Montenegro: Preparing for Prosperity

Ensuring Sustainability, Connectivity, and Flexibility for Dynamic Growth

Country Economic Memorandum

December 21, 2012

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

Document of the World Bank
**CURRENCY AND EQUIVALENTS UNITS**

Currency Unit = EUR (Euro)  
US$1 = EUR 0.79  
(As of November 14, 2012)

**FISCAL YEAR**  
January 1 – December 31

**WEIGHTS AND MEASURES**  
Metric System

**ACRONYMS AND ABBREVIATIONS**

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Definition</th>
<th>Acronym</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>A2A</td>
<td>Italian corporate group</td>
<td>MIPA</td>
<td>Montenegrin Investment Promotion Agency</td>
</tr>
<tr>
<td>AAK</td>
<td>Advance of Applied Knowledge</td>
<td>MIPA</td>
<td>Ministry of Interior and Public Administration</td>
</tr>
<tr>
<td>BEEP</td>
<td>Business Environment and Enterprise Performance surveys</td>
<td>MoE</td>
<td>Ministry of Economic</td>
</tr>
<tr>
<td>BRIICS</td>
<td>Group of countries comprising Brazil, Russia, India, Indonesia, and China</td>
<td>MOF</td>
<td>Ministry of Finance</td>
</tr>
<tr>
<td>CBCG</td>
<td>Central Bank of Montenegro</td>
<td>MONSTAT</td>
<td>Montenegro National Statistics Agency</td>
</tr>
<tr>
<td>CEAC</td>
<td>Central European Aluminum Company</td>
<td>NIS</td>
<td>National innovation system</td>
</tr>
<tr>
<td>CEFTA</td>
<td>Central European Free Trade Agreement</td>
<td>NMS</td>
<td>New EU member states</td>
</tr>
<tr>
<td>CEM</td>
<td>Country Economic Memorandum</td>
<td>NPL</td>
<td>Non-Performing Loans</td>
</tr>
<tr>
<td>DB</td>
<td>Doing Business (IFC) European Bank for Reconstruction and Development</td>
<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
</tr>
<tr>
<td>EBRD</td>
<td></td>
<td>OTP</td>
<td>Commercial Bank in Hungary</td>
</tr>
<tr>
<td>EC</td>
<td>Energy consumption</td>
<td>PEIR</td>
<td>Public Expenditure and Institutional Review</td>
</tr>
<tr>
<td>ECA</td>
<td>Europe and Central Asia</td>
<td>PMR</td>
<td>Product market regulation</td>
</tr>
<tr>
<td>EIB</td>
<td>European Investment Bank</td>
<td>PPP</td>
<td>Purchasing Power Parity</td>
</tr>
<tr>
<td>EPCG</td>
<td>Electricity company: Elektroprivreda Crne Gore AD Niksic</td>
<td>PPP</td>
<td>Purchasing power parity</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
<td>PRODY</td>
<td>An export basket’s associated productivity level</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign direct investment</td>
<td>PS</td>
<td>Product Space</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Full Form</td>
<td>Abbreviation</td>
<td>Full Form</td>
</tr>
<tr>
<td>--------------</td>
<td>-----------</td>
<td>--------------</td>
<td>-----------</td>
</tr>
<tr>
<td>FEC</td>
<td>Final energy consumption</td>
<td>RCA</td>
<td>Revealed comparative advantage</td>
</tr>
<tr>
<td>FMS</td>
<td>Family material support</td>
<td>SEE</td>
<td>South East Europe</td>
</tr>
<tr>
<td>FYR</td>
<td>Former Yugoslav Republic of Macedonia</td>
<td>SEETO</td>
<td>South East Europe Transport Observatory</td>
</tr>
<tr>
<td>G-Cloud</td>
<td>Government Cloud Computing</td>
<td>SME</td>
<td>Small and medium-size enterprises</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross domestic product</td>
<td>T&amp;D</td>
<td>Transmission and distribution</td>
</tr>
<tr>
<td>GNI</td>
<td>Gross national income</td>
<td>TEN-Ts</td>
<td>Trans-European Transport Network</td>
</tr>
<tr>
<td>GVA</td>
<td>Gross value added</td>
<td>TFP</td>
<td>Total Factor Productivity</td>
</tr>
<tr>
<td>HP</td>
<td>Hodrick-Prescott filter</td>
<td>UK</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>ICA</td>
<td>Investment climate assessments</td>
<td>USAID</td>
<td>U.S. government aid agency</td>
</tr>
<tr>
<td>ICT</td>
<td>Information and Communication Technologies</td>
<td>VAT</td>
<td>Value-added tax</td>
</tr>
<tr>
<td>IEA</td>
<td>International Energy Agency</td>
<td>VET</td>
<td>Vocational education and training</td>
</tr>
<tr>
<td>IFI</td>
<td>International Financial Institutions</td>
<td>VTB</td>
<td>Russia’s Foreign Trade Bank</td>
</tr>
<tr>
<td>ILO</td>
<td>International Labor Organization</td>
<td>WDI</td>
<td>World Development Indicators</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
<td>WEF</td>
<td>World Economic Forum</td>
</tr>
<tr>
<td>IMO</td>
<td>International Maritime Organization</td>
<td>WTO</td>
<td>World Trade Organization</td>
</tr>
<tr>
<td>ISP</td>
<td>Internet Service Provider</td>
<td>WTTC</td>
<td>World Travel &amp; Tourism Council</td>
</tr>
<tr>
<td>IXP</td>
<td>Internet Exchange Point</td>
<td>ZCG</td>
<td>Rail entity: Zeljeznice Crne Gore</td>
</tr>
<tr>
<td>KAP</td>
<td>Aluminum company</td>
<td>ZICG</td>
<td>Railway Infrastructure of Montenegro</td>
</tr>
<tr>
<td>LLLU</td>
<td>Local Loop Unbundling</td>
<td>ZPCG</td>
<td>Railway Transport of Montenegro</td>
</tr>
<tr>
<td>MICS</td>
<td>Montenegro Investment Climate Survey</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Role</th>
<th>Name</th>
<th>Department</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vice President:</td>
<td>Philippe H. Le Houerou, ECSVP</td>
<td></td>
</tr>
<tr>
<td>Country Director:</td>
<td>Jane Armitage, ECCU4</td>
<td></td>
</tr>
<tr>
<td>Sector Director:</td>
<td>Yvonne Tsikata, ECSPE</td>
<td></td>
</tr>
<tr>
<td>Sector Manager:</td>
<td>Satu Kähkönen, ECSPE</td>
<td></td>
</tr>
<tr>
<td>Team Task Leader:</td>
<td>Željko Bogetić, ECSPE</td>
<td></td>
</tr>
</tbody>
</table>
Acknowledgements

This report was prepared at the request of and in close cooperation with the Government of Montenegro to assist in identifying the development policy agenda now that Montenegro has formally opened negotiations with the EU.

The World Bank team would like to express gratitude to all the government agencies, private sector and foreign business associations, civil society, and think tanks that made this study possible by providing data, access to local publications and analysis, discussions, and insights. The team is especially grateful to Finance Minister Milorad Katnić and his team, who coordinated the government’s cooperation with the World Bank, as well as to Governor Radoje Žugić and his team at the Central Bank of Montenegro who were also key counterparts of the Bank CEM missions. Special thanks are also due to Montenegro Chamber of Economy and its president, Velimir Mijušković, and vice president, Ljiljana Filipović, for exemplary cooperation in helping design and conduct the Montenegro Investment Climate Survey (MICS) in the Spring 2012, which served as the basis for analysis of the investment climate. The team would like to express special gratitude and appreciation to the Prime Minister of Montenegro, Igor Lukšić, and Minister Katnić for their kind support, advice, and insights in the course of CEM policy discussions and also for hosting the joint World Bank – Government of Montenegro workshop, which discussed the select preliminary analyses underpinning this report. Jane Armitage (World Bank’s country director for Western Balkans), Yvonne Tsikata (World Bank’s director for poverty reduction and economic management, Europe and Central Asia Region), Satu Kähkönen (World Bank’s sector manager for economic policy for EU11 and Western Balkan countries), and Anabela Abreu (World Bank’s country manager for Montenegro and Bosnia and Herzegovina) provided valuable advice in all stages of this study.

This synthesis report was prepared by a team of World Bank economists led by Željko Bogetić, lead economist and country sector coordinator for economic policy for Western Balkans and the main author, who also coordinated the work on export potential and export sophistication, and trust experiments. The following team of authors prepared background papers, notes, and contributions to the synthesis report: Sanja Madžarević Šujster, senior economist, ECSPE (growth convergence and fiscal sustainability; who also coordinated the work of consultants on the investment climate and product market regulation), Arye Hillman, consultant (trade, incentives, entrepreneurship; trust experiments), Yannis Kessides, lead economist, DECRG (energy; infrastructure connectivity), Israel Osorio-Rodrarte, consultant (export potential and export sophistication), Martin Melecky, senior economist, ECSPF, and Mike Edwards, lead financial specialist and Country Sector Coordinator, ECSPF (financial sector), Velimir Šonje and Dragan Bagić, consultants (investment climate and firm performance; product market regulation and factors of FDIs), Ken Simler, senior economist, ECSPE (poverty and inequality), Milenko Popović, consultant (sources of growth; trust experiments), Christian Bjørnskov, consultant (trust experiments), Danijela Vukajlović-Grba, consultant (financial discipline), Oleg Petrov, Cecilia Maria Paradi-Guilford, Natalija Gelvanovska (information communication technologies). Naoko Kojo, senior economist, assisted on fiscal sustainability, and Anil Onal, consultant, provided research assistance in the final stage of the report preparation. Maria Andreina Clower (Washington D.C. office) and Dragana Varezić (Podgorica office) provided team assistance with Dragana providing team assistance to all the visiting CEM missions to Montenegro. Jovana Šljivančanin assisted the team with presentations at the workshop in June 2012. The background mission work and field interviews in preparation for this report were conducted by the core mission team consisting of Željko Bogetić (mission team leader), Sanja Madžarević-Šujster, Arye Hillman, Israel Osorio-Rodrarte, and Yannis Kessides who presented the preliminary findings of the report at the joint World Bank – Government of Montenegro workshop in July 2012 in Miločer, Montenegro.
# Table of Contents

INTRODUCTION ......................................................................................................................... 1

PART I: SUSTAINABILITY ......................................................................................................... 6
  A. Montenegro’s Sources of Growth ......................................................................................... 6
  B. Ensuring Fiscal Sustainability .............................................................................................. 12
  C. Ensuring Financial Sustainability ....................................................................................... 19
  D. Towards a New Growth Model ............................................................................................ 22
  E. An Agenda for Sustainable Growth and Income Convergence ........................................ 24

PART II: CONNECTIVITY ......................................................................................................... 28
  A. Why Connectivity Matters .................................................................................................. 28
  B. Expanding and Diversifying Exports .................................................................................. 30
  C. Application of Product Space Analysis to Montenegro ...................................................... 35
  D. Conclusions from Product Space Analysis ......................................................................... 40
  E. From Comparative to Competitive and Locational Advantages ......................................... 41
     E.1. Connectivity via the European Union and South East Europe ....................................... 44
     E.2. Connectivity and Infrastructure .................................................................................... 44
     E.3. Transport Connectivity ................................................................................................. 46
     E.4. Energy Connectivity ..................................................................................................... 49
     E.5. Information and Communication Technologies ............................................................ 58
     E.6. ICT for Growth .............................................................................................................. 59
  F. Policy Coordination and Decision Making ......................................................................... 61
  G. Country Models for Montenegro in Connectivity ................................................................. 63
  H. Policy Agenda for Greater Connectivity ............................................................................. 64

PART III: FLEXIBILITY .............................................................................................................. 67
  A. Flexibility as Precondition of Dynamic Growth ................................................................. 69
  B. The Legal Environment for Doing Business ...................................................................... 69
  C. Insights from the Montenegro Investment Climate Survey (MICS) 2012 and Field Interviews .............................................................. 73
     C.1. The Informal Sector and Connectivity .......................................................................... 75
  D. Product Market Regulation ............................................................................................... 78
  E. Labor Market Regulations ................................................................................................ 86
  F. Policy Agenda For Improving Flexibility ............................................................................ 92

Annex 1: Montenegro Doing Business Indicators, 2006-12 .................................................... 95

REFERENCES ......................................................................................................................... 97
List of Tables

Table I.1: Montenegro: Selected Macroeconomic Indicators, 2006-12 ................................................. 4
Table 1: Montenegro: Sectoral Decomposition of Gross Value Added Growth, 2000-10 .......................... 7
Table 2: Montenegro: Contribution of Education and Knowledge to GDP Growth, 2000-10 .................. 10
Table 3: Montenegro: Decomposition of Growth in GDP per Capita, 2000-10 ........................................ 11
Table 4: Montenegro: Medium-Term Fiscal Framework .......................................................... 14
Table 5: Montenegro: Basic Indicators of the Banking System ............................................................ 20
Table 6: GDP per Capita Growth Scenarios for Montenegro, EU27, and EU15 ................................. 27
Table 7: Montenegro: Exports, Comparative Advantage (RCA), Links with Export Structure (density), and Income Potential (prody) ............................................................. 40
Table 8: Montenegro Investment Climate Survey (2012): Top Six Constraints .................................. 73

List of Boxes

Box I.1: Recent Evolution of Poverty in Montenegro ............................................................................. 2
Box 1: Government of Montenegro Medium-Term Fiscal Reform Measures .................................. 15
Box 2: Eurozone Fiscal Rules ........................................................................................................... 17
Box 3: The Role of Foreign Banks ................................................................................................... 19
Box 4: How to Achieve Golden Growth in Montenegro? ................................................................. 26
Box 5: Regional Infrastructure in the Integration Process .................................................................. 45
Box 6: Improving Flexibility: Remaining Reforms and Policy Recommendations .......................... 68
Box 7: Montenegro Investment climate survey (MICS 2012) methodology ..................................... 73
Box 8: Product Market Regulation (PMR) Assessment Methodology ............................................. 79

List of Figures

Figure I.1: Per Capita Gross Domestic Product, Purchasing Power Parity .............................................. 1
Figure Box I.1: Montenegro: Poverty, Activity, and Employment Rates ................................................. 2
Figure 1: Montenegro: Demand-Side Sources of Growth, 2000-10 ...................................................... 6
Figure 2: Montenegro: Factor-Input Sources of Growth, 2000-10 ......................................................... 9
Figure 3: Real and Potential Output (HP-Filter) ................................................................................... 12
Figure 4: Fiscal Policy Stance ............................................................................................................ 16
Figure 5: Debt Sustainability ................................................................. 18
Figure 6: Economic Acceleration and Production Possibilities Frontier ......................................................... 23
Figure 7: Pillars of the Global Competitiveness Index, 2012-13 ........................................................................... 23
Figure 8: Worldwide Governance Indicators ........................................................................................................ 25
Figure 9: Illustration: Proximities Across Goods in the Product Space ............................................................. 33
Figure 10: Proximities Across Pairs of Goods in the Product Space ................................................................. 34
Figure 11: Concentration of Montenegro’s Exports .......................................................................................... 35
Figure 12: Comparative Export Concentration as Measured by the Herfindahl Index ......................................... 36
Figure 13: Exports by Technological Content in Selected Small Countries .................................................... 36
Figure 14: Export Sophistication and Economic Development ........................................................................ 37
Figure 15: Montenegro: A Dearth of Income-Enhancing Products ............................................................... 37
Figure 16: Montenegro’s Position in the Product Space, part 1 of 2 ............................................................... 38
Figure 17: Montenegro’s Position in the Product Space, part 2 ....................................................................... 39
Figure 18: Montenegro Competitiveness Indicators .......................................................................................... 47
Figure 19: Montenegro: Electricity Balance, 2003–11 .................................................................................... 51
Figure 20: Electricity Imports and Exports, 2003–11 ....................................................................................... 51
Figure 21: Electricity Imports, 2006–2012 ......................................................................................................... 51
Figure 22: Average Electricity Prices by Customer Type, 2009 ....................................................................... 53
Figure 23: Average Electricity Price for Residential Customers ......................................................................... 54
Figure 24: Average Retail Electricity Price (All Customers) ............................................................................... 55
Figure 25: Distance to the Frontier in the Ease of Doing Business ..................................................................... 70
Figure 26: Montenegro's Distance to the Frontier in the Nine Areas Measured by Doing Business .................. 70
Figure 27: Mean Rankings in the Ten Areas Measured by Doing Business, 2012 ............................................. 71
Figure 28: Total Tax Cost Borne by the Average Firm, 2012 .......................................................................... 75
Figure 29: Productivity Acceleration and Regulation .......................................................................................... 78
Figure 30: Aggregate PMR Score ....................................................................................................................... 80
Figure 31: PMR Medium-Level Indicators ....................................................................................................... 80
Figure 32: Public Business Enterprises: Montenegro in 2011 vs. Other Countries in 2007/08 ....................... 81
Figure 33: Licenses and Permits: Montenegro in 2011 vs. Other Countries in 2007/08 ................................. 82
Figure 34: Price Controls: Montenegro in 2011 vs. Other Countries in 2007/08 .............................................. 82
Figure 35: Command and Control Regulation: Montenegro in 2011 vs. Other Countries in 2007/08 ....... 83
Figure 36: Communication and Simplification of the Procedures: Montenegro in 2011 vs. Other Countries in 2007/08 ........................................................................................................... 83
Figure 37: Administrative Burden for Business Start-Ups, Montenegro in 2011 vs. Other Countries in 2007/08 .............................................................. 84
Figure 38: Tariffs: Montenegro in 2011 vs. Other Countries in 2007/08 .............................................................. 85
Figure 39: Regulatory Barriers: Montenegro in 2010 vs. Other Countries in 2007/08 .............................. 85
Figure 40: Labor Market Performance, 2011 .................................................................................................. 86
Figure 41: GDP Growth vs. Changes in the Unemployment Rate, 2006-11 ................................................ 87
Figure 42: Montenegro: Labor Demand, Unemployment, and GDP Growth, 2006-11 ................................. 87
Figure 43: Rigidity of Employment Index, 2012 ......................................................................................... 88
Figure 44: Difficulty of Hiring Sub-Index, 2012 ......................................................................................... 89
Figure 45: Rigidity of Hours Sub-Index, 2012 ............................................................................................... 89
Figure 46: Difficulty of Redundancy Sub-Index, 2012 ................................................................................ 90
Figure 47: Areas Contributing to Rigidity of Hiring Sub-Index, 2012 ...................................................... 90
Figure 48: Redundancy Costs, 2012 ............................................................................................................. 91
Figure 49: Montenegro: Tax/Wage Disincentives for Formal Work .............................................................. 92
EXECUTIVE SUMMARY

1. This report is intended to provide analytical support to the Government of Montenegro and inform its development strategy as it embarks on the next stage of the EU integration process. It provides answers to specific questions of importance for charting Montenegro’s macroeconomic and structural policies for the years ahead. For example, what have been the relative roles of different growth drivers, and how will they need to change in the new international environment? How can fiscal policy help ensure sustainability? What challenges must financial sector reforms overcome to ensure robust credit recovery? How can Montenegro best go about becoming better connected to world markets? Do exports have potential to be a new driver of growth and diversification? How can Montenegro better connect, internally and externally, to unlock productivity gains based on competitive advantages? What regulatory, investment climate, and institutional reforms will be needed to support more sustainable future growth? This executive summary provides an overview of the main conclusions and the resulting broad policy agenda; detailed analysis can be found in the chapters devoted to the three building blocks of the future growth model for Montenegro: sustainability, connectivity, and flexibility.

2. Montenegro has made major progress in recent years in increasing per capita income and reducing poverty, advancing structural reforms, and preparing for EU membership, which is the government’s main objective. Since 2003 Montenegro has trebled its gross national income per capita (World Bank Atlas method), from $2,400 to $7,160 in 2012. It now has the highest per capita income among the six South East European countries. The national poverty headcount fell from 11.3 percent in 2005 to 6.6 percent in 2010, the last year for which official data are available, and it still has less inequality of income (Gini coefficient 24.3) than the average for Europe and the Central Asian countries (31.9). Structural reforms in the public sector, the financial sector, and the investment climate have helped it advance on many comparative metrics, such as World Bank governance indicators, financial sector soundness measures, and Doing Business indicators. In 2011 Montenegro became the member of the World Trade Organization (WTO) and in June 2012 it entered into formal negotiations on accession to EU membership.

