished structural transformation agenda. The use of monetary policy is extremely limited and it is faced with limited fiscal space for managing volatility. Strengthening its ability for managing volatility by increasing productivity and flexibility and ensuring connectivity with the big EU block is essential for Montenegro.

233. **The private sector is still small.** At over 30 percent, employment in public sector and SOEs is high and is a source of distortions to the functioning of the labor market and of delays in improving productivity. The weak state of the private sector is evident in the situation of the financial sector, the weak development of private firms, and the still underutilized trade links between Montenegro and the rest of the world. At 104 percent the trade (exports plus imports) to GDP ratio is below that of other small states in the region (average 134 percent) and at about the same level as the average small state in the world. While there is room for progress there have been significant improvements especially in the export of services. Strengthening trade links with the rest of the world is important to reduce vulnerability to idiosyncratic shocks. Close collaboration between the Government and industry may identify obstacles to be removed in regulation and measures to unclog the banking sector and revive commercial credit to facilitate the expansion of private firms. Most of the private investment during recent years consisted in developing the physical infrastructure of the tourism sector and modernizing tourist services. One of the main challenges for the next decade is to develop complementary services that put the new infrastructure to work. The massive capital accumulation during the past decade will increase GDP, but may not necessarily increase the country's GNP. In an extreme case, the GNP may change very little if all inputs complementary to the initial investment are sourced abroad and the waiters, cooks, and most employees working in the new hotels and tourist facilities are foreigners. To capture part of the income generated by the new capital investments Montenegro has to work hard at developing its capacity to compete with foreign sourced inputs and to develop the skills for Montenegrin workers and strengthen the internal demand for these skills.

234. **The composition, not only the level, of growth matters.** The inclusiveness of growth depends crucially on how it translates in increased demand for low skilled jobs and on the reduction in unemployment. Currently, external factors limit growth prospects. The diagnostics reveals several factors that constrain the prospect of sustained economic growth and that growth is shared and reduces poverty. The EU has not emerged from the crisis and thus external demand is lingering. The country is faced by high long-term unemployment, especially amongst the youth. The latest growth episode has not produced an increase in the

demand for unskilled labor as had been the case previous, thus posing risks for the inclusiveness of growth. Hence, safety nets should be in place to ensure that those who are left out of the growth process directly can benefit from social programs. At the same time, design of eligibility criteria should minimize disincentives to work.

235. **Montenegro will face two key tradeoffs in the coming years.** Some of these are already evident, and are likely to become more pressing over the medium to long-term. The presentation of these tradeoffs will be useful in understanding the discussion of the priority areas for sustaining progress in the achievement of the twin goals.

236. **Manage consequences of volatility with limited fiscal space.** The indivisibility in the provision of public goods and the public sector being a large employer introduces rigidities into the budget, and high recurring spending can crowd out capital spending, with a negative impact on growth. As a small state, Montenegro is subject to revenue volatility owing to its exposure to exogenous shocks and a narrow production base (IMF 2015). This results in volatile spending patterns and pro-cyclical fiscal policy. Montenegro can manage this by building adequate fiscal buffers for countercyclical support and creating policy space for spending on infrastructure to boost potential output (IMF 2015).

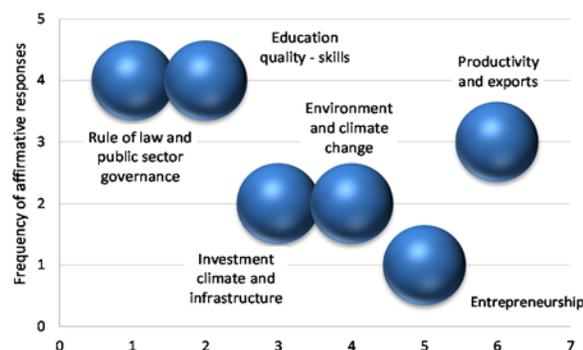
237. **The challenges of youth unemployment in an aging society.** The socialist legacy and the structural transformation have resulted in a large number of retirees in the country, with high pension spending and pressure to relax the current freeze in pension benefits. The pressure to increase benefits is likely to continue despite the system already being underfunded (IMF 2014). On the other hand, the high level of youth unemployment calls for heavily investment in both a short-term strategy to facilitate the school-to-work transition, and a long-term investment in early childhood education and the overall education system to ensure that it provides the skills needed. Besides supply side interventions, there may be need for demand side interventions to incentivize employment.