3. Yet despite considerable progress, the global crisis has exposed Montenegro’s vulnerabilities and called into question the sustainability of its growth pattern. The period 2006-08 in the immediate aftermath of independence was characterized by unsustainably large inflows of foreign direct investments (FDI) and inexpensive capital, which fueled a domestic credit consumption boom and a real estate bubble. With the economy overheated and growing at 7 percent, the bubble burst late in 2008. In 2009 real GDP shrank by almost 6 percent, triggering a painful deleveraging and a difficult recovery that is not yet complete. As a result, growth in 2010–11 averaged only 2.9 percent and for 2012 is only half a percent, and unemployment is very high at almost 20 percent. Moreover, the base for Montenegro’s growth is narrow. It has relied on factor accumulation rather than productivity, and exports are concentrated in a handful of metal products with little value added. As a result, with the “new normal” international environment of more limited capital inflows and slow credit recovery, with unemployment high and consumer debt suppressing consumption, and with external demand sluggish, it has become clear that the old pattern cannot deliver the growth performance seen a few years ago.

4. What kind of growth model could drive Montenegro’s next stage of development in what is bound to be a much more competitive international environment? This report addresses this question using an eclectic approach to analyzing Montenegro’s growth constraints that combines several analytical

---

1 The South East European countries (SEE6) are Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia.
approaches, such as growth accounting, sectoral analyses, and institutional and microeconomic analyses using firm and household surveys. This growth analytics approach recognizes that no single method of analyzing growth constraints is likely to provide comprehensive answers to the main growth questions. The report provides insights into growth-oriented fiscal and financial sector policies, exports, investment climate, and infrastructure policies that have the potential to improve growth prospects and prepare Montenegro for the next stage of prosperity. The overarching approach is to analyze macrofinancial as well as structural constraints and bottlenecks to growth and use the analysis as a basis for formulating actionable policy recommendations that will help Montenegro better prepare for the next stage of prosperity. Specifically, the report emphasizes the critical role of fiscal and financial sector sustainability in ensuring the macroeconomic stability and sustainability that are fundamental to long-term growth. At the same time, it recognizes the importance of Montenegro’s connectivity—via trade, infrastructure (physical and informational), and human capital—with world markets, and of regulatory and institutional flexibility for improving Montenegro’s long-term growth.

Sustainability

5. To accelerate growth in coming decades, Montenegro needs to shift to more productivity-based policies that foster knowledge and skills and fiscal and financial sector sustainability. Improving skills is a long term challenge to prepare Montenegro’s labor force for the challenges of a much more competitive international economy. But given its current indebtedness, an urgent priority for Montenegro is to address its vulnerabilities through fiscal consolidation and reduction in public and external debt, backed by credible rules to ensure fiscal discipline. Reinforcing the financial sector will be critical to support credit recovery and private sector investment. The analysis suggests three building blocks for a macroeconomic agenda for more sustainable growth and income convergence:

6. First, to ensure sustainable growth, Montenegro must unlock the potential of productivity. If it can achieve productivity growth of just 0.6 percent while sustaining past factor contributions to growth, it could achieve economic growth rates of 4 percent or more. Maintaining such growth over two decades would be truly transformational for Montenegrin incomes and living standards. With the right mix of the macroeconomic, institutional and structural policies that this report advocates, that rate of growth should be achievable. What could be the building blocks of a new growth model that fundamentally relies on productivity gains? Not surprisingly, as in other small countries where growth has been rapid (e.g., Finland, Ireland), knowledge, skills, and education are central. The World Bank’s recent Public Expenditure and Institutional Review (PEIR) report laid out a comprehensive agenda for improving the quality and efficiency of education. It emphasized strengthening early childhood development, modernizing higher education, and tailoring practical skills and vocational training and lifelong learning to private sector demand. But discussed in this report are other important elements of the knowledge agenda that also relate to the private sector and new information communications technology (ICT) and related skills for a digital and Internet economy important for high-wage job creation. The bottom line is that to achieve the necessary productivity improvements, Montenegro will need a more aggressive, comprehensive strategy to adjust and scale up the skills needed by the private sector that will lead Montenegro’s future growth.

7. Second, to ensure fiscal sustainability, Montenegro must move toward fiscal surpluses, build fiscal reserves, eliminate municipal arrears, and adopt and enforce credible fiscal rules. This is important to create room for the private sector to grow, reassure external financiers and rating agencies that Montenegro can manage its finances responsibly, and ensure that there are fiscal buffers available in difficult times to address emergencies. Montenegro’s public debt, including state guarantees, exceeds 57 percent of GDP, which is too high. It reflects past borrowing and the impact of the global crisis, and for
the past three years the government has commendably been pursuing significant consolidation. The fiscal consolidation plans, if implemented vigorously over the next four years, will ensure sustainability and the necessary buffers. In the baseline scenario of gradual growth recovery, they will mean that fiscal balance can be achieved by 2015–16 and surpluses thereafter, establishing reserves to be used in case of natural disasters and specifically identified emergencies. That will ensure gradual clearance of municipal arrears and stronger commitment controls and local public financial management systems. It will also be important to adopt and enforce a rule that will ensure permanent fiscal discipline.

8. Third, to keep the financial sector sustainable, Montenegro should continue firming up bank capitalization and liquidity positions, accelerate the resolution of nonperforming loans (NPLs), improve supervision, and broaden coverage of financial services. Reflecting past reforms, Montenegro’s banking system is now more robust than it was during the crisis and, despite painful deleveraging, credit is again beginning to flow again. Yet the share of NPLs is high at about 17 percent, which demands continued reforms. In particular, improvements in macroprudential supervision are warranted. Given the vulnerabilities of Montenegro’s banking sector and country characteristics (lending concentration, euroization, and high financial integration), in the medium term a higher minimum regulatory capital adequacy ratio (CAR) should be considered. Regulation and supervision should be directed to improving internal bank controls and credit risk management and reducing fixed costs. Finally, to broaden financial inclusion and access to financial services by poorer Montenegrins, including payment services, and to help reduce the shadow economy, banks should be encouraged to extend basic services to unserved areas and segments of the population.

9. To engender robust long-term growth, however, improving skills and ensuring fiscal and financial sector sustainability, as important as it is, is not enough. Further structural reforms are required to make Montenegro’s economy much more open, competitive, and better connected to the world markets and the opportunities it affords.

Connectivity

10. At 11 percent of GDP in 2011, Montenegro has one of the lowest ratios of goods exports to GDP in the world—it is not well-connected. And if metals exports are excluded, the ratio drops below 6 percent. With regard to goods exports, the Montenegro economy is quite autarkic. Movement across borders is slow and inefficient, and despite the large tourism sector, when services are also considered the exports-to-GDP ratio still averaged only about 39 percent for 2007–11. More prosperous small countries have much higher ratios than this. Slovenia, for example, has a ratio of 68 percent, Estonia 78 percent, and Malta 85 percent.

11. Connectivity depends on more than trade, which incorporates transport, trade, energy, and even computer and Internet access; skills also matter. Although Montenegro has one of the highest numbers of cell phones per capita, use of computers in schools is not yet extensive (and not especially productive); there are problems with Internet connectivity; and the country lags in the quality of information communication technology. Also, as documented in the recent World Bank PEIR, few of the graduates of local universities and local professionals are fully proficient in foreign languages. In what follows, we set out the principal conclusions of detailed analysis of connectivity in this report that were used to formulate the following messages:

12. There is a desperate need for export expansion and diversification to open up the economy. Montenegro’s principal export sectors are metals, tourism, and wine; its export basket is thus very narrow and highly concentrated. With metals on the decline, tourism and wine have become the country’s main
export success stories. Both are competitive exports with a good future, but the question is whether they should continue to be the mainstays of Montenegro’s export industry or whether there are also viable export opportunities in other products and sectors.

13. **Montenegro has significant opportunities to scale up and expand exports into new areas.** The technique of product space analysis, which investigates opportunities for export expansion and diversification, uses technological and resource-related connections between products to identify opportunities arising from the current trade pattern. Given difficulties in the traditional export industries and the government’s intention to reorient the export pattern, this type of analysis is timely and informative for Montenegro. The analysis confirms the excessive concentration of exports in metals, where opportunities for income growth and export expansion are limited. It also demonstrates that though Montenegro does have opportunities in other merchandise exports (e.g., many food products), many of which could be linked to the existing tourism-agriculture-energy value chain, many of these opportunities also have relatively limited income potential.

14. **But there is ground for optimism about Montenegrin connectivity.** In international trade a distinction is drawn between comparative, competitive, and locational advantage. Comparative advantage is revealed in the content and pattern of trade when a country moves from autarky to participation in world markets. Competitive advantage is a culturally based concept rooted in the education, work ethic, and other attributes of a population in a given area; this can a source of advantage for Montenegro. The country also has a locational advantage in its proximity to European markets. There is therefore every reason to believe that Montenegro can resolve its connectivity issues.

15. **Skills and human capital will be central not just to boosting productivity of the labor force but also to improving the country’s connectivity to world markets and sources of knowledge.** Presently, investment in human capital in Montenegro is misdirected because of outdated conceptions of labor demand and economic structure. If there is to be export expansion and diversification, the preferences of Montenegrin students and the courses available need to be changed to emphasize the skills and knowledge that the private sector requires. Presently the higher education system is based on a presumption of government employment. Vocational education needs to be changed to better accommodate the labor market skills in demand. Until educational preferences change, students will not be educated in ways that will help Montenegro realize a high-income comparative advantage. Montenegro certainly cannot afford to be a low-wage economy, especially given the incentives for emigration of skilled labor. Human-capital complementarities increase incomes, connectivity, and economic growth.

16. **Montenegro could also improve connectivity in relation to horizontally and vertically integrated multinational firms by making major improvements in the investment climate and—perhaps most important—clearly separating politics and economics.** Montenegro has lately improved its investment climate to the point that its ranking in Doing Business at 51 places it in the top 25 percent of world economies in ease of doing business. But a large share of the FDI it previously attracted have gone into purchase of real estate rather than greenfield or productive investments. Multinational firms have been reluctant to consider Montenegro as a production location or a research and development center. From a political-economy perspective, multinational firms are a challenge to domestic political discretion. Montenegro is competing with many other prospective locations, and multinational firms will choose locations where the investment is most conducive to non-politicized economic activity.

17. **Infrastructure—transport, energy, and ICT—is central to physical connectivity, expanded trade, and enhancing the country’s attractiveness as a tourism, ICT, and investment destination.** The analysis of internal (within-country) connectivity spotlights information and transportation infrastructure as being at the heart of domestic regional integration. It highlights the importance of the quality and safety of road infrastructure and opportunities for regional connectivity from enhancing the railways.
18. **Energy connectivity needs to be improved both internally and within the region.** Energy is recognized as a major infrastructure constraint on investment and the growth of small and medium businesses and thus a challenge for government policy. Improving the electricity tariff structure is needed for more efficient allocation and mobilization of resources for future investments and growth. But with strengthened tariff policy and institutions, new investments and expanded supply, energy could over the long term also become an important export industry. To take full advantage of this opportunity, Montenegro’s links with regional energy markets will need to be tightened and the important project of the undersea cable with Italy completed.

19. **Information and communication technologies (ICT) offer huge opportunities for a small country like Montenegro, and ICT could provide an important feedback loop to its knowledge and skills agenda.** ICT can help strengthen the country’s competitiveness, investment climate, and innovative capacity, and position Montenegro as a vibrant innovation hub linking the Balkans (and Montenegro’s industries) to the rest of Europe and to global value chains for tourism, manufacturing, and other sectors. The analysis suggests that smart investments in ICT infrastructure and related skills, especially in broadband, open data, and e-commerce, can have huge payoffs in terms of growth and high-wage jobs.

20. **Connectivity through integration into the European Union (EU) holds promise—but not a guarantee—of gradual income convergence with core European countries.** The EU offers Montenegro opportunities to connect with the larger markets beyond its borders. How Montenegro responds—in advancing its remaining structural and institutional reform agenda towards maximum sustainability, flexibility and connectivity, not just in completing the various accession chapters—will decide whether the opportunities eventually become sources of gain.

21. **Montenegro must also better integrate itself into the Western Balkans.** Although Montenegro was traditionally part of the wider regional market, trade restrictions, especially nontariff barriers, have segmented markets in the Western Balkans. Although there has been progress in reducing tariff barriers and integrating into the WTO, regional governments, including Montenegro, still retain nontariff barriers that stifle opportunities for more dynamic regional trade. Moreover, restrictions on international trade often protect domestic monopolies.

22. **Finally, government and the political economy influence connectivity.** In a market economy with private property rights, government can influence incentives but cannot directly implement or “command” connectivity. In a market economy connectivity requires a different political culture: There should be a clear separation—an enforced firewall—between holding a government office and seeking personal gain through business decisions. This goes beyond the issue of corruption, which itself should be rooted out as a matter of priority in governance reforms. Ambitious reforms should lead to a public sector populated by public servants who focus squarely and solely on the public interest and the most efficient delivery of services to citizens. Credible evidence of a clear separation between politics and business will encourage the foreign investment and multinational activity that are necessary to bring about the openness that Montenegro needs for prosperity. And this leads to the issue of flexibility i.e., the overall quality of the country’s investment and business environment and product and labor market regulation that to a large extent determine firm-level perceptions and crucial firm decisions about whether and how much to invest, expand, employ workers, and export in a given economy.

**Flexibility**

23. **Since changes in economic conditions are inevitable, the ability to respond flexibly to changes matters greatly to economic outcomes.** And because both government and the private sector
benefit from flexibility in setting and achieving economic objectives, the cost of adapting to changing conditions should be kept as low as possible. It is therefore crucial to dismantle to the extent possible policy and institutional barriers to change to help keep the costs of doing business low. To encourage new activities, incumbent producers should not be given domestic monopolistic advantages, and access to domestic and regional markets should be unimpeded. There should also be no barriers to exit when producers can no longer be profitable. Taxpayers should not be asked to pay for private business risks. Subject to a quick review of environmental impacts, construction permits should be relatively easy to acquire, as should bank credit, subject to reasonable collateral requirements. It should also be easy to obtain electricity and other utility connections. Registration of change of property ownership should be simple.

24. **In many ways Montenegro is relatively flexible in adapting to new opportunities and to change, but there is still considerable scope for improvement.** In the Western Balkans, Montenegro (Doing Business rank is 51 among 185 economies) consistently scores as having the second best investment climate after FYR Macedonia (ranked at 23) and its investment climate has been improving on many metrics. Among Montenegro’s areas of strength are regulations on starting a business, product market regulation, freedom of retail distribution, and absence of regulatory limitations on the number of competitors in a product market. However, in the construction sector particularly, access to electricity, registering property, enforcement of contracts, acquiring permits, and the costs of access to “communal services” heavily restrict flexibility, as is confirmed by the results of the World Bank’s Doing Business Indicators and the new Investment Climate Survey Assessment. An important benefit of increased flexibility in doing business is the incentive it offers to move economic activity from the informal to the formal sector. But though a considerable amount of red tape has been cut in terms of paying taxes and the tax rates have been lowered, the informal sector remains large. Workforce skills are also important: flexibility is enhanced if employees do not define themselves as narrowly specialized. Policies should ensure that worker benefits are readily transferable between employers.

25. **Montenegro must continue reinforcing what is functioning well in attracting investment while moving expeditiously to repair areas of weakness.** The CEM analysis of flexibility based on the latest Doing Business Indicators, a new Montenegro Investment Climate Survey (MICS) conducted in collaboration with the Montenegro Chamber of Economy in the Spring 2012, and the first product market analysis (PMR) for Montenegro suggest that many problematic areas in the investment climate are related to the depressed housing and construction industry, the informal sector, remaining trade barriers, and the impact of local fees and taxes on investment. High on the policy agenda for addressing these would be to significantly reduce the cost of entry and operation in construction and housing. For example, it could be critical to comprehensively review and reduce regulation-related costs and the time required to complete construction: getting and making changes in construction permits, the excessive cost of communal services, and delays in getting utility connections on completed projects; cut red tape in the land cadaster and speed up procedures for registration and transfer of property; and give teeth to enforcement of contracts by revisiting creditor rights and facilitating out-of-court and accelerated settlements of contract disputes. Policy should also promote intensified efforts to formalize informal activity by reinforcing the systems of penalties, rewards, and inspections of informal establishments, particularly in the tourism sector in the South and in retail trade and tourism in the North where informality dominates. Also, it will be important to continue to monitor and reinforce compliance by producers of excised goods, especially those more recently taxed (e.g., carbonated drinks). And longer term, tax reform could aim to shift the burden of taxes from labor (social security contributions) to consumption (value-added tax) to help stimulate employment, investments, and exports. Finally, it is crucial to reduce the red tape and the documentation required for exports and imports, and to identify and eliminate local barriers to investments (e.g., municipal “road access fees”).
26. As for product market regulation, Montenegro scores well compared with many middle-income countries but not so well compared with OECD averages, which suggests scope for improvement. The detailed PMR analysis conducted under the CEM identifies areas of comparative weakness and suggests that new product market regulation should focus on reducing state control in the areas where Montenegro lags behind OECD countries. These relate to the size of the government’s portfolio in the economy and coordination of its stake in enterprises, further reducing barriers to entrepreneurship, making the one-stop shops for businesses more effective, and here again reducing the cost of construction permits—consistently identified as a major constraint in a variety of business and investment climate diagnostics. Examples of concrete measures to improve product market regulations, detailed in the report, include extending one-stop shops to cover issuance of permits and licenses by local authorities.

27. Finally, the government should continue refining labor market regulations so that they do not become disincentives to opening up jobs, by allowing a variety of employment contracts and durations to make labor markets more flexible. It should also keep reviewing related tax, pension, and social safety net regulations to identify possible disincentives for employment. Policy should, for instance, aim to eliminate the maximum duration of fixed-term contracts, gradually increase the early retirement age to the OECD average, and, in the medium term reduce social security contributions as a tax on employment and shift the tax burden to consumption taxes. Given the very high unemployment, it would also be important to build up job search assistance, improve vocational training, review the coverage and duration of unemployment benefits during periods of recession, and enforce job-search availability and activation requirements.

28. The broad conclusion of the report is optimistic: if Montenegro vigorously pursues the remaining policy agenda (Table E.1) to strengthen sustainability, connectivity, and flexibility, it can reap the substantial benefits of higher and more robust growth, greater employment, and better living standards for its citizens. This will require that for sustainability it maintain the current policy of fiscal consolidation that will lead to surpluses and reserves in the medium term and will over the long term reduce public debt toward the desirable level of about 35 percent of GDP. Closer connectivity necessitates a major emphasis on exports and attracting export-oriented FDI; investing in practical skills and human-capital-based productivity and connectivity; dismantling barriers to export and entrepreneurship; improving transport, energy, and ICT) infrastructure; and better coordinating policy. Flexibility will depend particularly on restructuring the areas of the investment climate that relate to housing and construction (e.g., construction permits, cost and connections of communal services) while continuing to refine areas of strength (e.g., the environment for starting a business and paying taxes) and further reforming product and labor market regulation.

29. Finally, in pursuing this development agenda, Montenegro should learn from the success of others. One model for a transition path to development success is the state of Israel, which is now a member of the OECD and has a per capita income that is higher than the EU average. Like Montenegro it is a Mediterranean county with substantial tourism and wine production and has made the transition from a self-management economy similar to the past Montenegrin system to an economy based on diversifying exports by building human capital and attracting multinational firms. Finland offers lessons about the importance of investing in top-quality education, linking with world centers of excellence, and building up the private sector economy and information technology. Switzerland is a model of a world-class tourist destination that is extremely well connected with the world, including via a rail system that is friendly to the environment. Ireland is an example of a country whose environment for business entrepreneurship and innovation attracted considerable external investment, much of it from the diaspora. Lessons from Croatia’s EU accession should also be valuable for Montenegro’s accession efforts. Montenegro has much to learn from these experiences—all of which make it clear that fiscal prudence and fiscal sustainability, connectivity, and flexibility are critical to successful integration into the world economy.
<table>
<thead>
<tr>
<th>Policy Areas and Issues</th>
<th>Summary Policy Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SUSTAINABILITY</strong></td>
<td></td>
</tr>
<tr>
<td>• Ensure sustainable growth</td>
<td>Promote the strategic shift toward a new growth model based on exports, productivity, skills and human capital, and much greater connectivity and regulatory/institutional flexibility</td>
</tr>
<tr>
<td>• Ensure that the fiscal position and debt are sustainable</td>
<td>Sustain the government’s fiscal consolidation plans for fiscal surpluses and fiscal reserves in the medium term; urgently clear up public sector/municipal arrears; adopt and enforce fiscal rules; enforce limits on state guarantees only for priority investment projects</td>
</tr>
<tr>
<td>• Ensure financial sector sustainability and improve financial discipline</td>
<td>Continue strengthening supervisory integration and supervision and internal controls; accelerate the judicial, institutional, transparency and cadaster reforms to improve financial discipline in the private sector and reduce incentives for non-payment</td>
</tr>
<tr>
<td><strong>CONNECTIVITY</strong></td>
<td></td>
</tr>
<tr>
<td>• Promote exports</td>
<td>Make exports a top priority and promote them more aggressively using Montenegro’s missions abroad, dismantle remaining trade barriers, ensure wide export certification in the private sector, and attract export oriented-FDIs and multinational companies</td>
</tr>
<tr>
<td>• Improve transport connectivity</td>
<td>Focus on road <em>quality</em> rather than quantity, North-South connectivity, secondary roads, road safety, removing bottlenecks (North-South), and establishing better rail links</td>
</tr>
<tr>
<td>• Improve energy connectivity</td>
<td>Improve cost recovery and the tariff structure to reduce cross-subsidies from commercial to residential users and replace it by direct budgetary subsidies; finish vertical unbundling of the electricity company; expand energy efficiency measures and connectivity to regional markets</td>
</tr>
<tr>
<td>• Improving communications infrastructure and connectivity</td>
<td>Strengthen broadband infrastructure, and implement measures to jump-start ICT-driven skills build up and job creation; take advantage of cloud computing, open data, etc.</td>
</tr>
<tr>
<td>• Improve policy coordination, human-capital-based connectivity, and decision making</td>
<td>Enforce a firewall between political positions and business; improve incentives for students to pursue studies demanded by the private sector, exporters, and multinational companies</td>
</tr>
<tr>
<td>FLEXIBILITY</td>
<td></td>
</tr>
<tr>
<td>---------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------</td>
</tr>
<tr>
<td>• Improve the business environment and investment climate</td>
<td>• Focus on the weakest areas of doing business and investment</td>
</tr>
<tr>
<td></td>
<td>climate: Reduce the cost of entry and operation in the housing/</td>
</tr>
<tr>
<td></td>
<td>construction industry, speed utility connections, cut red</td>
</tr>
<tr>
<td></td>
<td>tape in registering property, review and reduce unnecessary</td>
</tr>
<tr>
<td></td>
<td>local fees, simplify export documentation</td>
</tr>
<tr>
<td></td>
<td>• Reduce the state footprint in product market regulation and</td>
</tr>
<tr>
<td></td>
<td>extend one-stop shops to cover local permits and licenses</td>
</tr>
<tr>
<td></td>
<td>• Eliminate the maximum duration of fixed-term contracts, raise</td>
</tr>
<tr>
<td></td>
<td>the early retirement age toward the OECD average, and over the</td>
</tr>
<tr>
<td></td>
<td>medium term, shift the tax burden from labor to consumption</td>
</tr>
<tr>
<td></td>
<td>taxes</td>
</tr>
<tr>
<td>• Improve product market regulation</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>• Improve labor market regulation</td>
<td></td>
</tr>
</tbody>
</table>
INTRODUCTION

1. Montenegro is—like Estonia, Malta, and Cyprus—a small, European state with a long coastline, tourism assets, and dependence on trade and financial integration. Of 185 members of the World Bank, 48 are small states, defined conventionally as countries with population of fewer than 2 million (Favaro 2008). Thus, the development challenges Montenegro faces—sustainability, connectivity, and management of volatility and external shocks—are not unique, but it also has the opportunities associated with small size, potential flexibility, and the lower cost of policy coordination (World Bank 2000). However, globalization is adding to the pressures on all countries, especially small states, to reduce costs, increase competitiveness, enhance the investment climate, and attract foreign direct investment (FDI). And governments of small states must deal with higher fixed costs of administration than larger countries that have economies of scale in public services. The policy effort and effectiveness needed to overcome these challenges in small states is substantial, especially in the current global environment. This report takes a fresh look at the challenges and opportunities as Montenegro prepares for a future anchored in its aspirations to EU membership and a prosperous society.

2. Montenegro has significantly increased its per capita income and reduced poverty in recent years, but unemployment, especially among youth, is still high. Montenegro has trebled its GNI income per capita (World Bank Atlas method), from $2,400 in 2003 to $7,140 in 2012, now the highest among the six South East European countries in its region (Figure I.1). FDIs averaged about 16 percent of GDP in the same period. The national poverty headcount fell from 11.3 percent in 2005 to 6.6 percent in 2010, the last year for which data are available (Box I.1). Montenegro still has lower inequality of income (Gini coefficient 24.3) than the average for Europe and Central Asian countries (31.9). Yet, despite a favorable record on income, poverty, and inequality, Montenegro still has significant social challenges. With the closing of large enterprises, and the global crisis, unemployment has been stuck at about 20 percent (ILO measure) and is especially high among the youth and in the northern part of the country.

3. Montenegro’s economic performance and conduct of macroeconomic and structural policies over the past 10 years had three distinct phases; despite the country’s achievements, the experience highlights the perils of boom-and-busts cycles. The first, from the adoption of the euro as the domestic currency in 2002 to independence in 2006, was characterized by a gradually improving macroeconomic environment, solid macroeconomic management, and structural reforms geared to privatization, attraction of significant FDIs, and financial integration, with foreign banks increasingly dominating the banking system. The second phase consisted of a short-lived, unsustainable boom in 2007 and 2008, which ended...
abruptly when Lehman Brothers collapsed in September 2008. During this phase, conduct of macroeconomic policy was mixed: more prudent policy could have been implemented sooner and more aggressively to contain the domestic credit boom and limit risk exposure. The third phase, the current period of adjustment, began in 2009 when the government responded to the crisis by adopted sounder macroeconomic policy and took fiscal and financial sector measures to stabilize the economy, restructure and firm up supervision of the banking system, improve the investment climate, and limit the social impact of the crisis.

**Box I.1: Recent Evolution of Poverty in Montenegro**

In Montenegro developments in real economic activity and labor markets have pronounced links to education and regional and rural-urban differences in poverty rates (Figure Box I.1). According to the official poverty line, poverty in Montenegro was already quite low in 2005, with only 11.3 percent of the population living below the line. The poverty headcount then fell by more than half during the boom years of 2007–08, but after the onset of the financial crisis and recession in late 2008, the official poverty rate increased, registering 6.8 percent in 2009 and 6.6 percent in 2010. However, a higher poverty line (125 percent of the national line), which indicates the vulnerability of a larger share of the population, shows more variability, with the latest figure at 17.4 percent. Labor force participation and employment rates are inversely related to poverty, showing the close link between poverty and labor markets. Household survey data show poverty in Montenegro to be closely and inversely related to education. Northern Montenegro and rural areas consistently exhibit much higher poverty rates than the national average. In general, poverty rates for men and women are nearly equalized nationally, but women fare much worse in rural areas while male rates are higher in the urban areas. This reflects in part recent retrenchment in construction and other sectors dominated by men.

In the future, whether rapid poverty reduction (perhaps against a higher poverty threshold) can be renewed will depend crucially on economic growth and job creation. A major policy challenge will be preserving social protection for retirees, the disabled, and the poor who are unable to obtain work during the continuation of the period of slow growth and fiscal consolidation.

4. Throughout the decade structural reforms—fiscal, enterprise, financial, investment climate, and social—advanced Montenegro steadily along the path to economic and trade integration. For
example, on the fiscal front, a modern Treasury and tax system anchored in a value-added tax and a low income tax rate were adopted with technical assistance from the international financial institutions (IFI) and bilateral donors. Governance and accountability indicators showed improvement, and the 2011 Transparency and Corruption Perception index ranked Montenegro 66th out of 183 countries, the highest ranking among the six Western Balkans countries. A sizable number of large and almost all small state enterprises were privatized, even in such major sectors as telecoms, petrol distribution, tourism, metals, and construction. Nonviable enterprises (e.g., in tobacco, heavy equipment, textiles, and furniture) were closed and excess employment in others (e.g., steel and aluminum companies) was scaled down in conjunction with a state severance program. Not surprisingly, however, social tensions arose in response to the large layoffs, structural unemployment, and public disputes about the transparency and equity of certain privatizations and shutdowns.

5. With the onset of the crisis, banking sector reforms advanced, resulting in a better capitalized, better supervised, and less vulnerable banking system than during the boom period, and other reforms enhanced both Montenegro’s competitiveness and its social safety net. The investment climate improved to the point where Montenegro now ranks 51th out of 183 countries on the Doing Business indicators, and its competitiveness indicators within the Balkans are relatively favorable, especially in tourism (World Bank 2012c). Owing partly to past technical assistance from the World Bank and others, Montenegro has one of the best targeted and fiscally affordable social assistance systems in Europe and Central Asia. It has advanced pension reform by moving toward retirement at 67, and streamlined the labor law. In recognition of such structural reforms, on October 12, 2011, the European Commission recommended the opening of formal membership negotiations for Montenegro. The country has also concluded a number of free-trade agreements with key partners and is a member of the main regional trade agreement, the Central European Free Trade Agreement (CEFTA). In December 2011, the World Trade Organization (WTO) also granted Montenegro membership, which is now being ratified. In June 2012, the country opened the first chapters in membership negotiations with the EU.

6. But now that the old growth model based on easy money and a credit boom has run its course, the question becomes: what next? With still considerable major structural and social challenges, and a substantially worse international environment, Montenegro must now search for a new growth model. This report considers what a sustainable model could consist of. For example, the recent Public Expenditure and Institutional Review (World Bank 2012b) documents public sector reforms to date but also outlines an ambitious agenda for a smaller, more efficient state. Indeed, since the 2009 crisis, the government cut public expenditures by almost 10 percentage points in an effort to adjust to the new external environment realities and lower government revenues (Table I.1). The further fiscal consolidation planned in coming years should lead to fiscal surpluses and a reduction in public debt. But beyond the necessary fiscal adjustment, what are the other elements of the policy reform agenda? Reflecting the regional tumult of the 1990s and years of underinvestment, infrastructure desperately needs rehabilitation and new investments in energy, transport, water and sanitation, and telecoms. Perceptions of corruption and inequities, especially related to some privatizations, have polarized politics, and the negotiations for prior actions for EU membership are making continued rule-of-law reform a priority. Construction permits, licenses, local fees and charges, contract enforcement, and other areas of the investment climate require significantly more work, and the daunting unemployment challenge eludes easy solutions.
Table I.1: Montenegro: Selected Macroeconomic Indicators, 2006-12

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011 (prel.)</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth (%)</td>
<td>8.6</td>
<td>10.7</td>
<td>6.9</td>
<td>-5.7</td>
<td>2.5</td>
<td>3.2</td>
<td>0.2</td>
</tr>
<tr>
<td>Consumer prices (period average, %)</td>
<td>3</td>
<td>4.3</td>
<td>8.6</td>
<td>3.4</td>
<td>0.5</td>
<td>3.1</td>
<td>3.6</td>
</tr>
<tr>
<td>Gross national savings (% of GDP)</td>
<td>1.6</td>
<td>-5.1</td>
<td>-10</td>
<td>-3.1</td>
<td>-2.6</td>
<td>-2</td>
<td>-0.2</td>
</tr>
<tr>
<td>Gross investment (% of GDP)</td>
<td>25.4</td>
<td>33.8</td>
<td>40.7</td>
<td>27.1</td>
<td>22.8</td>
<td>19.5</td>
<td>17.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fiscal sector</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues and grants (% of GDP)</td>
<td>44.6</td>
<td>48.5</td>
<td>49.9</td>
<td>43.9</td>
<td>42.4</td>
<td>39.8</td>
<td>38.1</td>
</tr>
<tr>
<td>Expenditures (% of GDP)</td>
<td>42</td>
<td>42.9</td>
<td>51.1</td>
<td>49.2</td>
<td>47.1</td>
<td>44.1</td>
<td>41.6</td>
</tr>
<tr>
<td>Primary balance (% of GDP)</td>
<td>4.1</td>
<td>7.4</td>
<td>-0.5</td>
<td>-4.4</td>
<td>-3.6</td>
<td>-2.8</td>
<td>-1.8</td>
</tr>
<tr>
<td>Overall balance (% of GDP)</td>
<td>2.6</td>
<td>5.6</td>
<td>-1.3</td>
<td>-5.3</td>
<td>-4.7</td>
<td>-4.3</td>
<td>-3.6</td>
</tr>
<tr>
<td>Public debt (% of GDP)</td>
<td>37.6</td>
<td>31.5</td>
<td>32.4</td>
<td>41.8</td>
<td>55.6</td>
<td>57.8</td>
<td>61.6</td>
</tr>
<tr>
<td>o/w Public guarantees (% of GDP)</td>
<td>0</td>
<td>0</td>
<td>3.4</td>
<td>3.6</td>
<td>10.1</td>
<td>10.8</td>
<td>9.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>External sector</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>External debt (% of GDP)</td>
<td>52.8</td>
<td>70.8</td>
<td>81.8</td>
<td>82.4</td>
<td>101.7</td>
<td>103.9</td>
<td>102.3</td>
</tr>
<tr>
<td>o/w Private debt (% of total)</td>
<td>44.5</td>
<td>69.8</td>
<td>75.8</td>
<td>69.1</td>
<td>68</td>
<td>64.5</td>
<td>60.4</td>
</tr>
<tr>
<td>Current account balance (% of GDP)</td>
<td>-31.1</td>
<td>-39.3</td>
<td>-49.6</td>
<td>-27.9</td>
<td>-22.9</td>
<td>-17.7</td>
<td>-17.8</td>
</tr>
<tr>
<td>Net foreign direct investment (% of GDP)</td>
<td>21.9</td>
<td>21.2</td>
<td>18.9</td>
<td>35.8</td>
<td>17.8</td>
<td>12</td>
<td>12.6</td>
</tr>
</tbody>
</table>

Sources: MONSTAT, MOF, CBGG, and World Bank staff calculations.

7. This report argues that raising growth potential will require lasting macroeconomic stability—more sustainable fiscal and debt positions; export-oriented growth driven by productivity gains; greater connectivity, and more flexible regulation. This means that Montenegro will need to:

- Ensure that it has fiscal surpluses and reserves for emergencies over the medium term; reduce public debt over the longer term toward 35 percent; clear the stock and prevent future municipal arrears; and further build up and better supervise the financial sector, and improve financial discipline.

- Implement a much more export-oriented growth strategy that builds on the areas of Montenegro’s comparative advantages (e.g., tourism, energy, food, other services) and builds up the competitive advantages (e.g., location, skills and human-based, infrastructure and ICT connectivity) necessary for much greater connectivity and productivity-based growth.

- Aggressively improve the environment for doing business and the investment climate, focusing on areas of relative weakness, many of which are related to the housing and construction industry (e.g., permits, cost and speed of utility connections, red tape in registering property), and further
improve labor market and related regulations that now act as disincentives for formal sector employment.

8. **With full membership in the EU expected in less than a decade, why should the government of Montenegro be concerned with growth potential and convergence?** Will not access to a large market and the process of institutional and economic policy convergence be sufficient to make the Montenegrin private sector more competitive? Should not access to EU funds and alleviating concerns about political stability generate opportunities for both foreign and domestic entrepreneurs? The experience of the EU10 countries, not only Croatia as a future member but also older member state from South Europe, shows that EU membership has both opportunities and challenges and that domestic policies and reforms are key for maximizing membership benefits.

9. **Even just slightly higher growth, if sustained over a longer period, significantly can improve living standards.** If Montenegro could improve on its recent growth performance even quite moderately, its citizens could within a few years benefit from substantially higher living standards. Extrapolation of recent average growth rates indicates that in 37 years per capita income would correspond to that of EU-27 countries in 2010. If Montenegro could raise these historical growth rates by just 1.0–1.5 percentage points in 25 years—something that should be achievable if the ambitious reform agenda proposed in this report is implemented—it could accomplish that in 25 years. Without such an improvement, lower income levels would imply less consumption, fewer job opportunities, and worse conditions for poverty reduction and middle-class prosperity.

10. **The structure of the report is organized around the main building themes of the analysis and the proposed policy agenda: sustainability, connectivity and flexibility.** Chapter 1 analyzes Montenegro’s sources of growth from various angles and emphasizes the critical role of productivity and education and skills as well as fiscal and financial sector sustainability, and associated, further policy reforms, in ensuring the macroeconomic stability that is fundamental to long-term growth. Chapter 2 provides a detailed analysis of Montenegro’s connectivity—via trade (especially exports), infrastructure (transport, energy, and information communication technologies) and human capital—with the world markets, and outlines further policy agenda in these areas. Finally, chapter 3 provides a comprehensive analysis of Montenegro’s regulatory and institutional flexibility based on the latest Doing Business indicators as well as a new Montenegro Investment Climate Survey and Product Market Regulation (PMR) analysis as well as an analysis of labor market regulation. The analysis leads to conclusions about desirable areas of focus for future policy to significantly improve the country’s business environment for investments and growth.
PART I: SUSTAINABILITY

11. Today Montenegro must rely increasingly on promoting productivity and competitiveness to drive future growth, but how is this to be done? What policies should have priority in the quest for a new growth model? And in which areas of the economy—particularly in exports—is Montenegro likely to find competitiveness and development niches? In this chapter, we first analyze the issue of growth sustainability, by identifying Montenegro’s sources of growth to understand whether and to what extent past growth drivers can be relied upon in the next decade. Next, we consider the role of fiscal and financial sector sustainability in ensuring robust growth. Finally, we discuss likely building blocks for a new growth model that will enable Montenegro to accelerate its income convergence with Europe and make sustained improvements in the living standards of its citizens.

A. Montenegro’s Sources of Growth

12. Before 2009, Montenegrin economic growth was robust, though slightly below regional performance. Real GDP growth averaged 5 percent annually for 2000–08, slightly below that of EU10 countries. Supported by credit, domestic demand made a buoyant contribution to growth. Demand-driven growth was associated with a rapid expansion of imports, but that aggravated external imbalances. To understand Montenegro’s sources of growth, we need the answers to the following questions: What were the sources of growth on the demand side? Are they sustainable? What is the sectoral structure of growth, and what do sectoral shifts tell us about future growth? Finally, what were the relative roles of factor accumulation and productivity growth? It is hoped that the answers to these questions will shed light on the building blocks of a future growth model for Montenegro.

Figure 1: Montenegro: Demand-Side Sources of Growth, 2000-10

13. Decomposing demand shows that growth has been essentially driven by domestic demand, something that cannot be taken for granted in future (Figure 1). Private consumption has been growing faster than GDP and its share in GDP went up from about 70 percent to more than 91 percent in
In the next two years the economic crisis brought it back down to about 82 percent, but its share in GDP averaged above 100 percent for the whole 2000–10 period and was almost 96 percent before the crisis. Because public spending also grew somewhat faster than GDP, by 2010 its share in GDP had increased to 23.4 percent. Investment in physical capital has grown even faster than all the other variables: with average growth of almost 16 percent pre-crisis, its share in GDP went from 17 percent in 2000 to 38 percent in 2008. But domestic demand was driven by an unsustainable boom in external inflows, which translated into a domestic credit boom, and a real estate bubble. The crisis resulted in a veritable crash that almost halved the share of investments in GDP. What is striking is the negative share of net foreign demand throughout the whole period and its negative contribution to growth, even though net exports grew much more than real GDP: for the whole period foreign demand grew by about 11 percent and pre-crisis it was more than 23 percent. Now—in the new normal without massive external inflows and with high unemployment and internal debt—domestic demand is likely to grow more slowly than in the past.