238. **The existing literature on Montenegro is extensive and provides a solid foundation for the prioritization process.** The evidence base was complemented by consultations with the World Bank Group’s Country Team as well as in-country consultations (in October 2014 and March 2015) and validation. The priorities identified are: managing volatility in a context of limited fiscal space and lack of independent monetary policy; addressing the challenges to youth unemployment, in particular long term unemployment; strengthening private sector development for job creation; and strengthening governance.

239. **The SCD prioritization relied on a thorough review of the evidence, a process of discussion and scoring of priorities, and engagement and consultations with local stakeholders to identify the most important priorities for sustainable achievement of the twin goals in Montenegro.** The prioritization exercise uses evidence and analysis presented in the report to begin to identify which constraints are more binding than others. The team consulted with stakeholders in Montenegro and took into account their views in identifying these priorities (Figure 142).

240. The team first identified three fundamental objectives on the basis of the impact on eliminating poverty and boosting shared prosperity: (i) Strengthening resilience to shocks and volatility; (ii) reducing unemployment and inactivity, in particular amongst youth; (iii) facilitating private sector development. For each of these objectives, it then identified the main pathways to achieving them and the

Figure 142. Priorities Set by Stakeholders, October 2014



Source: WB staff.

time horizon of impacts. While the focus of the SCD priorities is set for a medium term, some of the priority issues will only bear fruit in the longer term. The assessment attempts to differentiate between the short and longer-term impacts.

241. The prioritization of policy actions relied on a thorough review of the evidence, a process of team discussion, a scoring exercise and engagement with local stakeholders.

### ***Priorities and Opportunities***

242. **Priority 1: Ensure sound fiscal policy.** In the fully euroized Montenegrin economy, fiscal policy is the only macroeconomic tool that can serve as a critical fiscal buffer to backstop financial sector problems and respond to external shocks. Montenegro has limited fiscal space and is still facing high transition costs that leave little room to maneuver. Managing public finances so as to build buffers (could be in a form of debt reduction in good times) to use during periods of low demand is important, and presents a challenge for a country that used pro-cyclical spending amplifying the already large positive effect of massive capital inflows in 2006-08, rather than saving the higher tax revenue collected and build a contingency reserve fund. Improving the predictability of fiscal policy can open up the fiscal space for productive spending and for investing in human capital. The implementation of sound fiscal policies aimed at fiscal consolidation can be achieved by improving the efficiency and quality of public spending, carrying out revenue enhancing measures, tackling accumulate arrears that affect private sector, and addressing pension sustainability.

243. **Priority 2: Ensure financial stability.** Montenegro can make very limited use of monetary policy to curb risks associated with fast credit growth. Thus, it needs to develop and enforce macro-prudential policy to control credit booms and their consequences, as the supervisory integration and macro-prudential improvements have been proven essential to carefully supervise nonbank institutions. Maintaining financial sector stability, implementing complementary policies to improve the allocation of financial resources (by reducing NPLs and building up bank capitalization and liquidity positions, reviving credit growth) are essential to boost economic growth. Soundness across the system is needed to stimulate lending to creditworthy enterprises and projects. Monitoring of the financial exposure of firms and banks is even more important with a view to existing limitations in the lender of last resort framework. The most challenging domestic constraint to recovery is the cost of financing commercial banks offer to the private sector. Whether this reflects perceived commercial risks, the current level of non-performing loans or international circumstances has to be understood and addressed. Strengthening contract enforcement system would need to go in parallel with the NPLs resolution.