<p>| Table 1: Montenegro: Sectoral Decomposition of Gross Value Added Growth, 2000-10 |
|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|----------------|</p>
<table>
<thead>
<tr>
<th></th>
<th>Sectoral decomposition of growth</th>
<th>Share in value added (%)</th>
<th>2000-08</th>
<th>2000-10</th>
<th>2000</th>
<th>2008</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross value added</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Agriculture, hunting, forestry and fishing</td>
<td>8.9</td>
<td>9.6</td>
<td>12.5</td>
<td>9.3</td>
<td>9.2</td>
<td>2.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>0.7</td>
<td>-0.7</td>
<td>2.9</td>
<td>1.5</td>
<td>1.4</td>
<td>1.4</td>
<td>1.4</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>2.9</td>
<td>-5.1</td>
<td>10.1</td>
<td>6.7</td>
<td>5.4</td>
<td>5.4</td>
<td>5.4</td>
</tr>
<tr>
<td>Electricity, gas and water supply</td>
<td>1</td>
<td>8.8</td>
<td>6.1</td>
<td>5.2</td>
<td>6.6</td>
<td>5.6</td>
<td>5.6</td>
</tr>
<tr>
<td>Construction</td>
<td>13.8</td>
<td>6.8</td>
<td>4.3</td>
<td>7.7</td>
<td>6.1</td>
<td>6.1</td>
<td>6.1</td>
</tr>
<tr>
<td>Wholesale and retail trade; repair of motor vehicles, motorcycles, and personal and household goods</td>
<td>49.4</td>
<td>41.6</td>
<td>14.1</td>
<td>15.4</td>
<td>14.6</td>
<td>14.6</td>
<td>14.6</td>
</tr>
<tr>
<td>Hotels and restaurants</td>
<td>10.3</td>
<td>11.7</td>
<td>2.8</td>
<td>5.4</td>
<td>6.2</td>
<td>6.2</td>
<td>6.2</td>
</tr>
<tr>
<td>Transport, storage and communications</td>
<td>21.5</td>
<td>29.4</td>
<td>10.5</td>
<td>11.7</td>
<td>11.5</td>
<td>11.5</td>
<td>11.5</td>
</tr>
<tr>
<td>Financial intermediation</td>
<td>-0.8</td>
<td>-0.1</td>
<td>3.5</td>
<td>4.9</td>
<td>4.8</td>
<td>4.8</td>
<td>4.8</td>
</tr>
<tr>
<td>Real estate, renting and business activities</td>
<td>-5.9</td>
<td>-2.6</td>
<td>12.8</td>
<td>10.1</td>
<td>10.4</td>
<td>10.4</td>
<td>10.4</td>
</tr>
<tr>
<td>Public administration and defense; compulsory social security</td>
<td>2.9</td>
<td>3.5</td>
<td>8.9</td>
<td>10.8</td>
<td>9.8</td>
<td>9.8</td>
<td>9.8</td>
</tr>
<tr>
<td>Education</td>
<td>-0.1</td>
<td>0.04</td>
<td>4.4</td>
<td>4.7</td>
<td>5.4</td>
<td>5.4</td>
<td>5.4</td>
</tr>
<tr>
<td>Health and social work</td>
<td>-2.1</td>
<td>-2.8</td>
<td>4.2</td>
<td>4.4</td>
<td>4.8</td>
<td>4.8</td>
<td>4.8</td>
</tr>
<tr>
<td>Other community, social and personal activities</td>
<td>-1.1</td>
<td>1.9</td>
<td>2.8</td>
<td>2.1</td>
<td>3.6</td>
<td>3.6</td>
<td>3.6</td>
</tr>
</tbody>
</table>

Sources: MONSTAT and World Bank staff calculations.

Looking at the sectors of the economy, Montenegro has increasingly become a service-oriented economy—with tourism leading the shift—which may be a source of real opportunity. The sectoral structure of aggregate output (gross value added [GVA]) showed a significant decline in the shares of agriculture (over 3 percentage points) and manufacturing (almost 5 percentage points) and an equivalent increase in the share of services, which went from 68 percent in 2000 to 77 percent in 2010 (Table 1). Trade, finance, hotels and restaurants, and transport are dominant sectors in the GVA structure.
Most discouraging is that the share of manufacturing in total output has declined to about 6 percent. The data on trends and structural changes are not surprising considering that in the predominant growth model FDIs in real estate played the most important role. The shift toward services is part of a global trend; many services, such as tourism, energy, and services associated with the rise of the digital economy (e.g., call centers, e-commerce, IT, etc.) can be a significant source of new dynamism and job creation in Montenegro.

15. **Finally, was growth driven by factor accumulation or productivity gains?** The answer to this question might provide a clue about the pattern of future growth that might be needed to accelerate Montenegro’s income convergence. To answer it, we use the standard Cobb-Douglas production function (Madžarević-Šujster and Popović 2012) to explain economic growth by decomposing growth in total output into the contributions of capital, labor, and a residual measure of gains in the efficiency with which capital and labor are used. This residual is an estimate of changes in total factor productivity (TFP) that reflect, a wide range of factors affecting input efficiency in addition to methodological assumptions and measurement errors. The residual is defined as the growth in output that occurs when levels of factor inputs are unchanged. The interpretation of the residuals in the analysis may be based on such elements as the accumulation of intangible assets (e.g., brands, knowledge and skills, consumer loyalty); advances in production techniques and in labor organization; changes in institutions and regulation, and qualitative changes in actual output factors, in particular human capital. Labor productivity is affected by, among other things, educational attainment and work experience. The productivity of capital is affected by, among other things, the age of equipment, the level of technology embodied in it, and whether the capital good is publicly or privately owned. Fundamentally, however, productivity is affected by institutions and policies.

16. **The quality of institutions and policies has been found to be a central driver of productivity and overall economic growth.** Broadly defined, the investment climate consists of policies and institutions that influence the return and the risk associated with investment. It thus incorporates macroeconomic and regulatory policies, public administrative procedures, infrastructure conditions, and incentives embodied in institutional arrangements, such as security of property rights and the rule of law. Easterly, Ritzen, and Woolcock (2006) offered evidence that even with a good policy poor institutional quality can lead to failure in growth. Institutional differences affect laws and regulations and shape the incentives individuals and firms have for efficient use of resources, accumulation, trade, and innovation. Hausmann, Rodrik, and Velasco (2005) emphasize that high-quality institutions ensure convergence with the living standards of advanced countries and higher sustainable growth. Since macroeconomic conditions, growth, and micro institutions are so closely related, policies and reforms should aim to eliminate micro-level constraints within the investment climate (markets and institutions) as well as improve macroeconomic stability because:

- The decisions of firms are at the core of growth process;
- The investment climate refers to the environment for firms, such as input markets, economic institutions, microeconomic incentives, and policies that affect firm-level decision; and
- Changing the investment climate should affect firm-level decisions in a way that generates high and sustained growth rates.

17. **Recent studies suggest that there are “proximate” and “fundamental” causes of growth** (Acemoglu 2008). Proximate causes are related to the Solow Growth Model: (i) labor; (ii) human capital (skills); (iii) capital accumulation (K/L, or stock of capital—machinery, equipment, and infrastructure—per worker); and (iv) TFP (efficiency, innovation, and frontier technology for endogenous growth). While differences in the proximate causes explain differences in income levels, the question is causes countries to diverge in the accumulation of factors, the efficiency of their use, and the creation of new and better
products? Acemoglu defines fundamental causes of growth as relating to luck (or lack thereof), geography, culture, and institutions. We are agnostic about sources of luck in development, so the rest of the report delves into other proximate and fundamental factors in Montenegro’s growth to date and its future prospects.

18. **Which were the proximate causes of economic growth in Montenegro over the last decade?** Interestingly, the most important—productivity—is missing. A standard growth accounting exercise using the Cobb-Douglas production function shows that between 2000 and 2010 capital accumulation (Figure 2) explains almost 80 percent of growth. However, there is a caveat: data for both gross value and the net value of capital do not exist in Montenegro. We approximated the data 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. An increase in the labor force explains about a quarter of growth; however, the contribution of TFP was negative and insignificant—a finding that is particularly worrisome. It suggests that Montenegro has not taken much advantage of recent technological and digital advances to improve productivity. By contrast, in many countries in Central and Eastern Europe, growth in the last two decades has been essentially driven by productivity gains resulting from structural reforms.

![Figure 2: Montenegro: Factor-Input Sources of Growth, 2000-10](Image)

**Sources:** MONSTAT and World Bank staff calculations.

19. **What does this imply for Montenegro’s future growth policy?** Considering the demographic trends and Montenegro’s ageing population, the central challenge for both policy and institutions is that they must advance structural reform if they are to unlock the potential of the now dormant engine of growth—productivity. Without higher productivity, future growth will be entirely dependent on a single growth engine—capital—which will be more difficult to access and costlier than it was in the past.

20. **What is the feasible TFP growth rate that Montenegro could hope to achieve through macroeconomic, institutional, and structural reforms?** Because of the recent crisis, the economic results through 2010 cannot be used as a basis for approximating long-run growth. To isolate the cyclical effect, we analyzed the anatomy of growth for 2000–08. In that period the rate of GDP growth was almost 5 percent—very close to the 5.1 percent achieved in 1965–1985, which are considered to be the years of Montenegro’s renaissance (Popović 2010). The contribution of capital accumulation was again the most important factor, explaining almost 60 percent of growth. The contribution of labor explains less than one-third of economic growth, while TFP, although positive and higher than in 1965–1985, was insignificant. In countries like Montenegro, which are far from the production function frontier and
working to catch up, the contribution of TFP to growth is much higher, on the order of 1.5 percent or more. Ireland’s TFP, for example, was in recent decades about 2.4 percent. If Montenegro can maintain the past contribution of capital (2.9 percentage points)—not counting the highly episodic crisis period—with half the contribution of labor (0.5 percent) in the past decade but productivity growth of just 0.6 percent, it could achieve overall economic growth rates of about 4 percent. Achieving and maintaining such growth rates over two decades would be truly transformational for Montenegro, and with the right mix of macroeconomic, institutional and structural policies, it should be achievable. What could be the building blocks of such a new growth model that fundamentally relies on productivity gains? Not surprisingly, as in other countries, the role of knowledge, skills and education is foundational.

21. Improvement in education has already had a significant impact on economic growth in Montenegro (Table 2). Once we isolated from 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, we found the educational structure to be quite robust. 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 previously estimated; it explains almost 46 percent of GDP growth rather than 28.2 percent. Education makes the difference. The 29.7 percent total contribution of education to GDP growth is significant and it grew over time. In 1965–1985 this contribution was only 12.6 percent of GDP, and the impact of improved educational structure was actually negative (−1.57 percent) due to the egalitarian behavior and a low and decreasing wage premium (from 2.75:1 of the wages of college graduates to those of uneducated workers in 1965 to 1.99:1 in 1985). Over the last decade, the wage premium rose to 3.05:1.

| Table 2: Montenegro: Contribution of Education and Knowledge to GDP Growth, 2000-10 |
|---------------------------------|---------------------------------|---------------------------------|-----------------|
| GDP                             | 5.0%      | 3.6%      | 100  |
| Capital                         | 2.9%      | 2.9%      | 58.2 |
| Uneducated labor force          | 0.8%      | 0.5%      | 16.2 |
| Retaining existing educational level of labor force | 0.6% | 0.4% | 12.0 |
| Improvement of educational structure | 0.9% | 0.9% | 17.7 |
| Advance of applied (technical/vocational) knowledge | -0.2% | -1.1% | -4.1 |

Sources: MONSTAT and World Bank staff calculations.

22. The significant improvement of the educational structure of the labor force is led by a higher propensity to invest in higher education because of the high perceived rate of return on investment in postsecondary education. It is also the result of there being few opportunities to find work with only secondary education. As noted above, poverty analysis suggests that education in Montenegro remains the surest way out of poverty. One recent cost-benefit analysis found the internal private rate of return for investments in higher education to be about 20 percent (Popović 2010), providing rationale for the strong preference of Montenegrin youth to continue university studies rather than look for difficult-to-find jobs with only a secondary education. Yet a paradox of Montenegro’s education system is that there is still a shortage of labor with skills demanded by the labor market. Montenegrin Chamber of Commerce research from 2009 found that during the summer season Montenegro hosts about 30,000 guest workers in tourism and another 40,000 people in construction. In contrast to educational structure, the contribution to growth of advances in practical (technical/vocational) knowledge and skills has been small and negative (−0.2 percent) though part of this may reflect measurement error.
23. World Bank’s 2006 and 2012 PEIR reports for Montenegro remain cautious about the effectiveness of vocational schools. On the one hand, vocational schools typically have higher recurrent costs than general education secondary schools. On the other hand, vocational education, as is commonly implemented, is becoming irrelevant in today’s world where math and reading have become real vocational skills and three-year vocational programs in particular often do not improve the chances of success in the labor market after graduation. Today, two-thirds of the secondary education enrollment in Montenegro is for vocational schools even though the number of students enrolled in a three-year vocational school has been decreasing. The Montenegrin government introduced reforms to the vocational education and training system: (i) modernized curricula and a move towards a modular system whereby students can move through a hierarchy of qualifications or pick up practical skills and qualifications as they go through working life; and (ii) changes to entry for higher education to give greater access to this level of education for graduates from secondary vocational programs.\(^2\) The World Bank’s 2006 and 2012 PEIRs recommend that reducing the proportion of time students spend in vocational programs in favor of general education has the potential to lead to overall improvements in learning outcomes as evidenced, for example, in Poland (World Bank 2012b).

24. Analysis of the sources of growth in GDP per capita terms reveals another growth reserve—
an increase in the participation rate (Table 3). The conclusion is that labor force participation is potentially another important source of per capita growth. The policy implication is that incentives for participation in the labor market should be heightened to help unlock this reserve.

<table>
<thead>
<tr>
<th>Table 3: Montenegro: Decomposition of Growth in GDP per Capita, 2000-10(^3)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP per capita</strong></td>
</tr>
<tr>
<td>-------------------</td>
</tr>
<tr>
<td>Labor participation rate</td>
</tr>
<tr>
<td>Labor productivity</td>
</tr>
<tr>
<td>Capital to labor ratio</td>
</tr>
<tr>
<td>Total factor productivity</td>
</tr>
</tbody>
</table>

Sources: MONSTAT and World Bank staff calculations.

25. Real GDP per capita is a good, though not perfect, proxy for standard of living. The less developed a country, the better measure of standard of living it is. Also, the less developed a country, the more important an increase in the ratio of labor force to population is for growth. Almost 40 percent of growth in real GDP per capita is explained by increases in the labor force to population ratio, the participation rate. We conclude that after the unused growth reserve of TFP, increased participation is the second most important reserve for growth of the Montenegrin economy.

\(^2\) Ministry of Education and Science.  
\(^3\) With \(P\) representing population and \(Q\) representing real GDP, growth of real GDP per capita can be is decomposed as follows:

\[
\frac{Q}{P} = \frac{L}{P} \frac{Q}{L} = \left(\frac{L}{P}\right) f \left[\frac{C}{L}; t\right] = \left(\frac{L}{P}\right) A \left(\frac{C}{L}\right)^a = r_Q P = r_L P + a r_C L + r_A .
\]

where \(r\) represents the rate of growth of variable given in the subscript and \(A\) represents TFP. Growth of GDP per capita is decomposed in part by measuring the increase in the labor force share in population (participation rate, \(r_L P\)), in part by measuring the contribution of an increase in the capital to labor ratio (\(a r_C L\)), and in part by measuring the contribution of TFP (\(r_A\)).
26. **Shifting attention to the future, then, can Montenegro accelerate and sustain higher rates of economic growth?** To find an answer we used two approaches to estimate potential Montenegrin output (the level of output where factors of production are fully employed at a given level of technology). First, we simply extended the Cobb-Douglas function of the growth accounting exercise: this approach estimates potential output growth of 3.9 percent a year, just above the current rate of 3.6 percent.

27. **The Hodrick-Prescott (HP) filter** yields a similar result: an estimate of potential growth of 3.8–4.4 percent. The HP filter helps to identify how much of Montenegro’s past growth fluctuations can be attributed to the trend component by removing temporary shocks within the business cycle. The result suggests that recent growth in Montenegro has been fairly close to calculated potential output except for the exceptional volatility of the pre-crisis and crisis years (Figure 3). The largest negative gap was in 2009, which can be explained by the recent recession, and the largest positive gap was recorded in the pre-crisis years of overheating. Otherwise, actual GDP was quite close to potential GDP. We tentatively interpret this result as a convergence toward a balanced growth path, which then implies, according to the standard growth theory, that in Montenegro the effects of past positive shocks that caused growth will soon end and new sources of positive shocks must be found, or generated, if growth is to be sustained.

![Figure 3: Real and Potential Output (HP-Filter)](chart.png)

**Source:** World Bank staff calculations.

28. **But given that macroeconomic stability is fundamental for long-term growth, what policies are central to achieving dynamic productivity growth?** In the rest of this chapter, the report analyzes Montenegro’s fiscal and financial sector situation, and identifies the remaining weaknesses and the resulting policy agenda in support of stable and predictable environment conducive for private and foreign investments, productivity and growth.

### B. Ensuring Fiscal Sustainability

29. **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.** The government recognizes the importance of devising prudent fiscal policies over a longer

---

4 See Madzarević-Šijster and Popović (2012).
horizon to ensure sustainability through different phases of the business cycle, and has taken substantial, and politically difficult, measures to boost revenue and consolidate spending.

30. The government started significant fiscal consolidation in 2010-11, mostly on the spending side: By 2011, the government had cut total public spending by about 8 percentage points of GDP from its peak in 2009. A freeze in public sector wages, staffing rationalization, and restraint in operations and maintenance costs and the capital budget helped reduce spending so that the government deficit is estimated to have been about 4.3 percent of GDP in 2011. This was achieved despite the decline in the revenue-to-GDP ratio, a rise in tax arrears, and a call on a government guarantee to a steel mill equivalent to 0.8 percent of GDP. Nevertheless, at the end of 2011 total public debt, including guarantees, came close to 58 percent of GDP.

31. In parallel, the government advanced social reforms toward a more fiscally affordable and efficient safety net. After previous increases in the retirement age, the latest amendments to the Pension Insurance Act in 2011 resulted in automatic annual increases in the retirement age from 60 (women) and 65 (men) to 67 for both men and women by 2040. The authorities introduced amendments to the Labor Law to reduce dismissal costs and simplify hiring. Parliament has also adopted amendments (i) to the Law on Social Security to introduce a voluntary insurance premium to cover 20 percent of the basic health package, which would otherwise be subject to copayments, and is discussing the amendments to the Law on Child Care, which limit the maternity leave benefits at the average wage, introduces activation elements to social welfare and limits the duration of social benefits to 9 months for able-bodied; and introduces social card to improve targeting of benefits and limit the error of inclusion. The aim of these measures is to ensure fiscal sustainability and limit work disincentives since the labor force participation rate (60 percent) and the employment rate (56 percent) are low in Montenegro. Montenegro now has one of the better targeted and fiscally affordable social assistance systems in developing Europe and Central Asia.

32. Unfortunately, recent developments with the aluminum company have resulted in unexpected budgetary outlays and future fiscal risks, which threaten to undermine hard-won gains on fiscal consolidation so far:

- In February 2012, the government converted into public debt its €22 million guarantee to Deutsche Bank on a loan to the aluminum company. The loan, repaid in full, raised current public debt service by about 0.7 percent of GDP.

- Moreover, the aluminum company, currently majority-owned by the Russian CEAC group, had accumulated payment arrears to the electricity company amounting to €55 million which may not be recoverable by the electricity company (EPCG) or the state, and €30 million and tax arrears of about €20 million, which triggered a request from Parliament to the government to cancel the privatization contract. Resolution of the contract terms and future ownership is pending. The EPCG, on the other side, has become late with its tax liability, which additionally negatively impacted the 2012 budget.