244. **Priority 3: Strengthen the social protection system to safeguard against shocks.** In a country vulnerable to shocks and undergoing an economic transformation like Montenegro, the role of social protection programs is crucial. The government needs to provide risk management tools as well as anti-poverty programs, which would prevent such high volatility of poverty and improve households' ability to respond to shocks.

245. **Priority 4: Safeguard against environmental risks and protect natural resources.** Montenegro should encourage private sector savings and insurance against the high exposure to environmental risk as the country copes with the climate change impact. It also needs to protect its natural resources which with growing importance of tourism in generating economic gains, faces quite a pressure mainly in the coastal zone. Apart from the inadequate waste management, insufficient water quality and unplanned/unmanaged fast urban growth, industrial pollution also remains to be addressed. Namely, some polluted sites are not far from the country's most valuable natural resources.

246. **Priority 5: Increase access to economic opportunities, including for vulnerable groups (youth, rural population).** The high level of youth unemployment and its long-term duration call for interventions attempting to facilitate the process of transition from school into stable employment, in particular for the least educated, who can struggle with the process for years. The most important key deficits (lack of work-relevant experience, lack of information and connections, limited opportunities for entry-level work, etc) need to be

identified for specific groups in designing interventions. It is also important to ensure that the design of any intervention takes into account the specific barriers of different groups: rural population, women and ethnic minorities face specific constraints in accessing the labor market that need to be accounted for.

247. **Priority 6: Increase quality of human capital, including through strengthened education and skill acquisition.** While school-to-work transition interventions can be used to address the issues faced by the current youth, a more long term approach requires strengthening the education system starting from early childhood education, lifelong learning and ensuring equal access. As the nature of the economy is changing, there is a need to ensure that the next generation is fully equipped with the skills required to enter the labor market. The more dynamic and innovative firms, those holding greatest potential to lead future growth, are also those most likely to cite lack of relevant skills as a constraint. A priority should be also to expand access to quality of education for all, in particular women and ethnic groups, and to reduce inequity and increase workforce productivity by improving skills and learning outcomes. Due to aging population and increased lifestyle-related risk factors, the health system requires a different service mix that would ensure the healthier aging of the labor force and prevent early withdrawals from the labor market.

248. **Priority 7: Facilitate activation and strengthen incentives for work.** Activation measures benefiting particularly the less well-off and youth, and improving access to formal employment are two of the areas that can deliver a substantial impact on the achievement of the twin goals. Improving effectiveness and expanding inclusive access to employment services, keeping in mind deficits faced by specific groups, could be enabled by linking employment services with last-resort social assistance so that the poor would access these services. Further, there is a need to address information barriers to accessing productive employment faced by vulnerable groups, and reduce workers' disincentives for work in the design of social assistance and pensions, the latter focusing on addressing early retirement.

249. **Priority 8: Improve commercial and institutional integration with the EU.** Integration is a cross-cutting theme: it has implications for the design of institutions, commercial policy, the regulatory framework for business activity, and for coordination of physical infrastructure (electricity grid and power generation, roads, ports and airports, etc.). A useful exercise is to assess each regulatory or legislative decision through one lens: Does this regulatory or legislative framework contribute to further integration with the rest of the world or not? In any and all of the aforementioned areas Montenegro gains by strengthening its links with the rest of the world. Montenegro has undertaken important strides in institutional integration by adopting a modern EU based framework, the implementation of which it is currently coordinating with the EU. Financial integration is incomplete, as Montenegro has adopted the euro as its currency but is not fully integrated into the euro financial system. One consequence is that there are limitations on the CBM's ability to act as a lender of last resort, which poses a huge challenge given the magnitude of capital inflows and outflows. With respect to institutional integration, Montenegro has undertaken important strides in institutional integration by adopting a modern EU based framework. It is currently coordinating with the EU the implementation of this framework agreement and continuous improvements along these lines are a challenge. In terms of commercial integration, Montenegro has one of the lowest goods export-to-GDP ratios in the world. The EU markets offer Montenegro opportunities to connect with the larger markets beyond its borders, but regulatory standards need to be effective (as is the case for food safety, phytosanitary standards, intellectual property rights, etc).