- Finally, another potential liability could arise from the government’s negotiations with the Hungarian company, OTP, and the Russian company, VTB, on rescheduling guaranteed loans to the company in the amounts of €42.2 million and €60 million. While the current loan schedule spreads repayments over three to five years, together they add up to another €102 million (3 percent of 2012 GDP) in public debt service.
Table 4: Montenegro: Medium-Term Fiscal Framework

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011 (prel.)</th>
<th>2012 (revised budget)</th>
<th>2013 (proj.)</th>
<th>2014 (proj.)</th>
<th>2015 (proj.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenues and grants (% of GDP)</td>
<td>49.9</td>
<td>43.9</td>
<td>42.4</td>
<td>39.8</td>
<td>38.1</td>
<td>36.9</td>
<td>35.9</td>
<td>35.5</td>
</tr>
<tr>
<td><strong>Current revenues (% of GDP)</strong></td>
<td>49.7</td>
<td>43.5</td>
<td>42.2</td>
<td>39.6</td>
<td>37.9</td>
<td>36.9</td>
<td>35.9</td>
<td>35.5</td>
</tr>
<tr>
<td>Tax revenues (% of GDP)</td>
<td>41.0</td>
<td>37.0</td>
<td>36.6</td>
<td>35.5</td>
<td>34.2</td>
<td>33.1</td>
<td>32.6</td>
<td>32.3</td>
</tr>
<tr>
<td>Nontax revenues (% of GDP)</td>
<td>8.7</td>
<td>6.5</td>
<td>5.6</td>
<td>4.1</td>
<td>3.7</td>
<td>3.8</td>
<td>3.3</td>
<td>3.1</td>
</tr>
<tr>
<td><strong>Grants (% of GDP)</strong></td>
<td>0.1</td>
<td>0.4</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Total expenditure and net lending (% of GDP)</td>
<td>51.1</td>
<td>49.2</td>
<td>47.1</td>
<td>44.1</td>
<td>41.6</td>
<td>39.2</td>
<td>37.6</td>
<td>36.1</td>
</tr>
<tr>
<td><strong>Current expenditure (% of GDP)</strong></td>
<td>38.8</td>
<td>41.5</td>
<td>40.7</td>
<td>39.4</td>
<td>38.2</td>
<td>36.3</td>
<td>34.7</td>
<td>33.2</td>
</tr>
<tr>
<td>Wage bill 1/ (% of GDP)</td>
<td>11.3</td>
<td>11.1</td>
<td>11.3</td>
<td>13.4</td>
<td>12.6</td>
<td>11.7</td>
<td>11.1</td>
<td>10.4</td>
</tr>
<tr>
<td>Other purchases of goods and services (% of GDP)</td>
<td>6.8</td>
<td>5.9</td>
<td>6.5</td>
<td>5.7</td>
<td>6.6</td>
<td>5.8</td>
<td>5.3</td>
<td>4.8</td>
</tr>
<tr>
<td>Interest payments (% of GDP)</td>
<td>0.8</td>
<td>0.9</td>
<td>1.0</td>
<td>1.5</td>
<td>1.8</td>
<td>2.2</td>
<td>2.4</td>
<td>2.6</td>
</tr>
<tr>
<td>Subsidies and current transfers (% of GDP)</td>
<td>19.9</td>
<td>23.6</td>
<td>21.8</td>
<td>18.8</td>
<td>17.2</td>
<td>16.5</td>
<td>15.9</td>
<td>15.4</td>
</tr>
<tr>
<td>o/w steel mill and aluminum guarantees 2/ (% of GDP)</td>
<td>0.0</td>
<td>0.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Capital expenditure (% of GDP)</strong></td>
<td>10.2</td>
<td>8.6</td>
<td>5.7</td>
<td>4.7</td>
<td>2.7</td>
<td>3.0</td>
<td>2.9</td>
<td>2.9</td>
</tr>
<tr>
<td><strong>Net lending (% of GDP)</strong></td>
<td>2.1</td>
<td>-0.9</td>
<td>0.7</td>
<td>0.0</td>
<td>0.7</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Current surplus/deficit (% of GDP)</strong></td>
<td>11.0</td>
<td>2.0</td>
<td>1.5</td>
<td>0.1</td>
<td>-0.3</td>
<td>0.6</td>
<td>1.2</td>
<td>2.2</td>
</tr>
<tr>
<td><strong>Primary surplus/deficit (% of GDP)</strong></td>
<td>-0.5</td>
<td>-4.4</td>
<td>-3.6</td>
<td>-2.8</td>
<td>-1.8</td>
<td>0.0</td>
<td>0.7</td>
<td>2.0</td>
</tr>
<tr>
<td><strong>Overall fiscal balance (% of GDP)</strong></td>
<td>-1.3</td>
<td>-5.3</td>
<td>-4.7</td>
<td>-4.3</td>
<td>-3.6</td>
<td>-2.3</td>
<td>-1.6</td>
<td>-0.6</td>
</tr>
<tr>
<td>Total financing (% of GDP)</td>
<td>-0.3</td>
<td>4.3</td>
<td>4.7</td>
<td>4.3</td>
<td>3.6</td>
<td>2.3</td>
<td>1.6</td>
<td>0.6</td>
</tr>
<tr>
<td>Net domestic financing (% of GDP)</td>
<td>-0.7</td>
<td>-4.2</td>
<td>-3.3</td>
<td>0.0</td>
<td>-2.8</td>
<td>-3.5</td>
<td>-1.7</td>
<td>-1.5</td>
</tr>
<tr>
<td>Privatization receipts (% of GDP)</td>
<td>1.2</td>
<td>4.4</td>
<td>0.8</td>
<td>0.5</td>
<td>0.4</td>
<td>0.5</td>
<td>0.6</td>
<td>0.5</td>
</tr>
<tr>
<td>Net foreign financing (% of GDP)</td>
<td>-0.2</td>
<td>4.1</td>
<td>5.2</td>
<td>4.0</td>
<td>6.0</td>
<td>5.2</td>
<td>2.7</td>
<td>1.7</td>
</tr>
<tr>
<td>Increase in payment arrears (% of GDP)</td>
<td>2.0</td>
<td>-0.2</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Public debt with guarantees (% of GDP)</td>
<td>32.4</td>
<td>41.8</td>
<td>51.0</td>
<td>57.8</td>
<td>61.6</td>
<td>60.5</td>
<td>58.4</td>
<td>55.1</td>
</tr>
<tr>
<td>Memo items:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign borrowing (% of GDP)</td>
<td>9.3</td>
<td>7.2</td>
<td>5.4</td>
<td>9.3</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign borrowing (in million EUR)</td>
<td>309.0</td>
<td>250.0</td>
<td>199.9</td>
<td>365.4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>o/w Commercial borrowing/bonds</td>
<td>0.0</td>
<td>6.1</td>
<td>5.4</td>
<td>9.3</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial borrowing/bonds (in million EUR)</td>
<td>0.0</td>
<td>211.5</td>
<td>199.9</td>
<td>365.4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>o/w IBRD budget support included guaranteed debt (in million EUR)</td>
<td>309.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: Ministry of Finance and World Bank staff estimates.
33. These developments and the major growth slowdown in 2012, prompted additional fiscal measures and reconsideration of the country’s medium-term macroeconomic framework (Table 4). In May 2012, the Parliament approved an amended budget to reflect these developments and introduced additional revenue and expenditure measures. Over the medium term, growth is expected to pick up and become more diversified, driven by moderate growth in domestic demand as disposable income rises; investments are expected to stabilize at about 21 percent of GDP. With the continued strengthening of the financial sector and the gradual firming up of economic activity and incomes, national savings are projected to gradually rise to an average of about 3 percent of GDP in 2014-2015, which will somewhat reduce reliance on foreign savings. However, recovery in growth will translate only gradually into labor market improvements.

34. Over the medium term, the government intends to deepen fiscal consolidation, move toward fiscal surpluses, and thus set Montenegro’s public debt on a downward trajectory (Table 4). The short-term challenge is to persevere with fiscal consolidation during the current period of low growth and the ongoing recession in the wider Western Balkan region (World Bank 2012d). Given the large cuts in public expenditures so far and further rationalization, it might be prudent to consider moderately increasing the VAT rates in order to accelerate fiscal consolidation. The Government’s objective is to stem further growth in public debt which, along with guarantees, which reached almost 58 percent of GDP in 2011. The medium-term strategy is built on a more moderate adjustment, with a plan to reduce general government spending by another 1 percentage point of GDP annually (for a total of 4.5 percentage points of GDP) down to about 36.1 percent of GDP, by 2015 (from close to 51 percent in 2009). To reach its long-term objective—the expenditure ratio of about 30-35 percent of GDP—the Government has either prepared or implemented significant measures to further restrain spending and improve its efficiency over the medium term (Box 1). The most important of these relate to the control of pension increases and moderation of wage bill in line with formal agreements with the labor unions.

**Box 1: Government of Montenegro Medium-Term Fiscal Reform Measures**

- **Pension system reform**, in line with good international practice, has raised the retirement age from 55/60 to 67 for men and women, with a transition period of 20 years. Pension indexation was changed to 75 percent of CPI and 25 percent of the average wage, a more conservative mechanism than the so-called Swiss formula (50–50).
- **Public administration reform** through staff downsizing implemented a “two-for-one” principle, i.e., one person hired for two leaving the public sector or three retiring, calculation of the central payroll, and a wage freeze.
- Because of **state aid reform**, subsidized electricity to metal industries will cease by year-end 2012.
- The **rationalization of social security costs and transfers** is capping total health and social benefit expenditures, consolidating insurance funds under the Single Treasury Account, and imposing central oversight of the use of budget funds.
- Authorization and management of public procurement and the **Single Treasury Account** commitment module is being centralized to prevent further accumulation of arrears.
- The Ministry of Finance is working with municipalities to help them reduce **municipal arrears**.
- **Capital spending** is being moderated and its level protected at 3.5 percent of GDP throughout the period.
- Amendments to the organic budget act to formally introduce the **Medium-Term Expenditure Framework** and the fiscal rule in 2013.
- **Tax collection** efforts are being stepped up, and gradual increases in property tax and excise duties (also required as a part of the EU accession program) are being scheduled.
35. The Montenegrin government has moved to stabilize the economy by re-launching the fiscal consolidation process and continuing structural reforms. External vulnerability indicators somewhat stabilized in 2011; however, past borrowing and the crisis in 2009 moved Montenegro to the indebted class of countries (external debt was 100.7 percent of GDP). While public debt is much lower, about 58 percent of GDP in 2011, it, too, is too high, calling for forceful fiscal consolidation to reduce the general government deficit and move to fiscal surpluses in medium term, and rapid reductions in the level of public debt.

36. Reducing the deficit to a cyclically-balanced level will require structural reduction in public spending because the country is exposed to contingent liabilities from the metal industry, an aging society, and also the coming EU accession-related costs. Contingent fiscal exposure in state guarantees to the metal industry amounts to almost 5 percentage points of GDP, of which around 1.7 percent of GDP was assumed as public debt since 2011. It is instructive that Croatia’s EU-accession related costs rose before the conclusion of negotiations to above 1 percent of GDP, including co-financing of EU projects. Additionally, as a small country vulnerable to shocks, to credibly reverse its debt dynamics, Montenegro needs to create fiscal buffers even after it balances its budget. This requires not only moving to a policy of fiscal surpluses but also building a stock of fiscal reserves, which can be used in case of emergencies and major external shocks. For a country with so much public and external debt, Montenegro has no growth versus savings dilemma. It must raise its public and private saving rate and ensure lasting macroeconomic stability while vigorously pursuing remaining structural reforms as a precondition for growth.

37. Since 2011, the government has pursued prudently conservative fiscal policy (Figure 4). In the years before the crisis, the authorities relied on expansionary fiscal policy to stimulate consumption and growth. For 2002–2011 fiscal policy was mostly procyclical and amplified business cycle. In the future, the challenge is to sustain fiscal consolidation in medium term and the objectives of fiscal policy should be to (i) tighten fiscal discipline and enforce zero tolerance toward arrears; (ii) lower public debt to a sustainable level; and (iii) implant counter-cyclicality. The authorities have launched discussions to that effect.

Risks and the government’s contingency fiscal plans

38. Policy and external risks to the implementation of the government’s program remain substantial. A potential liability for the budget could arise from the Government’s ongoing negotiations with the Hungarian OTP and Russian VTB on rescheduling of the other two guaranteed loans in the amount of EUR118 million with interest payments. While the current loan schedule spreads repayments over a three to five-year period, these pressures together add up to an additional 3.5 percent of 2012 GDP to public debt service. Additionally, the future ownership of KAP itself is unclear—with potentially additional budgetary implications for the government unless it decides to liquidate the company or a new strategic investor is found that does not expose the government to new contingency risks. These risks are not currently accounted for in the government medium-term fiscal framework.
39. As with any long-term adjustment, there is a risk that social tensions and political pressures weaken the fiscal consolidation efforts and adversely affect the investment climate. The heavy reliance on tourism revenues and FDI makes the country vulnerable to the recession in the EU. Also, deleveraging and low capital inflows may put further pressures on the private sector and households, worsening the payment discipline. In addition, the municipalities and the state accumulated a stock of arrears of about EUR116 million (equivalent to about 3.6 percent of GDP), half of which is concentrated in the coastal city of Budva, which experienced the biggest real estate bubble. This and the VAT refund arrears are adversely affecting private sector liquidity and payments discipline and will need to be dealt decisively in the period ahead. Finally, Montenegro is vulnerable to natural (e.g., earthquakes, floods) and climatic risks. To the extent these risks materialize further policy efforts would be required. 

Box 2: Eurozone Fiscal Rules

Well-designed and implemented fiscal rules can help eliminate the deficit bias and support prudent fiscal policies. To be effective, fiscal rules must be flexible to address exceptional circumstances and simple and transparent to be understood by policymakers and the public. But the experience in the Eurozone suggests that effective enforcement and sanctioning mechanisms must also be in place to ensure compliance.

Eurozone’s national fiscal policies are coordinated by the supranational Stability and Growth Pact (SGP), a rules-based framework that entered into force on January 1, 1999. The SGP has two nominal anchors: 3 percent of GDP for general government deficit and 60 percent of GDP for public debt. In addition to these two nominal anchors, the SGP requires the Eurozone national budget balances to converge towards a medium-term objective. This constitutes the preventative arm of the SGP. An excessive deficit procedure (EDP) applies when either the deficit threshold is breached or the public debt threshold is exceeded and the debt level has not been diminishing towards the threshold. In the event of non-compliance with the policies proposed by the European Commission, sanctions are implemented.

In practice, the SGP fell short of promoting fiscal discipline in the Eurozone. Between 1999 and 2011, the 12 initial Eurozone member countries all exceeded the deficit threshold 60 percent of the time. As a result, the so-called “six-pack,” five regulations and one directive, entered into force on December 13, 2011 to strengthen the SGP. The six-pack quantitatively defines what a significant deviation from the medium-term objective or the adjustment towards it means. It also operationalizes the debt criterion. In order to promote enforceability, the six-pack introduces reverse qualified majority voting (RQMV) for most sanctions. The RQMV implies that a proposal or recommendation is adopted in the Council of the European Union unless a qualified majority (at least 255 out of a total of 345) votes against it.

The Fiscal Compact is the fiscal part of the Treaty on Stability, Coordination, and Governance (TSCG). The TSCG is an international agreement and not an EU law. The fiscal Compact, once it enters into force, will run in parallel to the six-pack and further strengthen the implementation and enforcement of the existing fiscal rules in the Eurozone. The Fiscal Compact requires the medium-term objective as well as automatic correction rules in case of breach to be written into national laws. The medium-term objective, as defined in the SGP, is a structural deficit of 0.5 percent of GDP (1 percent of GDP if public debt is less than 60 percent of GDP). The Fiscal Compact is more stringent with the deficit criterion: the EDP with RQVM applies when the general government deficit exceeds the threshold of 3 percent of GDP.

The “two-pack,” a work in progress, will strengthen the preventative arm of the SGP by requiring the draft budgetary plans and progress in the EDP to be monitored and assessed by independent institutions.

Sources: European Commission (2012a and 2012b) and Wyplosz (2012). 

40. The government has so far shown resolve and has additional revenue measures available in case risks escalate. The government has backed its fiscal strategy with a key agreement with the unions regarding wage and pension adjustments. Also, it is preparing an explicit fiscal rule in 2013 (to limit deficit, expenditures, and debt) to institutionalize fiscal discipline over the long term, as recommended by
the World Bank’s recent Public Expenditure and Institutional Review (2012). This is an important step in ensuring lasting fiscal discipline, following similar initiatives in the EU (Box 2). Finally, Montenegro has some of the lowest main tax rates in the developing Europe and Central Asia region (e.g., flat income tax rate of 9 percent and the standard VAT rate of 17 percent). Some taxes (e.g., VAT) could be increased moderately if economic conditions deteriorate. The central government is also working to incentivize municipalities (e.g., through explicit contracts and conditions on central government transfers) to clear their arrears through additional privatizations, asset sales, and local fiscal adjustment.

**Debt sustainability analysis**

41. **Given the baseline outlook and medium-term fiscal plans, Montenegro’s public debt is sustainable, but significant risks make it clear there is no room for complacency.** If the government’s fiscal strategy is implemented as planned with 1 percentage point of GDP annual savings in public spending, it is estimated that public debt with guarantees will decline to 48 percent of GDP by 2015 or 55 percent of GDP with guarantees (Figure 5). The Government also intends to build over the medium term fiscal reserves as a cushion against unforeseen shocks. The sensitivity analysis shows, however, that under the growth shock scenario of real growth at zero percent throughout the observed period (rather than 3 percent in the baseline) and with no policy response, public debt would widen by 10 percentage points of GDP compared to the baseline. The full assumption of guarantees in 2013 would increase public debt by 9.5 percentage points of GDP in 2015 compared to the baseline of 48 percent. Such a significant risk suggests that it is critical for the government to actualize its medium term fiscal consolidation plans.

**Figure 5: Debt Sustainability**

![Debt Sustainability Graph](image)

**Notes:** Contingent liabilities’ shock assumes a one-off assumption of total guarantees in 2013. Growth shock assumes 0.2 percent average growth for 2013-2015. The baseline scenario follows the Government’s amended budget scenario, which assumes 0.5 percent growth in 2012 and the pick-up thereafter. Historical scenario implies CAD, excluding interest payments at 26% of GDP (average for 2007-2012) throughout the projection period.

**Sources:** CBCG and MoF, and World Bank staff calculations.

42. **Montenegro’s total external debt is also projected to decline to 99 percent of GDP by 2015, having peaked at 104 percent of GDP in 2011 (Figure 5).** However, the projection is highly sensitive to changes in macroeconomic assumptions. In particular, assuming a moderate export recovery, the debt-to-export ratio will decline to about 238 percent by 2015 (having peaked in 2010 at 270 percent). Debt
service as a share of exports is expected to decline to about 32 percent by 2014 before it increases again in 2015 to 44 percent as inaugural Eurobonds mature. Sensitivity analysis suggests that the combined shock of an implicit interest rate of 4.3 percent, real growth at zero percent throughout the observed period (rather than 3 percent in the baseline), and a non-interest current account deficit at 17 percent (as opposed to 26 percent) would widen external debt by almost 20 percentage points of GDP compared to the baseline in 2015.

43. But even with prudent fiscal policy and public debt on a sustainable path, macroeconomic stability and dynamic growth cannot be assured unless supported by a sound banking system. This is one of the key lessons of the global crisis, which emphasized the crucial role of macro-financial links and vulnerabilities in the banking sector, which contributed to the escalation of public debt in many Eurozone countries. Hence the need to consider the roots and lessons of Montenegro’s own financial crisis and the remaining financial sector reforms to ensure future sector sustainability and support to robust private sector growth.

C. Ensuring Financial Sustainability

44. Montenegro's substantial credit boom before 2008 was mainly financed by foreign parent banks. Total credit in Montenegro averaged 145 percent annual growth in 2006 and 2007, increasing from 39 percent of GDP to 84 percent. Credit was concentrated in the real estate sector. The high credit growth was coupled with lax underwriting standards that heightened the credit risk in bank loan portfolios, resulting in high liquidity exposures as funding from foreign parent banks jumped from 8 percent of total liabilities in 2006 to 21 percent in 2008. By June 2009 the loan-to-deposit (LTD) ratio had shot up from 79 percent in 2006 to 150 percent. Foreign banks maintained their presence after the crisis (Box 3).

Box 3: The Role of Foreign Banks

The Montenegrin banking system is dominated by foreign banks. The system comprises 11 banks, nine of which are majority-foreign-owned and account for about 89 percent of system assets. The banking system is highly concentrated. At the end of 2011, the three largest banks held 60 percent of total assets and deposits; the largest bank alone accounted for 25 percent of assets and 30 percent of deposits.

Though some foreign banks are facing a difficult environment at home, they have stayed active in Montenegro. Parent banks demonstrated their commitment by providing Montenegrin subsidiaries with liquidity support and substantial capital injections, which helped to offset declining domestic deposits and capital erosion.