250. **Priority 9: Improve connectivity and infrastructure integration.** With respect to infrastructure integration, investments in energy and ICT and upgrading maintenance of transport infrastructure while encouraging private sector investment into logistics and ports is a central to physical connectivity, expanded trade and enhance the attractiveness of Montenegro as a tourism, ICT, and investment destination. This is an area that needs coordination at the regional level, as it relates to the electricity grid, roads, ports, airports and broadband connectivity. In order to meet increased domestic power demand, additional private sector investments in construction of new power generation (most notably in the RE sector) and transmission capacities are needed. Further investment in improving energy efficiency is also needed to manage public

resources and improve competitiveness.

251. **Priority 10: Level the product and labor market playing field to foster private sector development.** Montenegro has been very successful at attracting foreign capital and is still, given current international circumstances, receiving significant capital inflows. These flows suggest that Montenegro is perceived as a safe destination for international funds. Staying the course of reform to improve the business climate has certainly had a noticeable reward. Improving business environment by cutting the regulatory burden (for example, reducing regulations on construction permits, trade logistics, inspections, and so on) and strengthening the institutional framework for private investment will be essential. However, effort needs to be devoted to attract investments in more sectors and in particular in labor intensive ones (e.g tourism service-supporting sectors) and those that require unskilled labor as this will have more of an effect on poverty reduction and shared prosperity. Most of the private investment during recent years consisted in developing the physical infrastructure of the tourism sector and modernizing services; one of the main challenges for the next decade is to develop complementary services that bring the new infrastructure to work.

252. **Priority 11: Strengthen governance, public service delivery and the rule of law.** With regard to the accountability and integrity of the judiciary, the independence and the professionalism of the judiciary needs to be strengthened, along with its efficiency. Montenegro still needs to develop an initial track record of investigations, prosecutions and final convictions in cases of corruption and organized crime, with the newly established Anti-Corruption Agency yet to become fully operational. Montenegro has made enormous strides in adopting modern institutions and a regulatory system in line with that of the rest of Europe. However, that does not imply that the quality of government services and institutions can automatically reach the level of the more developed countries of the region. Montenegro still has bloated public sector which delivers moderately good services. Given the fiscal sustainability pressures, there is a need to increase the efficiency of public service delivery, including of the higher quality (e.g. water and waste water, education, health, social protection). This is happening at the time of political transition to EU which requires professional and accountable administration. Modernizing public sector and strengthening the checks and balances institutions are priorities for improved service delivery for shared prosperity.

**Table 16. Priority Areas to Progress toward the Twin Goals in Montenegro**

	IMPACT ON PRIORITY OBJECTIVES			IMPACT ON TWIN GOALS	
	Increase resilience to shocks and volatility	Reduce unemployment and inactivity	Facilitate private sector development	Poverty	Shared prosperity
Ensure sound fiscal policy	✓			High	High
Ensure financial stability	✓			Medium	High
Strengthen the social protection system to safeguard against shocks	✓			High	Medium
Safeguard against environmental risks and protect natural resources	✓			Medium	High
Increase access to economic opportunities, including for vulnerable groups (youth, rural population)		✓		High	High
Increase quality of human capital, including through strengthened education and skill acquisition		✓		High	Medium
Facilitate activation and strengthen incentives for work		✓		High	High
Improve commercial and institutional integration with the EU			✓	Medium	High

	IMPACT ON PRIORITY OBJECTIVES			IMPACT ON TWIN GOALS	
Improve connectivity and infrastructure integration			✓	Medium	Medium
Level the product and labor market playing field to foster private sector development			✓	Medium	High
Strengthen governance, public service delivery and the rule of law			✓	High	High

### ***Knowledge Gaps***

253. A number of knowledge gaps have emerged in the course of the SCD analysis, which should be addressed:

- a. **Labor demand:** Better firm-level data (firm census or panel data) and analysis to understand the dynamics of labor demand, the impacts on labor market outcomes, and whether labor supply responds effectively, with particular attention to specific groups like women and ethnic minorities;
- b. **Agriculture:** data and potential of agricultural exports in the context of EU accession
- c. **Municipal public finance/expenditure/service delivery review** to assess the capacity of local administration to deliver local services.
- d. **Tourism:** quantifying the potential for SMART tourism and the dangers in concentration on high-end tourism.
- e. **RAE:** Data availability of ethnic groups is limited. The agenda to enhance inclusion is not simple, and continuing to experiment, evaluate and learn is necessary to better inform what works best to address this challenge;
- f. **Skills:** The extent to which skills gaps would be a constraint for business and productivity in a growing economy is unclear, suggesting an important knowledge gap for further investigation.
- g. **Rural economy apart from agriculture.** Understanding the dynamics of the economy in rural areas apart from agriculture is essential given the high poverty rates in rural areas, with particular attention paid to understanding the large gender gap in labor force participation in rural areas versus urban areas.
- h. **Employment and pension:** Further diagnostic work is needed to determine the relative importance of labor force participation rate and the informality rate; the role of reservation wages in determining labor force participation; and the existence of skill mismatch.
- i. **Firm growth and entrepreneurship:** Barriers to the survival of new entrants and of the growth of innovative and younger firms requires further investigation.

## Annex 1. Literature

- Acemoglu D. and J. Robinson (2013). "Why Nations Fail: The Origins of Power, Prosperity and Poverty". Crown Business.
- Anusic, Z. (2012). "How Can the Pension System Design Contribute to Better Employment Outcomes in Montenegro?". World Bank.
- Azevedo, J.P., Sanfelice, V., and M. Cong Nguyen (2012). "ADECOMP: Stata module to estimate Shapley Decomposition by Components of a Welfare Measure," Statistical Software Components S457562, Boston College Department of Economics.
- Babic, M. and E. Primorac (1986) "Some Causes of the Growth of the Yugoslav External Debt". Soviet Studies. Vol. 38, No. 1 (Jan., 1986), pp. 69-88. <http://www.jstor.org/discover/10.2307/151992?uid=3739584&uid=2&uid=4&uid=3739256&sid=21104941813567>
- Bartlett, W., Cuckovic, N., Jurlin, I., Nojkovic, A. and V. Popovski (2011). "Institutional Quality and Growth in EU Neighborhood Countries", WP5/11: Search Working Paper.
- Business Environment and Enterprise Performance Survey (BEEPS), various.
- Blanchard, O. and M. Kremer, "Disorganization", The Quarterly Journal of Economics, Vol. 112, No. 4, 1091-1126, November 1997.
- Blue Marble Navigator. [www.blue-marble.de](http://www.blue-marble.de)
- Bussolo, M. and L. F. Lopez-Calva (2014). "Shared Prosperity: Paving the Way in Europe and Central Asia". World Bank. <https://openknowledge.worldbank.org/handle/10986/17696>
- Carruthers, R. (2012). "Transport Infrastructure for MED11 Countries", CASE Network Reports 108, July 1, 2012
- CBCG, various statistics.
- CEPEJ (2014). "Report on European judicial systems – Edition 2014 (2012 data): efficiency and quality of justice", Evaluation Report 2014.
- Ceriani, L. and M. E. Dávalos (2014). "First Insights into Promoting Shared Prosperity in South East Europe", February 2014.
- Cuberes, D. and M. Teignier (2014). "Gender Inequality and Economic Growth: A Critical Review". Review Article. Journal of International Development, J. Int. Dev. 26, 260–276 (2014).
- Cullen International (2014). "Enlargement Countries Monitoring Report 4", December 2012.
- Demirgus-Kunt, A. and L. Klapper (2012). "Measuring Financial Inclusion. The Global Findex Database". The World Bank, Policy Research Working Paper 6025, April 2012.
- Eichengreen, B. (2010). "Globalization and the crisis". Ifo Institute for Economic Research at the University of Munich, CESifo Forum, Vol. 11, Issue 3, p. 20-24, October 2010.
- Elance, [www.elance.com](http://www.elance.com)
- Energy Community (2013). "Study on the Need for Modernization of Large Combustion Plants in the Energy Community".
- Environmental Protection Agency of Montenegro (2013). "Impact of Industrial Polluters on Environment". Presentation held by Lidija Scepanovic, Assistant to Director of Sector for monitoring, analysis and reporting.