45. The Central Bank of Montenegro (CBCG) as prudential supervisor moved to curb the credit boom. In 2006 and 2007 the CBCG widened the deposit base subject to reserve requirements to include savings deposits and differentiated the reserve requirement rate for demand (19 percent) and savings (5 percent) deposits. The main regulatory restrictions, quantitative limits on the credit growth of the largest banks, were introduced in 2007 to both slow credit growth and improve the maturity structure of bank deposit financing. In early 2008 a new law increased bank capitalization; it was also designed to improve the quality of supervision. Though credit growth slowed in 2008 in response to the prudential measures, as the global financial crisis unfolded the banks became more concerned about their deteriorating liquidity position.
46. Yet even without monetary policy instruments, more could have been done through macro-prudential policy. Because Montenegro is fully euroized, monetary policy was not available to curb the increasing risk associated with the fast credit growth. Although at the time macroprudential policy instruments were not being widely used elsewhere, there were successful examples in the region (e.g., Poland and Croatia). Therefore, at least from the perspective of hindsight, more could have been done using micro and macroprudential policy tools to manage the capital flowing into the banking sector, and the accumulating risk.

47. When the global crisis beginning in late 2008 slammed the brakes on the credit expansion, Montenegro experienced a severe credit crunch. Total bank assets, which stood at 111 percent of GDP at the end of 2007, have been contracting since (Table 5). In 2009 the credit crunch peaked with a 14 percent decline year-on-year, partly because bank asset quality problems were rising and partly because as the economy weakened demand for commercial loans declined. Parent bank credit became less available and Montenegro’s banks were forced to adjust their liquidity risk exposures. Borrowings from parent banks as a share of total liabilities dropped from 20 percent (21 percent of GDP) in 2008 to 13 percent (11 percent of GDP) in 2012, bring the loan-to-deposit down from 150 percent in June 2009 to 92 percent by September 2012. Further, as banks worked to clean up their balance sheets, credit continued to decline throughout 2010 and 2011 before returning to modest growth in 2012 (Table 5).

<table>
<thead>
<tr>
<th>Table 5: Montenegro: Basic Indicators of the Banking System</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Number of banks</td>
</tr>
<tr>
<td>Number of foreign banks</td>
</tr>
<tr>
<td>Asset/GDP (%)</td>
</tr>
<tr>
<td>Assets growth y/y (%)</td>
</tr>
<tr>
<td>Deposits/GDP (%)</td>
</tr>
<tr>
<td>Deposit growth y/y (%)</td>
</tr>
<tr>
<td>Credit/GDP (%)</td>
</tr>
<tr>
<td>Credit growth y/y (%)</td>
</tr>
<tr>
<td>NPLs/loans (%)</td>
</tr>
<tr>
<td>Provisions/NPLs (%)</td>
</tr>
</tbody>
</table>

Source: CBCG. NPL data are as of September 2012.

48. The confidence of bank depositors was shaken beginning in 2008 and a rise in non-performing loans (NPLs) made banks draw down their capital buffers. A massive withdrawal of deposits undermined system liquidity in late 2008, especially for Prva Banka, which at the time was a large domestic bank of systemic importance. The decline of deposits was arrested by mid-2009. Still, between September 2008 and 2011, overall, the banking sector lost more than 21 percent of total deposits. In 2008 the ratio of liquid assets to short-term liabilities hit bottom at 21 percent. As a consequence of rapidly increasing NPLs, nine of the 11 banks had to be recapitalized by shareholders, and at the same time bank profitability turned deeply negative (ROE at –10 percent), reaching its low of –27.1 percent in 2010.

49. An emergency anti-crisis Law on Measures for Protection of the Banking System (MPBS) was passed in October 2008 as a response to the crisis. It was generally consistent with crisis responses seen in other countries; it gave the government authority to (i) fully guarantee the deposits of all
individuals and legal persons; (ii) facilitate credit guarantees for interbank loans; (iii) provide emergency liquidity support to a bank for up to one year; (iv) upon a bank’s request, make a prepayment of state borrowing from that bank (including loans carrying a government guarantee); and (v) provide funds for bank recapitalization to protect banking system stability. The law also allowed the CBCG to (i) approve the use of required reserves; and (ii) use up to 50 percent of its capital for short-term loans to banks. Having served its purpose, the MPBS expired at the end of 2009. Prva Banka was recapitalized and the CBCG has been working to help it restructure. A number of other banks benefited from guarantees given by the MoF for credit lines provided by the European Investment Bank (EIB) and KfW totaling €122 million to support lending to small and medium enterprises (SMEs).

50. **Banks are now completing recapitalizations and trying to lower liquidity risk exposures by raising more local deposits because loan repayments have been slow.** Recently deposits have been showing signs of recovery. As a result of previous recapitalization efforts, the capital adequacy ratio (CAR) of the system stood at 13.6 percent as of September 2012, above the prudential minimum requirement of 10 percent.

51. **Midsize banks that were conservative during the credit boom are now leading renewed lending activity** even though credit standards have tightened in view of the uncertainty caused by the economic slowdown in the Eurozone and still-high NPL levels. Banks with low NPLs are increasing their lending; those with high NPLs have reorganized internally to work out NPLs with clients and resume lending in the short term. By June 2012 aggregate annual credit growth had turned positive but was very heterogeneous across banks. Healthier, midsize banks have been growing their loan portfolios.

52. **The NPL situation is complicated by the stock of bad debt and payment arrears in the real economy, and bottlenecks in the insolvency and debt restructuring legal frameworks.** The limited amount of new lending is concentrated in consumer lending and SMEs (including the self-employed) as banks try to diversify their portfolios away from large enterprises. There are also indications of an increase in cross-border claims on the Montenegrin non-banking sector, which suggests that domestic clients are accessing parent bank financing directly.

**Policy priorities**

53. To ensure financial sector sustainability, short-term priorities for Montenegro’s banking sector are to continue building up bank capitalization and liquidity positions and, as is critical, to resolve NPLs. Banking system profitability remains in the negative territory in 2012 and, despite progress, the financial soundness indicators suggest that the banking sector has yet to demonstrate a decisive recovery trend. Thus, restoring soundness across the system is a priority in order to stimulate new lending to creditworthy enterprises and projects. Through the recently reinforced legal framework, the CBCG is empowered to foster financial stability, and the authorities have been drawing up contingency plans to be able to cope with any future external shocks from, e.g., the Eurozone.

54. **Supervisory integration and macroprudential improvements should continue to be high on the agenda,** in light of the experience of other small open economies that chose to integrate their supervisory agencies into the central bank, and the lessons the global financial crisis has provided for small open economies, among them the need to carefully supervise all nonbank credit institutions. Further improvements in macroprudential supervision are also warranted. Given the vulnerabilities of Montenegro’s banking sector and country characteristics (lending concentration, euroization, and high financial integration), a higher minimum regulatory CAR should be considered for the medium term.

55. **Regulation and supervision should be directed to improving internal bank controls and credit risk management and reducing fixed costs.** There is considerable scope to do so and it would make bank operations more efficient, given that the ratio of overhead expenses to assets is the second highest among regional peers—and trending up. CBCG supervision can do a great deal to ensure these priorities
are given appropriate attention. Fostering competition between bank and nonbank credit institutions through regulation could also help increase bank efficiency and expand access to credit.

56. Finally, although financial deepening advanced very fast in Montenegro during 2006–08, the poor did not benefit much. Financial inclusion and access to financial services, including payment services, still lag behind Montenegro’s comparators and support the existence of the shadow economy.

D. Towards a New Growth Model

57. The previous analysis shows that growth in Montenegro between 2000 and 2010 was essentially driven by capital accumulation, with some contribution of labor and virtually no contribution from productivity. The contribution of exports, which are concentrated in metals for which demand is declining, was negligible. This growth pattern is strikingly different from the new EU member states, where the expansion of labor productivity in the 10 years leading to accession was driven essentially by TFP gains associated with macroeconomic stabilization, structural reforms, and the prospect of EU accession (Arratibel et al. 2007). It is also at odds with the experience of small successful countries that exploited exports as a growth engine. However—and this is perhaps also a warning of what might be wrong with Montenegro’s growth—its growth pattern very much resembles that of neighboring Croatia, which still has an ample unfinished transition agenda and which has recently entered a period of several years of negative growth. In both cases, the past growth pattern has generated major macroeconomic imbalances.

58. In parallel, government must continue positive structural changes to ignite Montenegro’s growth reserves. This would also help ensure macro-stability, which would create a virtuous circle of stability-with-growth. Such a change could come about with consistent pursuit of good economic policies and structural reforms; the challenge here is to identify such policies and reforms. This requires a deeper analysis of the structural issues underpinning Montenegro’s problem of connectivity and flexibility, and also of international experience and the development literature. But the literature is often not conclusive, much less prescriptive. Indeed, the main conclusion of a recent review of 80 episodes of rapid and sustained economic growth in the last half century is that growth accelerations are very hard to predict (Hausmann, Pritchett & Rodrik 2006). Without new sources of dynamism, diminishing returns can cause attrition in growth, leading in the long run to a steady state where the average rate of growth is zero.

59. One way to avoid a low-growth steady state would be continuous economic accelerations or structural shocks that shift the economy’s production possibilities frontier, e.g., adoption of new technologies and skills that improve productivity or generate a process of “creative destruction” in the Schumpeterian sense. Another way would be by directly increasing TFP via improvements in the business environment that enable more efficient use of economic resources. Once Montenegro is producing efficiently on the frontier, adoption of new innovations, improvements in the terms of trade, or productivity enhancements that displace the production possibilities frontier will be the only ways to sustain growth (Figure 6).
60. The most important growth reserves are related: productivity and exports. The World Economic Forum’s Global Competitiveness Index (Figure 7) shows the largest gaps in competitiveness for Montenegro are in the areas of technological readiness, innovation, and business sophistication. In 2000–08 Montenegrin TFP growth averaged only 0.68 percent a year. As the Irish experience demonstrates, with appropriate policies this rate can be increased to as much as 2.4 percent. But even modest growth in TFP of just 0.5 percent, as shown above, can make a huge difference in national growth performance. If Montenegro can achieve the Irish TFP growth, annual GDP growth would increase to as much as 6.7 percent, and GDP per capita growth to 6.5 percent, and make Montenegro one of the world’s fastest- growing economies—such is the power of vibrant productivity growth. The contribution of TFP to GDP growth would increase to about 35 percent, though this would still be less than the 40 percent average for other countries at a similar stage of development. But to engender such productivity gains, Montenegro needs to look at underlying drivers that have proved important in other countries, such as innovation.
For its stage of development, however, the Montenegrin economy is not very competitive, and innovation and export performance are particularly weak (Figure 7). In countries far from the production function frontier, like Montenegro, innovation offers a large catch-up opportunity. The Internet and the digital revolution have created major opportunities for even small countries to leapfrog old technologies and benefit on the margin from imitation, adaptation, and innovation. But Montenegro’s spending on research and development (R&D) is minimal—less than 0.5 percent of GDP—75 percent comes from the public sector, and it is not very efficient. Its R&D has shown few results in terms of international patents and innovations, which is apparent from international measures of competitiveness on the innovation scale (Figure 7).

The authorities can encourage private sector R&D through a variety of measures. This might include support directly or through the Montenegrin Investment Promotion Agency (MIPA), for example, by attracting R&D-intensive FDI. Particularly important would be development of the national innovation system (NIS) based on good international practices. Conditions for university-industry collaboration need to be improved, for example, by facilitating commercialization of research and fostering restructuring of public R&D institutes by declining earmarked funding and researcher-level incentives for diversification of revenue.

E. An Agenda for Sustainable Growth and Income Convergence

To accelerate growth, Montenegro needs to shift to productivity-based policies that foster knowledge and skills and fiscal and financial sector sustainability. Given its current indebtedness, an urgent priority for Montenegro is to address those vulnerabilities through fiscal consolidation and reduction in public and external debt, backed by credible rules to ensure fiscal discipline. Reinforcing the financial sector will be critical to support the nascent credit recovery and private investments. The analysis suggests three building blocks for a macroeconomic agenda directed to sustainable growth and income convergence:

First, to ensure that growth is sustainable, Montenegro must unlock the potential of productivity. With the mix of macroeconomic, institutional and structural policies advocated in this report, this should be achievable. What could be the building blocks of a new growth model that fundamentally relies on productivity gains? Not surprisingly, as in other small countries that achieved rapid growth (e.g., Finland, Ireland), knowledge, skills, and education have a central role. The World Bank’s recent PEIR report laid out a comprehensive public agenda for improving the quality and efficiency of education. It emphasized strengthening early childhood development, modernizing higher education, and tailoring practical skills and vocational training and lifelong learning to private sector demand. Perhaps equally important, these skills oriented measures will also make growth more inclusive, strengthening the middle class and contributing to long-term social stability. Other important elements of the knowledge agenda discussed below also relate to the private sector and new information communications technology (ICT) and related skills for a digital and Internet economy. Investments in training and infrastructure will also support greater innovation. Montenegrin firms investing in research and development are found to grow faster percent faster than non-innovating firms but these effects are weaker than in new EU member states that invest much more in innovation (Şeker 2012).

Second, to ensure fiscal sustainability, Montenegro must move toward surpluses, build reserves, eliminate municipal arrears, adopt and enforce credible fiscal rules, and continue improving public sector governance. The government’s fiscal consolidation plans, if implemented vigorously over the next four years, will ensure sustainability and the necessary buffers. That will mean achieving fiscal balance by 2015–16 and surpluses thereafter, establishing reserves to be used in case of natural disasters and well-defined emergencies, ensuring gradual clearance of municipal arrears and
strengthening commitment controls and local public financial management systems, and adopting and enforcing a rule that will ensure permanent fiscal discipline. Enforcing public sector discipline will be key to strengthening financial discipline in the private sector, which will require additional institutional, legal, and judiciary reforms. Montenegro has been improving the dimensions of governance. The comparative governance indicators are largely better than in the rest of the Balkans, but continue to lag Croatia and the other EU member states; hence there remains significant governance agenda for Montenegro (Figure 8).

Figure 8: Worldwide Governance Indicators

![Graph showing governance indicators for Montenegro and other countries](image)


66. **Third, to ensure the sustainability of the financial sector, Montenegro should continue reinforcing bank capitalization and liquidity positions, accelerate the resolution of NPLs, improve supervision, and broaden coverage of financial services.** Further improvements in macroprudential supervision are warranted. Given the vulnerabilities of Montenegro’s banking sector and the country specificities (lending concentration, euroization, and high financial integration), in the medium term a higher minimum regulatory CAR should be considered. Regulation and supervision should be directed to improving internal bank controls and credit risk management and reducing fixed costs. Finally, to broaden financial inclusion and access to financial services by poorer Montenegrins, including payment services, and help to reduce the shadow economy, banks should be encouraged to extend basic services to unserved areas and segments of the population.
Box 4: How to Achieve Golden Growth in Montenegro?

The recent World Bank report, *Golden Growth: Restoring the Lustre of the European Growth Model*, provides insights into what makes the European growth model effective. Its conclusions are consistent with this detailed CEM country analysis. The Golden Growth report shows that EU10 countries (like earlier entrants into the EU) have taken advantage of finance and trade integration as the main drivers of income convergence—the “income convergence train”—in principle awaiting other prospective entrants, such as Montenegro. Indeed, Montenegro’s financial integration with the adoption of the euro, its open capital account, and the almost complete foreign ownership of its banks have provided it with currency stability and access to capital and FDI. But Montenegro has had little success in taking advantage of greater trade and export opportunities. Furthermore, *Golden Growth* shows that to fully take advantage of the convergence train, countries like Montenegro must reform their enterprises, foster innovation, and make their labor markets and the public sector much more flexible and efficient.

Specifically:

“The best way for the countries in Central and South East Europe to contribute to the reinvigoration of the European project is to continue—even accelerate—this convergence. How can this be done? Facilitate trade and foreign investment. Make finance more resilient to crises by both welcoming foreign capital inflows and worrying about them. Improve the investment climate to make sure foreign capital makes the economy more efficient. Make workers more productive through freer enterprise and better education. Make governments solvent by borrowing only for the most-needed public investments. Make government spending more growth-oriented by providing social protection to only the most unfortunate, the old, and the infirm.

“In other words, do what Poland has been doing to educate its young, what Bulgaria has done to balance its books, what the Slovak Republic has done to make its enterprises more productive, and what the Czech Republic and Poland have done to regulate their banks. Do what Latvia has done to improve the conditions for doing business. Do what Estonia has done to keep public debt low, even though it has had to borrow to contribute to the bailouts for those who have been spending money they never had.” (Gill and Sagawara 2012).

Sources: Gill and Sagawara (2012); Gill and Raiser (2012).

67. **Finally, beyond the growth, fiscal, and financial sector sustainability, there is a lengthy agenda for structural reforms—institutional, sectoral, and microeconomic.** In some ways, this agenda, discussed next under the broad headings of connectivity and flexibility, though more difficult is equally important if Montenegro is to reap the benefits of accelerated growth and convergence. In broad terms, Montenegro’s specific growth agenda is similar to that of other European countries grappling with structural constraints to unlock the potential of long-term growth (Box 4). If such an agenda is implemented, per capita income convergence can be much more rapid (Table 6).
Table 6: GDP per Capita Growth Scenarios for Montenegro, EU27, and EU15

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP per capita in Montenegro (2010 EUR)</th>
<th>GDP per capita in EU27 (2010 EUR)</th>
<th>GDP per capita in Montenegro (TFP scenario) / GDP per capita in EU27 (%)</th>
<th>GDP per capita in EU15 (2010 EUR)</th>
<th>GDP per capita in Montenegro (TFP scenario) / GDP per capita in EU15 (%)</th>
<th>GDP per capita in Montenegro (TFP scenario) PPP adjusted / GDP per capita in EU27 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>5,107</td>
<td>25,100</td>
<td>20</td>
<td>29,100</td>
<td>18</td>
<td>10,291</td>
</tr>
<tr>
<td>5</td>
<td>6,389</td>
<td>28,015</td>
<td>25</td>
<td>32,097</td>
<td>22</td>
<td>12,655</td>
</tr>
<tr>
<td>10</td>
<td>8,101</td>
<td>31,269</td>
<td>31</td>
<td>35,403</td>
<td>27</td>
<td>15,563</td>
</tr>
<tr>
<td>15</td>
<td>10,272</td>
<td>34,901</td>
<td>38</td>
<td>39,049</td>
<td>34</td>
<td>19,138</td>
</tr>
<tr>
<td>20</td>
<td>13,025</td>
<td>38,955</td>
<td>47</td>
<td>43,070</td>
<td>42</td>
<td>23,534</td>
</tr>
<tr>
<td>26</td>
<td>17,318</td>
<td>44,446</td>
<td>60</td>
<td>48,446</td>
<td>55</td>
<td>30,163</td>
</tr>
<tr>
<td>37</td>
<td>25,358</td>
<td>56,600</td>
<td>83</td>
<td>60,106</td>
<td>78</td>
<td>47,540</td>
</tr>
<tr>
<td>46</td>
<td>32,763</td>
<td>68,979</td>
<td>102</td>
<td>71,705</td>
<td>98</td>
<td>68,979</td>
</tr>
<tr>
<td>47</td>
<td>33,709</td>
<td>70,512</td>
<td>104</td>
<td>73,124</td>
<td>101</td>
<td>77,554</td>
</tr>
<tr>
<td>50</td>
<td>36,714</td>
<td>75,318</td>
<td>112</td>
<td>77,554</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes: The baseline scenario assumes GDP per employee growing by 2.89 percent with constant employment and activity rates. The TFP scenario assumes an annual 2.4 rate of growth in TFP, as was the case for Ireland. EU27 GDP per capita growth rate is assumed to be equal to the pre-crisis period, 1995-2007 average (2.22%).

Sources: EUROSTAT and World Bank staff estimates.

68. Faster convergence to EU income levels is possible; economies of similar size have already done it. As noted, Montenegro can reach the current EU27 level of GDP per capita after 37 years in the baseline scenario (assuming GDP per employee grows by 2.89 percent with constant employment and activity rates), and in only 26 years in the TFP scenario (assuming higher GDP growth per employee due to the rise in TFP rate of growth to 2.4 percent per year, as was the case for Ireland).  

---

5 EU27 GDP per capita growth rate is equal to pre-crisis period, 1995-2007 (2.22%).
PART II: CONNECTIVITY

A. Why Connectivity Matters

69. **Montenegro is a European country of about 14,000 square km on the Mediterranean with a population of about 640,000; like other small countries, it faces development constraints.** Smallness is of course a relative concept, but development principles that apply to “small countries” certainly apply to Montenegro. The most basic is the fundamental need for connectivity both internally and to foreign markets so that the country can access international trade and international capital markets and benefit from the globalized pool of information, knowledge, and ideas.