[European Commission \(2013\). “Enlargement Strategy and Main Challenges \(2013-2014\)”, Brussels.](#)

European Commission (2014). “The 2015 Aging Report. Underlying Assumptions and Projection Methodologies”, European Economy 8/2014.

European Commission (2015). “Montenegro 2015 Report”, October 2015,

[http://ec.europa.eu/enlargement/pdf/key\\_documents/2015/20151110\\_report\\_montenegro.pdf](http://ec.europa.eu/enlargement/pdf/key_documents/2015/20151110_report_montenegro.pdf)

European Environmental Agency, <http://www.eea.europa.eu/#tab-datamaps>

Eurostat, various statistics.

FINDEX database.

Friedman, E., Johnson, S., Kaufman D. and P. Zoido Lobaton (2000). “Dodging the Grabbing Hand: The Determinants of Unofficial Activities in 69 Countries”. *Journal of Public Economics*, 76 459-493 et al., 2000.

Global Entrepreneurship Monitor (GEM), various.

Government of Montenegro. Directorate for Development of Small and Medium Sized Enterprises (2011). “Strategy for Development of Small and Medium Sized Enterprises 2011-2015”, January 2011.

Government of Montenegro (2011). “Strategy of Public Administration Reform in Montenegro 2011-2016”, March 2011.

Government of Montenegro. Ministry of Economy (2013). “Manufacturing Development Strategy of Montenegro 2014-2018”, December 2013.

Government of Montenegro. Ministry of Finance (2014). “Macroeconomic and Fiscal Policy Guidelines 2014-2017”, April 2014.

Government of Montenegro. Ministry of Economy (2014). “Regional Development Strategy of Montenegro 2014-2020”, May 2014.

Government of Montenegro. Ministry of Finance (2014). “Forecasts of Macroeconomic and Fiscal Indicators 2014-2018”, September 2014.

Grecic, V. and J. Kaludjerovic (2012). “Social Impact of Emigration and Rural-Urban Migration in Central and Eastern Europe”. Final Country Report, July 2012.

Grigoryan, A., Becchi, G. and V. Santos (2011). “Disaster Risk Reduction Capacity Assessment Report for Montenegro”. UNDP, April 2011.

Household Budget Survey (HBS). Various years.

ILO (2011). “A Comparative Overview of Informal Employment in Albania, Bosnia and Herzegovina, Moldova and Montenegro”.

International Energy Agency (IEA). World Energy Statistics and Balances.

International Transport Forum, Statistics Brief, 2012, <http://www.internationaltransportforum.org/statistics/statbriefs.html>

Jahan S. and K. Wang (2013). “A Big Question on Small States. Can they overcome their size-related vulnerabilities and grow faster and more consistently?”. *Finance & Development*. September 2013.

KfW. Wind Atlas, software tool.

KfW (2012). “Montenegro. Climate-Fact-Sheet”, June 2012.