70. **But at 11 percent of GDP in 2011, Montenegro has one of the lowest goods export-to-GDP ratios in the world—it is not well-connected.** And if metals exports are excluded, the ratio drops below 6 percent. With regard to goods exports, the Montenegro economy is quite autarkic. Movement across borders is slow and inefficient, and despite the large tourism sector, when services are also considered the export ratio still averaged only about 36 percent for 2007–11. More prosperous small countries have much higher ratios than this. Slovenia, for example, has a ratio of 68 percent, Estonia 78 percent, and Malta 85 percent.

71. **Connectivity depends on more than transport, trade, energy, and even computer and Internet access; skills also matter.** Although Montenegro has one of the highest numbers of cell phones per capita, use of computers in schools is not yet extensive (and not especially productive), and there are problems with Internet connectivity. Also, as documented in the recent World Bank’s Public Expenditure and Institutional Review (World Bank 2012b), few graduates from local universities and local professionals are proficient in foreign languages.

72. In what follows, we set out the **principal conclusions** of detailed analysis of connectivity in this report that were used to formulate the following messages:

- **There is a dire need for export expansion and diversification to open up the economy.** Montenegro’s principal export sectors are metals, tourism, and wine; its export basket is thus very narrow and highly concentrated. With metals on the decline, tourism and wine have become the country’s main export success stories. Both are competitive exports with a good future, but the question is whether they should remain the mainstays of Montenegro’s export industry or whether there are viable export opportunities in other products and sectors.

- **Montenegro has significant opportunities to scale up and expand exports into new areas.** The technique of product space analysis, which investigates opportunities for export expansion and diversification, uses technological and resource-related connections between products to identify opportunities arising from the current trade pattern. Applied to Montenegro, given difficulties in the traditional export industries and the government’s intention to reorient the export pattern, this type of analysis is timely and informative. The analysis confirms the excessive concentration of exports in metals, where opportunities for income growth and export expansion are limited. It also demonstrates that though Montenegro does have opportunities in other merchandise exports, many of which could be linked to the existing tourism-agriculture-energy value chain, these opportunities also have relatively limited income potential.
• **But there is ground for optimism about Montenegrin connectivity.** In international trade a distinction is drawn between comparative, competitive, and locational advantage. Comparative advantage is revealed in the content and pattern of trade when a country moves from autarky to participation in world markets. By contrast, competitive advantage is a culturally based concept rooted in the education, work ethic and other attributes of a population in a given area; this can a source of advantage for Montenegro. It also has a favorable location close to European markets. There is therefore every reason to believe that Montenegro can resolve its connectivity issues.

• **Skills and human capital will be central to improving connectivity.** Presently, investment in human capital is misdirected because of past conceptions of labor demand and economic structure. If there is to be export expansion and diversification, the preferences of Montenegrin students and the courses available need to be changed to emphasize the skills and knowledge required by the private sector. Presently the higher education system is based on a presumption of government employment. Vocational education needs to be changed to better accommodate the labor market skills in demand. Until educational preferences change, students will not be educated in ways that are consistent with realization of high-income comparative advantage. Montenegro certainly cannot afford to be a low-wage economy, especially given the incentives for emigration of skilled labor. Human-capital complementarities increase incomes, connectivity, and economic growth.

• **Montenegro could improve connectivity through horizontally and vertically integrated multinational firms by making further, major improvements in the investment climate and—importantly—clearly separating politics and economics.** Montenegro has lately improved its investment climate and its ranking in Doing Business at 51 places it in the top 25 percent of world economies in the ease of doing business. But a large share of foreign direct investments it attracted has been in purchases of real estate and not greenfield nor productive investments. Multinational firms have been reluctant to consider Montenegro as a production location or a research and development center. From a political-economy perspective, multinational firms are a challenge to domestic political discretion. Montenegro is competing with many other prospective locations for investment, and multinational firms will choose locations where the investment is most conducive to non-politicized economic activity.

• **Infrastructure—transport, energy, and ICT—are central to physical connectivity, expanded trade, and enhancing the attractiveness of Montenegro as a tourism, ICT, and investment destination.** The analysis of internal (within country) connectivity spotlights information and transportation infrastructure as being at the heart of domestic regional integration. It highlights the importance of the quality and safety of road infrastructure and opportunities from improved railway for regional connectivity.

• **Energy connectivity needs to be improved both internally and within the region.** Energy is recognized as a major infrastructure constraint on the investment climate and growth of small and medium businesses and thus a challenge for government policy. But with new investments and expanded supply, energy could also become an important export industry over the long term. To fully take advantage of this opportunity, Montenegro’s links with the regional energy markets will need to be strengthened and the important project of the undersea cable with Italy completed.

• **Information and Communication Technologies (ICT) and innovation offer huge opportunities for a small country like Montenegro and it could provide an important feedback loop to its knowledge and skills agenda.** ICT can help strengthen the country’s competitiveness, investment climate and innovative capacity, and position Montenegro as a vibrant innovation hub linking the Balkans (and Montenegro’s industries) to the rest of Europe and global value chains for tourism, industrial manufacturing and other sectors. The analysis suggests that smart investments in ICT infrastructure and related skills, especially in broad band,
open data, and e-commerce can have huge payoff in terms of growth and high-wage jobs in these sectors. Montenegrin firms investing in R&D tend to grow faster than non-innovating firms and investments in training and (hard and soft) infrastructure can help spur greater innovation and growth.

- **Connectivity through integration into the European Union (EU) holds promise—but not a guarantee—of gradual income convergence with core European countries.** The EU markets offer Montenegro opportunities to connect with the larger markets beyond its borders. How Montenegro responds—in advancing its remaining structural and institutional reform agenda towards maximum sustainability, flexibility and connectivity, not just completing the various accession chapters—will decide whether the opportunities eventually become sources of gain.

- **Montenegro must also better integrate itself into the Western Balkan region.** Although Montenegro was traditionally part of the wider regional market, trade restrictions, especially nontariff barriers, have segmented Western Balkans markets. Although there has been progress in reducing tariff barriers and integrating into the WTO, regional governments, including Montenegro, still retain nontariff barriers that stifle opportunities for more dynamic regional trade. Moreover, restrictions on international trade often protect domestic monopolies.

- **The role of government and political economy influence connectivity.** In a market economy with private property rights, government can influence incentives but cannot directly implement or “command” connectivity. Connectivity in a market economy requires a change in political culture: There should be a clear separation—an enforced “firewall”—between holding a government office and seeking personal gain through business decisions. This goes beyond the issue of corruption, which itself should be rooted out as a matter of priority in governance reforms. Such ambitious reforms should lead to a public sector populated by public servants focused squarely and solely on public interest and most efficient delivery of services to the citizens. Georgia is an example of a country with many more constraints than Montenegro that was able to implement successful governance reforms and, as a result, attract worldwide attention. Credible evidence of such clear separation between politics and business will encourage the foreign investment and multinational activity that are necessary to bring about the openness that Montenegro needs for prosperity.

- **Finally, Montenegro would be advised to learn from the success of others.** Though such models of rapid development may be rare in the south Mediterranean area, to the north there are successful economies that previously had an ownership and management structure similar to that of Montenegro, as well as a similar tourism sector. The lesson from this economy and others that have achieved high income is a focus on education and human capital and integration into the world market. Estonia is an example of how fast expansion of connectivity and openness can be following a tumultuous independence transition. Similarly, Ireland offers an example of how a small country with few resources can make itself a highly attractive place to do business, innovate, and invest. With concerted effort by key actors in Montenegrin society, especially the government, the payoff in dynamism and development can be massive.

### B. Expanding and Diversifying Exports

73. **At present, Montenegro is not using the principal growth engine—exports—that has transformed many small countries, especially those with significant locational advantages.** Montenegro is not nearly as open or connected as it needs to be, internally or externally, in order to activate that growth engine. Its exports are the lowest in the Western Balkans except for Kosovo, and very low compared to most small-state comparators. An outcome consistent with the trade participation and
high incomes of other small countries requires more, and more diverse, exports. Expanded exports will also drive expansion of not only imports but also knowledge, skills and resources, creating a virtuous circle of openness. So exports—not just FDI—need to be brought to the top of the government’s and society’s development agenda.

74. **There are thus critical development questions for Montenegro:** What does Montenegro export? What is the income potential of its exports? Why is the export structure a constraint on development? And how can export expansion be achieved? The CEM detailed analysis of exports, energy, transport, ICT and some institutional constraints, summarized here, suggests the elements of an answer.

75. **Because Montenegro’s export basket depends so heavily on traditional metals exports whose potential is dissipating, export expansion will depend on diversification.** Presently, a significant share of exports is associated with the socialist heritage—so much that Montenegro’s limited exports are dominated by a few large firms that still are, or were until recently, state-owned.

**Principal Export Sectors**

*Metals*

76. **The aluminum plant, once the crown of Montenegrin industry, appears to be operating with negative value-added at international market prices.** Employment there has been declining but it is still in operation because a complete and sudden closing would have heavy political costs. The lack of investments, the build-up of arrears to the electricity company, and loan guarantees that the Montenegrin government provided when the plant was sold to a foreign investor cloud its future. With negative value-added and its current technology, the plant cannot be the source of export expansion. The government has proposed to search for investors who will use the aluminum produced to make higher value-added products closer to final consumption—but in the present circumstances, it would be more efficient for the economy as a whole to import aluminum to be used as inputs. Inevitably, expanding Montenegro’s exports means expanding into nontraditional exports.

77. **Niksic Steel and other privatized metal-related factories export their output.** While the recent sale of Niksic to the Turkish steel company Toscelik may indeed promise a new start, it is not evident that such factories, given their capacity and technological limitations, can become the foundation for long-term, large-scale expansion of exports that will open up the Montenegrin economy.

*Tourism*

78. **Tourism is a major source of growing earnings and economic success in Montenegro and it will continue to be so.** Tourism, which is based mainly in the coastal region, offers the usual summer type of “sea—and-sand” leisure, plus casinos. Old coastal towns like Budva, Kotor, Herceg-Nov, Perast, and Petrovac are regional attractions. The national and royal capital Cetinje also attracts tourists, as do ancient monasteries like those in Cetinje, Morača, and Ostrog. According to the latest economic impact research from the World Travel & Tourism Council (WTTC) and Oxford Economics, Montenegro is expected to be the fastest-growing travel and tourism economy in the world over the next 10 years in terms of contribution to GDP and employment. In 2010 the total contribution of tourism to GDP, including indirect and induced impacts, was 15.7 percent. According to the WTCC, by 2021 this share is projected to more than double to 36.3 percent—an increase of 12.4 percent annually for the next 10 years.

79. **Commendably, although for the foreseeable future large-scale tourism will continue to have a role, the government aims to steer the growth toward high-end tourism.** For example, the Mediterranean’s newest mega-yacht marina is Porto Montenegro in the coastal town of Tivat, owned by Canadian investors; now fully operational it has transformed the local economy. Nearby an international-
quality golf course is being built. The government has also signed a long-term investment agreement with Swiss-based Orascom to build an extensive complex of 5-star hotels, a golf course, and related tourist facilities on the Luštica peninsula.

80. **Yet there are limitations to relying on tourism for economic development, such as road infrastructure and the capacity limitations of the coastal airport at Tivat.** Furthermore, tourism employment is significantly seasonal, concentrated in the South and Central areas, and consists primarily of relatively low-skilled, numerous jobs for hotel staff and waiters and cleaners and fewer, higher-level skilled position, calling for language abilities for receptionists and the culinary skills of cooks, not to mention management skills. But Montenegrins do not seem to take advantage of even the present seasonal employment opportunities. The workers come principally from neighboring countries, which suggests that wages are too low to be attractive to Montenegrins—including students, who rarely use the summer vacation to take jobs in tourism, wine, and agriculture. This is unlikely to change overnight, which raises the question of where Montenegrin graduates and entrants into the labor market will find jobs.

81. **Tourism also introduces the possibility of problems in relations between local government and private investors that elsewhere have been problematic.** Government officials determine the conditions of entry into the tourism industry for foreign investors through zoning and provision of infrastructure. Negotiations about the contributions of local government and the provision of land are often not transparent. With poor governance or management of the growth of tourism or because of the consequence of the external financial crises, major local development projects and potential tourist assets could become liabilities. The construction boom and bust of the town of Budva shows why growth of tourism must be managed carefully and apolitically.

82. **Tourism has remarkable potential for diversifying by strengthening its links with agriculture, transport, and logistics.** But because tourist demand is seasonal, productive capacity will not be utilized year-round. Such issues as business planning for future tourist facilities are best resolved—within a clear and transparent spatial and regulatory environment—by private entrepreneurs and firms making decisions about the profitability of investments.

### Wine

83. **A state-owned wine producer is an export success on demonstrating that an even stronger wine export industry, including many small private producers, could thrive.** The company has been well-managed and among consistent profit makers and leading exporters; its wines are beginning to be sold in many more countries. The long tradition of winemaking in some areas of Montenegro is a natural basis for this activity. Ownership of vineyards by wine producers has significant environmental and touristic benefits and could stimulate development of the private wine industry—already emerging—in previously rural areas (e.g., Crmnica, Danilovgrad). The state company is planning to expand exports to even more new markets, such as China, and move to higher-value-added wines.

84. **But with limitations of land and capacity, wine cannot be the sole source of major export growth, although it will certainly contribute significantly.** Also, with the exception of a few skilled experts and management, wine production employs primarily unskilled labor, which cannot be the basis for Montenegro’s desired transition to a high-income economy. With the decline of the metals industry and constraints on growth and incomes in tourism and wine, what new export opportunities are there for Montenegro to diversify? To answer this question, we conduct the first product space analysis on Montenegro’s exports to ascertain the income, growth, and diversification potential of the existing and potentially new exports. The analysis identifies potentially promising, new products and sectors that can drive the necessary export expansion and diversification.
85. **Product Space (PS) Analysis** provides a measure of “proximity” between pairs of goods by observing global trade data and patterns of revealed comparative advantage for countries (Figure 9). For example, the proximity between two agricultural products is high if the inputs (e.g., land) used for the production of one (e.g., pears) can also be used for others (e.g., apples) at relatively low cost. Likewise, the proximity between two consumer electronics products should be relatively high. On the face of it, apparel’s proximity to agricultural products might be greater than its proximity to electronics, just as proximity between auto parts and electronics is greater than between auto parts and agricultural products.

**Figure 9: Illustration: Proximities Across Goods in the Product Space**

![Diagram of Proximities Across Goods in the Product Space](image)


86. The **PS model** can reveal the extent to which a country’s knowledge and capital can be adapted for use in structural transformation—in other words, how “nimble” the local economy and its inputs are in shifting to new export opportunities. The model is based on the principle of similarity in production functions and mobility of inputs. It may reveal vertical links between sectors, as for example between tourism, agro-processing, and transportation. The aim of the PS analysis is thus, given initial PS positions and production transformation trends, to identify the sectoral diversification that has the most potential for a country’s export growth.

87. A country may, for example, be specialized in low-value-added industries or products for which world demand is declining, suggesting avenues for diversification. Ideally, through market responses (and government regulation), the product mix should then adapt to higher-value industries and expanding export markets. Figure 10 shows an example of how an economy can form clusters across the 785 products in the Standard Industrial and Trade Classification (SITC Rev. 2).

88. The **global experience and research findings** show that a country’s PS export position is highly correlated with its GDP per capita and that the level of income is determined by capabilities, technology, and resource endowments. Because of differences (“heterogeneity”) in the distribution of capabilities across countries, those with small populations whose capabilities are limited can be expected to experience only minor diversification gains if only a few capabilities are added. The structure of the PS also has implications for technology and geographic links, transfers, and spillovers. For example, the probability that a new product will be added to a country’s export basket has been found to be on average 65 percent higher if a neighboring country is a successful exporter of the same product—countries can learn from each other. Moreover, technology diffusion is stronger the shorter the geographical distances (proximity matters), weaker for more knowledge-intensive products (adding value with knowledge
products is difficult), and has speeded up over time (countries are competing in new products and markers more intensely than ever before).

89. **PS analysis produces empirical measures of relatedness between products and income levels for individual products.** Thus, a diversification strategy should increase competitiveness in product categories that are within reach and that offer more scope for further diversification—which in the PS terminology are referred to respectively as products with higher density and with higher paths. Goods with higher income potential (PRODY) increase GDP per capita.⁶

**Figure 10: Proximities Across Pairs of Goods in the Product Space**

![Diagram of product space](http://www.chidalgo.com/productspace/network.htm)


⁶ PS is a stepwise methodology. For the case of Montenegro, because data are lacking for a long time series of exports, products cannot be categorized by structural shifts in revealed comparative advantage (RCA), as has been done in several other World Bank studies. However, even without time-series data, the concept of density can be used to rank products according to the country’s capability to export. Products can also be ranked according to prospects of further diversification (path) and associated productivity level (PRODY). Products with a high density, high path, and high PRODY are the best candidates for export diversification. The empirical structure of the PS tends to show a negative relationship between the concepts of density and PRODY and density and path, and a positive relationship between PRODY and path. The PS thus reveals the difficulty of formulating a successful development strategy when products that are highly profitable are not within easy reach, while nearby products have limited scope for diversification and growth.
C. Application of Product Space Analysis to Montenegro

90. The PS methodology was applied to bilateral trade data for Montenegro from 2006 to 2011. Because of the short export series, however, inferences had to be made from (i) the export basket’s associated productivity level (prody and EXPY); (ii) the scope for further diversification (path); and (iii) the strength of comparative advantage (density).

91. The data confirm Montenegro’s fundamental export problem: high concentration in metal products that have little value-added and little technological sophistication. The category of unwrought aluminum and aluminum alloys accounts for 60 percent of merchandise exports, followed by wine from fresh grapes (5 percent), and coniferous wood (3 percent). Metals—aluminum, iron, and nonferrous metals—account for two-thirds of all goods exports. Clearly, traditional industries dominate Montenegro’s export structure.

92. Comparatively, Montenegro has the highest export concentration in its region, though neighboring Balkan countries are not particularly well-diversified either. Figure 11 shows that the 6 largest export categories accounted for 75 percent of Montenegrin exports and the next 84 for only 22 percent. The Herfindahl index of concentration of exports (0.37) is much larger for Montenegro than for neighboring Albania (0.05), Slovenia (0.03), or Bosnia and Herzegovina (0.02), indicating less diverse exports.

Figure 11: Concentration of Montenegro’s Exports


93. The level of concentration of merchandise exports in Montenegro is also high compared with the comparator group of small countries. Its Herfindahl index (0.37) is substantially above the median (0.17) and the average (0.26) for all small countries. Yet prosperous small countries such as Malta, Cyprus, Ireland, Singapore, or Estonia have well-diversified export baskets, not only in terms of the number of products, but also in their technological content (Figure 12 - Figure 13).
94. **In Montenegro government and the private sector should be concerned about the structure of the export basket because exports can drive competitiveness and economic growth.** Export diversification and sophistication have proved to be prerequisites for sustained episodes of economic growth. Growth over the long term cannot be explained as simply the consequence of the accumulation of aggregate factors of production, such as labor. Countries that have grown successfully have done so by acquiring capabilities that allow them to introduce more and newer goods into foreign markets. Figure 14 shows the relationship between the sophistication of the export basket (measured by the Log of EXPY) and its relationship with GDP per capita for 138 developing and developed countries. Clearly small countries do not necessarily rely on a few unsophisticated exports. Producers and entrepreneurs in Montenegro can learn from successful experiences to take into account the opportunities of export markets.
Figure 14: Export Sophistication and Economic Development

Source: Osorio-Roddarte and Bogetić (2012).

Figure 15: Montenegro: A Dearth of Income-Enhancing Products

Source: Osorio-Roddarte and Bogetić (2012).
Moreover, Montenegro’s few merchandise exports have relatively little income potential. What this means is that even if Montenegro could expand the current export structure significantly, it would not bring in much additional revenue or create many jobs. In Figure 15 red and blue dots are products that Montenegro currently exports (gray dots are not produced by Montenegro). The negative relationship between PRODY and the inverse of density indicates that products that are within reach (left on the x-axis)—“low-hanging fruit,” given Montenegro’s export structure—unfortunately do not have much income potential (above on the y-axis). Also, products that are income-enhancing (above the red line, where PRODY is greater than EXPY) are not easily “reachable” in terms of the density of Montenegro’s exports. Moreover, exported products for which Montenegro has revealed comparative advantage (RCA > 1) are sparse in the product space and often located in the difficult-to-reach periphery of the PS (Figure 16-Figure 17).