Kiss, J. (1994). “Debt Management in Eastern Europe”. *Eastern European Economics*, May-June 1994, p 59.

Knack, S. (2003). "Democracy, Governance and Growth". Ann Arbor: University of Michigan Press.

Labor Force Survey (LFS), various years.

McCarthy, M. and M. Bracovic (2008). "Elderly and Palliative Care Services in Montenegro". Conference Proceedings - Transforming Elderly Care at Local, National and Transnational Levels. Danish National Centre for Social Research, Copenhagen, June 26-28, 2008.

Ministry of Finance of Montenegro (2015). "The Development Directions of Montenegro for 2015-2018", Podgorica, June, 2015.

Ministry of Economy (2014). "Energy strategy of Montenegro until 2030".

Ministry of Health of Montenegro (2013). "Health System in Montenegro. Opportunities for Investment". Presentation held by N. Todorovic, Deputy Minister of Health, Podgorica, March 17, 2013.

Ministry of Sustainable Development and Tourism (2013). "Agenda reformi u oblasti turizma", Akcioni plan za pripremu turistickih sezona, March 2013.

Ministry of Sustainable Development and Tourism (2014). "Information on the Environment in Montenegro in 2013", July 2014.

MONSTAT, various statistics.

MONSTAT and UNICEF (2014). "Montenegro and Montenegro Roma Settlements. Monitoring the Situation of Children and Women. Multiple Indicator Cluster Survey 2013", September 2014.

Montenegrin Employers Federation (2013). "Assessment Of The Environment For Women Entrepreneurship In Montenegro", September 2013.

Multiple Indicator Cluster Survey (MICS), various.

Murthi, M. (2015). Equal opportunities for Europe's Roma: an economic imperative in an ageing Europe.

North, D. (1990). "Institutions, Institutional Change and Economic Performance". Cambridge: Cambridge University Press.

OECD (2014). "PISA 2012 Results in Focus: What 15-year-olds Know and What They Can Do With What They Know".

Official Gazette, various.

Osorio-Roddarte I. and Z. Bogetic (2012). "Increasing Montenegro's Export Potential and Export Sophistication".

Radovic, M. et al. (2014). "Report: Informal Employment in Montenegro: Estimates of Scale and Effects", Faculty of Economics Podgorica, EU and UNDP.

Rutkowski, Jan J. (2011). "Does the Labor Law Contribute to Poor Employment Outcomes in Montenegro?" The World Bank, Technical Note, November 2011.

Rutkowski, Jan J. (2013). "Montenegro Jobs Challenges". The World Bank, Policy Note, November 2013.

SAPUCCA for European Commission - Directorate-General Home Affairs (2013). "Organised Crime and the Fight Against Crime in the Western Balkans: a Comparison with the Italian Models and Practices

SEETO Road Safety Strategy Survey 2014, March 2014, [www.seetoint.org](http://www.seetoint.org)

Telegeography GlobalComms Database, [www.telegeography.com](http://www.telegeography.com)

Torgler B. and F. Schneider (2007). "The Impact of Tax Morale and the Institutional Quality of the Shadow Economy". Linz: Institute for the Study of Labor. Discussion Paper No. 2541. Available on the web at: <http://ftp.iza.org/dp2541.pdf>

UN (2014). World Population Prospects: The 2012 Revision.

UNDP (2011). Women Entrepreneurship in Montenegro, December 2011.

UNDP. Enterprise Survey, 2015.

UNDP/World Bank/EC regional Roma survey 2011.

UNDP (2012a). "The Health Situation of Roma Communities". Analysis of the data from the UNDP/World Bank/EC Regional Roma Survey. Roma Inclusion Working Papers.

UNDP (2012b). "Roma Education in Comparative Perspective". Findings from the UNDP/World Bank/EC Regional Roma Survey. Roma Inclusion Working Papers.

UNDP (2014). National Human Development Report - Montenegro. Resource Efficiency and Sustainable Human Development.

UNECE (2007). "Environmental Performance Reviews, Republic of Montenegro", Second Review.

UNICEF (2011). "Child Poverty in Montenegro", November 2011.

UNICEF. Children of Montenegro. Realizing Children's Rights in Montenegro. <http://www.humanium.org/en/montenegro/>

UNODC (2008). "Crime and Its Impact on the Balkans". Vienna: UNODC (United Nations Office of Drugs and Crime)

UNODC (2011). "Corruption in Montenegro: bribery as experienced by the population". Vienna: UNODC (United Nations Office of Drugs and Crime).

UNODC (2013). "Business, Corruption and Crime in Montenegro: the impact of bribery and other crime on private enterprise". Vienna: UNODC (United Nations Office of Drugs and Crime).

World Bank. World Development Indicators, various.

World Bank Group. Doing Business, [www.doingbusiness.org](http://www.doingbusiness.org).

World Bank Group Entrepreneurship Snapshots (WBGES), various.

World Bank (2000). "The Impacts of Natural Disasters on the Poor: A Background Note". Consulting Agreement No. 35113-9382.

World Bank (2005). "A Better Investment Climate for Everyone". Washington, DC: The World Bank.

World Bank (2008). "Montenegro: Beyond the Peak: Growth Policies and Fiscal Constraints". Public Expenditure and Institutional Review, November 24, 2008, Report No. 46660-ME.

World Bank (2012a). "Montenegro: After the Crisis: Towards a Smaller and More Efficient Government". Public Expenditure and Institutional Review, January 2012, Report No. 65909-ME.

World Bank (2012b). "Montenegro: Preparing for Prosperity. Ensuring Sustainability, Connectivity, and Flexibility for Dynamic Growth". Country Economic Memorandum, December 21, 2012, Report No. 73826-ME.

World Bank (2013a). "Activation and Smart Safety Nets in Montenegro: Constraints in Beneficiary Profile, Benefit Design, and Institutional Capacity", June 2013.

World Bank (2013b). "Energy Efficiency Project". Concept Note (P145399).

World Bank (2013c). “Industrial Waste Management and Cleanup Project”. Project Appraisal Document, Report No. 73636-ME.

World Bank (2013d). “Montenegro: Gender Diagnostic: Gaps in Endowments, Access to Economic Opportunities and Agency”, June 2013, Report No. 78678-ME.

World Bank (2013e). “Political Economy of Reforms in Western Balkans: Are there quick wins in the environment of Reform Fatigue”. Washington DC: World Bank (mimeo).

World Bank (2014a). “Analytical Approaches for a Systematic Country Diagnostic (SCD)”. A Resource Document, March 10, 2014.

World Bank (2014b). “Brittle Recovery”. South East Europe Regular Economic Report, No. 6, May 2014.

World Bank (2014c). “Fiscal and Debt Management”. Project Concept Note, Program-for-Results (P150439), July 31, 2014.

World Bank (2014d). “Interim Guidelines for Systematic Country Diagnostic (SCD)”, February 21, 2014.

World Bank (2014e). “Is there a skills shortage in Montenegro?” Presentation held by Jan J. Rutkowski, Podgorica, May 6, 2014.

World Bank (2014f). “Project Paper for Small RETF Grant to Montenegro for EU/IPA Agriculture and Rural Development Institution Building Project”, October 7, 2014, Report No. 91319-ME.

World Bank (2015). “Pension System in Montenegro: Outlook and Further Reform Options” June 2015.

World Bank (2015). “Montenegro: Options to Restore Fiscal Sustainability and Improve Spending Efficiency at Subnational Level”, July 2015

World Bank, IFC and MIGA (2014). “World Bank Group: A New Approach to Country Engagement”, April 29, 2014.

World Economic Forum. Global Competitiveness Report, various.