**Figure 16: Montenegro’s Position in the Product Space, part 1 of 2**

![Montenegro's Position in the Product Space, part 1 of 2](http://www.chidalgo.com/productspace/network.htm)

Montenegro’s economic diversification potential can be classified into three main groups with very different income potential (Table 7).

- The first group consists of dominant, traditional merchandise exports, aluminum and iron, that according to the PS metrics could in principle offer relatively large income potential, but only with significant additional investments and a major move up the value chain. The argument behind providing additional support to aluminum and iron has been associated with gains in diversification. It is true that technological advances and the new wave of industrialization of East Asian countries have imprinted dynamism and demand for aluminum and iron; nevertheless, for Montenegro the risk of failure is high given current uncertainty and falling prices in international markets, its small number of products, their low technical content, and the fact that these heavy industries need large investments to modernize equipment, strengthen supporting infrastructure, and ensure cheap energy.

- The second group consists of other products in food and agro-processing, hides and skins, wood processing, and miscellaneous manufactures. While the relative low value of PRODY indicates that on average these sectors have limited income potential, especially hides and skins, the value of density indicates that their potential for Montenegro is relatively substantial. Of special interest
is a subgroup of 18 products with high density and revealed comparative advantage that could satisfy the domestic market, especially in the food category, if the products were appropriately linked to tourism (Table 7). This suggests an important opportunity for Montenegro to expand existing and develop new agricultural and food exports; if linked with related sectors, multiplicative effects on growth and jobs could be substantial, especially in the relatively underdeveloped areas of the country. Although machinery is the product group with the highest income potential and the most options for diversification, here Montenegro is weak in PS density, meaning that these products have only tenuous backward and forward linkages with Montenegro’s current export structure.

Table 7: Montenegro: Exports, Comparative Advantage (RCA), Links with Export Structure (density), and Income Potential (prody)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Number of products</th>
<th>Products with RCA&gt;1</th>
<th>Imports 2006-2010 ('000 USD) (% of total imports)</th>
<th>Exports 2006-2010 ('000 USD) (% of total exports)</th>
<th>Prody Path Density</th>
<th>Export Destinations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aluminum</td>
<td>2</td>
<td>1</td>
<td>119 (0.001)</td>
<td>1,260,879 (61.1)</td>
<td>18,680</td>
<td>136</td>
</tr>
<tr>
<td>Mining, metals, raw</td>
<td>11</td>
<td>7</td>
<td>328,491 (2.5)</td>
<td>135,710 (6.6)</td>
<td>10,781</td>
<td>112</td>
</tr>
<tr>
<td>Manuf Iron</td>
<td>7</td>
<td>4</td>
<td>55,615 (0.4)</td>
<td>111,352 (5.4)</td>
<td>15,528</td>
<td>151</td>
</tr>
<tr>
<td>Food</td>
<td>24</td>
<td>11</td>
<td>646,269 (5)</td>
<td>246,276 (11.9)</td>
<td>12,709</td>
<td>127</td>
</tr>
<tr>
<td>Hides</td>
<td>4</td>
<td>2</td>
<td>187 (0)</td>
<td>20,644 (1)</td>
<td>7,860</td>
<td>118</td>
</tr>
<tr>
<td>Wood</td>
<td>14</td>
<td>5</td>
<td>29,131 (0.2)</td>
<td>117,685 (5.7)</td>
<td>12,687</td>
<td>133</td>
</tr>
<tr>
<td>Misc.</td>
<td>9</td>
<td>2</td>
<td>-</td>
<td>15,983 (0.8)</td>
<td>14,324</td>
<td>133</td>
</tr>
<tr>
<td>Machinery</td>
<td>22</td>
<td>2</td>
<td>-</td>
<td>91,705 (4.4)</td>
<td>19,510</td>
<td>144</td>
</tr>
</tbody>
</table>


- The third group is tourism and the related service chain, such as transport, energy, and logistics but also modern digital and IT services. The potential for exports here is significant but it will depend critically on how well it is linked with the second group of new exports to exploit synergies and stimulate productivity.

D. Conclusions from Product Space Analysis

97. Montenegro has substantial export potential in tourism, wine, food, energy, and a number of newer products. Exploiting that potential will require a government strategy, but the government should limit its role to dismantling barriers to exports, whether physical, infrastructure, regulatory, or institutional; and ensuring greater connectivity with external markets—physical, informational, and institutional. The analysis could be useful in informing private sector and export associations and international and domestic chambers of commerce about likely opportunities for future export expansion and diversification.
98. The analysis should not be interpreted as a call for a state-led export push, with state subsidies to identified sectors; this would carry substantial risk of failure and capture by special interests. The terminology of PS analysis describes “countries” (not governments per se) as bodies guided by the data to adopt “export diversification” strategies. Since Montenegro is predominantly a market economy based on private ownership, comparative advantage can therefore only be realized through the private sector’s evaluation of the profitability of investments. Private commercial enterprises do not need subsidies for success and taxpayers should not be underwriting private risks and enterprises. The government role in increasing exports should be limited to promotion of Montenegro’s brand through its diplomatic and commercial representations abroad, using its convening power, and ensuring maximum regulatory transparency and ease of doing business and exporting. This is a tall order for governments of much larger countries; if Montenegro can be effective in these areas, the export supply response is likely to follow, as it has in other small and now prosperous exporting countries.

99. The PS analysis can, however, help guide the private sector in choosing how to use accumulated expertise and experience in different ways. The information from the analysis can also act as a signal to the private sector as to where comparative advantage might lie and where producers might succeed in global markets. Government assistance in the export area should be limited to improving the enabling environment and bringing Montenegro’s exporters and exports to the attention of potential markets. Finally, it is important to recognize that the above analysis is just one tool in ascertaining opportunities for more effective opening up and connectivity, based on the notion of comparative advantage and product space analysis. To understand and identify other components of success in ensuring greater connectivity of Montenegrin economy, one must look beyond exports into other concepts such competitive advantage and the role of human capital, multinational firms, and infrastructure—especially transport and energy.

E. From Comparative to Competitive and Locational Advantages

Comparative Advantage

100. Comparative advantage is a concept based on the expected change in an economy when a closed economy, such as Montenegro, becomes more open to free trade. Traditional predictions of comparative advantage look to a country’s factor endowments, technological advantages, and economies of scale and scope. The focus in such predictions is often on industrial output, but as the Western world deindustrializes, it is difficult to find standardized products in which high-wage Western countries can compete with production in China and other low-wage countries. The competitive dimension on which high-wage economies succeed is knowledge, and the use of the input of human capital and human imagination.

Competitive Advantage

101. Whereas comparative advantage looks to purely economic aspects that underlie competitiveness, competitive advantage is a cultural concept that explains why countries with the same resource endowments and similar access to technology fare differently. In a world of quite liberal trade and capital mobility, domestic and foreign investment decisions are guided not only by labor costs but also by the culture of the workforce and the society in general, including respect for the rule of law and property rights protection, the level of trust in society and the private sector, and the prominence or absence of a work ethic. All these aspects of the cultural framework for economic activity determine the productivity with which resources are used and thereby the economic prosperity of a given country.

102. Competitive advantage also reflects the degree of objectivity and a legal system that is not politicized. Evidence that a private firm or person challenging the government in court has an objectively
fair chance of success, for example, is a component of competitive advantage. Competitive advantage requires in particular separation of political behavior from quests for profit in the private sector. Many studies show how incentives for rent-seeking through the use of political prerogative undermine national competitiveness. In particular, small and medium-sized firms can be inhibited from expanding if there is no clear demarcation between political prerogative and economic activity.

103. **Importantly, Montenegro can build a competitive advantage over many countries if it invests in skills, innovation, and a depoliticized business environment.** The presence of a motivated, skilled, and reliable labor force is a basic element of competitive advantage, but it is facilitated by reduction of political risk for investors. This report takes the view that Montenegro cannot afford to be a low-wage economy. If wages in Montenegro remain low, people with entrepreneurial skills and prospects will have an incentive to leave for higher wages elsewhere. Montenegro therefore needs to build knowledge-based industries.

104. **The basic human capital is available in Montenegro but it appears that investment of it is misdirected.** The recent World Bank PEIR report including an analysis of education and skills puts it right: a basic problem in Montenegro is that of quality of education and its efficiency. That report, as well as the CEM analysis of the investment climate detailed in chapter 3 below show that there is a mismatch between skills and an educational system that is not yet adjusted to the needs of global competition. CEM-related research and extensive field consultations suggest that this educational maladjustment may reflect, in part, the persistence of cultural presumptions about human behavior. Specifically, in the socialist past, the omnipresence of government in the economy made a public-sector career a natural first choice for many people, especially the more capable. The culture that presumes that public-sector employment is preferred is reflected in the fact that Montenegrin students are still heavily biased toward subjects that prepare them for such a career. Yet if anything the government and public sector must become leaner and more efficient so it will be providing fewer employment opportunities. Moreover, foreseeable fiscal constraints on the public sector also suggest that expansion of the public sector cannot be a basis for growth in Montenegro (World Bank 2012b).

105. **Montenegrin student preferences therefore need to be directed to more practical skills and the knowledge demanded by the private sector, domestic and foreign.** Computer science; physics and chemistry; electrical and mechanical engineering; maritime skills; advanced economics, including finance and Western accounting and auditing methods; and business studies incorporating marketing, data processing, and data management are growth professions with high payoffs in high- and middle-income countries today. The reality is that until educational preferences change, students will not be educated in areas that are consistent with realization of high-income comparative advantage. In more technical terms, comparative advantage is endogenous to the type of factor endowment created by investment in human capital and the knowledge base of the population. Firms will increasingly employ Montenegro’s students and through production and communication provide connectivity with international markets when employees with the attributes they need are available—provided that entrepreneurial initiative is not stifled by government bureaucracy and political intervention, such as a requirement for political and bureaucratic permission to engage in economic activity.

106. **Vocational education is also important, especially for encouraging the small and medium-size businesses at the heart of job creation in dynamic countries.** It is instructive that European countries that have institutionalized vocational training programs for apprenticeships in export industries (e.g., Germany) have the lowest rates of youth and general unemployment. Having said this, compared to more traditional three-year vocational schools, four-year vocational programs and a delayed entry into vocational practical skill-building experiences and programs better provide the students with improved chances of success in the labor market.

---

7 On political risk and investment, see Busse and Hefker (2007).
107. Student preferences could be directed toward modern skills and higher-wage opportunities in the private sector. First, High school and college students can be systematically provided with guidance regarding the income-earning prospects in the private sector available from choosing different fields of specialization, and university curriculum can be made more flexible and tailored to the forecast demand for skills. Second, the government should make it clear that rather than envisaging increases in government employment in coming years, it expects that there will be fewer government jobs because of a more modest role for government and an emphasis on private initiative, exports and attraction of international firms. Third, as a direct measure, the government should significantly limit enrollment of students in the state university in traditional courses like humanities and political sciences as part of a broader repositioning of its educational system (World Bank 2012b).

Locational Advantage

108. Montenegro also has the advantage of a favorable geographic location close to EU markets, and, as a candidate country, a future path to convergence with EU incomes and eventual membership (World Bank 2012a). Studies based on gravity models of international trade show that countries tend to trade disproportionately with neighbors. The European Union is not only a very large neighbor but a source of knowledge, finance, and trade opportunities. Montenegrin producers have access to European markets. Montenegro’s use of the euro reduces the transaction costs of trade and investment. Moreover, using Montenegro’s locational advantage, it could make much more concerted effort to attract major multinational companies and intensify its trade links with the neighboring region and the European Union.

Multinational Firms

109. Connectivity in successful small countries is provided by horizontally and vertically integrated multinational firms. For example, a recent study of Singapore, Finland and Ireland (Sifire, for short) (Yusuph et al. 2011), shows the importance of connectivity of these countries to world markets, including via links to skills and multinational companies operating in its territory. Multinational firms are the repositories of and sources of advancement in knowledge and also account for substantial amounts of international trade through shipments of intermediate inputs as well as sales for final consumption. Established international companies such as Ikea, Nestle, Nokia, Samsung, and large major hotel chains are examples of large international employers which all operate in sectors in which Montenegro’s labor skills and location could prove potentially attractive. Yet, so far, they have not chosen Montenegro as a location for production, exports, or research and development. However, if the necessary knowledge-based skills were available—particularly proficiency in English and other major foreign languages—Montenegro would be more attractive to multinational firms. Once the skills and human capital are available, demand can be expected to arise and wages to increase—at least as there are no political or bureaucratic impediments.

110. Multinational firms challenge domestic political discretion. If Montenegro is to become attractive to multinational firms, there must be a clear separation between politics and economics. A major multinational will not come to a country where a domestic business owner uses political connections to monopolize an activity, industry, or location. That this has happened at times in Montenegro is common knowledge. So the question is what the government, other institutions, and civil society will do to change these perceptions. Montenegro is competing with many other prospective locations; multinational firms will choose to locate where the investment is most conducive to non-politicized economic activity.
111. **EU membership is a Montenegrin government objective.** Though it would increase access to European resources and programs, however, the benefits previously enjoyed by other southern European countries may not be available to Montenegro. Being an EU neighbor, or even a member, has not prevented other countries from confronting serious economic difficulties. EU markets offer opportunities, not sinecures. Moreover, EU taxpayers are being asked to participate in subsidizing countries within the union where banks have encountered financial difficulties. Currently, the Montenegrin taxpayers avoid this bailout burden because Montenegro is neither an EU member or in the formal euro zone.

112. **Montenegro shares history and language with many of its neighbors.** The commonality of language lowers transaction costs and encourages trust and is also a basis for large tourism and other links with the broader region. In that sense, despite their own development constraints, the countries of South East Europe do provide a large market beyond the small domestic market of Montenegro. There are also historical ties and links that are the basis for maintained business connections.

113. **But the market of the former Yugoslavia has become fragmented because of trade restrictions, particularly nontariff barriers to free movement of goods.** Some of these remain Montenegrin barriers to trade that need to be dismantled, either unilaterally or through negotiation. Among the barriers are product quality standards, product marketing (including branding), inefficiency in customs and ports, licenses, certifications, and sanitary and phytosanitary regulations (in both Montenegro and its neighbors). Many of the barriers are informal, no more than border crossing delays and at times insistence on payment to verify the documentation of goods shipments. The tradition of consumers in markets of the former Yugoslavia buying goods from other former-Yugoslav countries offers an opportunity for connectivity through regional specialization in trade if not impeded by artificial barriers.

114. **International trade restrictions often sustain domestic monopolies.** Protection of monopoly often requires political acquiescence, which keeps politics active in the economy. Barriers to entry that sustain domestic monopoly also disallow entry of new producers with an eye beyond the limited domestic market. Sustained domestic monopoly, therefore, inhibits connectivity and in a real sense stifles Montenegro’s development.

115. **Montenegro consists of three distinct regions:** the coastal tourist areas, the developed center of the country where both the former and the present capital cities are located, and the rural and mountainous north. For a small middle-income European country Montenegro is poorly connected internally as well as externally. Railway links require investment to increase average speed. In the winter, long delays in traffic on the motorway linking the center and the north often effectively cut off access to the north for hours, days, even weeks when winter conditions are extreme.

116. **The famed black mountains, canyons, and white-water river rafting in the north are a tourist attraction.** Current tourist capacity in the north could not accommodate the type of mass tourism of the coastal region and mass tourism is not ecologically feasible, but a modest increase in tourism would not be environmentally disruptive. Incomes there would be significantly enhanced; although the tourism is seasonally based, in the winter there are skiing attractions.

117. **The main road leading to the north from the capital is narrow and dangerous in winter.** Expanding it would be extremely costly because of the terrain; perhaps more important, it is undesirable to disrupt the natural pristine beauty that is the attraction for tourists.
118. In some areas, rail transport might be preferable to the ecological disruption of road construction. The rail line between the northern Montenegrin port of Bar and Serbia is being upgraded. Fast and efficient train service would significantly increase the tourism potential of the north in addition to ensuring more efficient transit of goods from Serbia and through the port of Bar (and vice versa). An efficient rail link to Podgorica airport could also attract tourists and shift some of the peak tourism transport from roads to train. The model in this case could be Switzerland, where the terrain is similar to the mountains of Montenegro and rail is used extensively for tourism.

119. One of Montenegro’s greatest assets is the diversity of its physical resources. However, efficient, fast, reliable, reasonably priced, and seamless infrastructure connections are indispensable for effective exploitation of natural resources and production complementarities and the free flow of goods and services. Thus upgrading infrastructure is crucial to improve productivity and trade competitiveness.

120. The resumption of economic growth in recent years has exerted significant pressure on existing networks and is rapidly unmasking transportation and energy deficiencies. The substantial deficiencies in Montenegro’s infrastructure networks are major bottlenecks to economic growth and international competitiveness.

The General Case for Infrastructure Connectivity

121. A large number of studies have uncovered solid empirical evidence of the important economic benefits of infrastructure in general. The impact of regional infrastructure—i.e., the additional economic benefits of connecting national infrastructure networks and regionalizing infrastructure reform—has not been as extensively analyzed (see Box 5).

<table>
<thead>
<tr>
<th>Box 5: Regional Infrastructure in the Integration Process</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Attracts investments to the region</td>
</tr>
<tr>
<td>• Helps to eradicate poverty</td>
</tr>
<tr>
<td>• Promotes intra-regional trade and cooperation</td>
</tr>
<tr>
<td>• Promotes value addition to raw materials</td>
</tr>
<tr>
<td>• Enhances the competitiveness of the region</td>
</tr>
<tr>
<td>• Contributes to attainment of the Millennium Development Goals</td>
</tr>
<tr>
<td>• Enhances peace and security</td>
</tr>
</tbody>
</table>

122. There is an important reciprocal relationship between infrastructure, regional economic integration, and globalization. Efficient infrastructure is necessary if globalization and regional integration are to achieve their full potential to expand and integrate markets, exploit economies of scale, and attract foreign direct investment and technology. Indeed, driving forces behind globalization are lower barriers to trade and investment and lower transportation and communication costs. Efficiency improvements in transportation and the application of modern information and communication technologies have facilitated geographic dispersion of production processes. A much larger number of dispersed production units can participate, contributing to the value-added chain according to their
comparative advantage. Thus the opportunities of individual economies to participate in international production networks have been broadened considerably. The development of regional markets, in turn, creates interdependencies that increase demand for infrastructure—infrastructure networks are the conduits through which these flows move.

E.3. Transport Connectivity

123. Transportation infrastructure is especially central to regional integration for Montenegro. Traded goods flow through roads, railways, inland waterways, ports and airports—as do people seeking to take advantage of attractive services or job opportunities in other nations. An efficient and integrated transport system thus facilitates trade and factor mobility. An integrated communications system also can spur the growth of trade and reduce costs by enhancing the accessibility and affordability of information, facilitating long-distance transactions, and linking the region with the rest of the world. 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, as was evidenced by obvious severe transport bottlenecks during the summer season. Based on a detailed analysis of the sector’s strengths and weaknesses (Banjo 2012), this section reviews the sector’s performance within the broader logistics and trade complex, the government’s approach to transport development and identifies remaining issues in enhancing Montenegro’s transport connectivity.

Logistics and Trade

124. Montenegro performs relatively well on a number of measures of trade facilitation but there is clear room for improvement. The Doing Business 2013 index puts the country at 51 in the world, up six places from 2012, ahead of neighbors Albania (85) and Kosovo (98). For the sub-index Trading Across Borders, the country is ranked at 42, down eight places from 2012. In the 2012 Logistics Performance Index (a composite of measures related to customs, infrastructure, international shipments, logistics competence, tracking and tracing, and timeliness), Montenegro ranks 120 out of 155 countries with a score of 2.45. This is very low for a middle-income country with Montenegro’s geographic advantages and development aspirations. Weak areas are tracking, with a score of 2.62, and timeliness at 2.89 respectively. On the infrastructure pillar, overall rating is 107 from a score of 3.5, with road infrastructure rated 99, rail 58 and port infrastructure 100. Figure 18 illustrates that inadequate infrastructure is the most problematic factor for Montenegro doing business.
Despite relatively well developed road network, transport in Montenegro suffers from a number of weaknesses. Poor maintenance and road safety are major issues. While the indicators of physical coverage of the road network are favorable, there is a problem of quality of roads, especially smaller and rural roads. Connectivity of the north with the center and south is a big issue, especially in the winter. But Montenegro’s difficult topography makes road construction very expensive. Railway has been improving performance but much more improvement and investments are needed to bring it up to the international standards. Airline transport is Montenegro’s important link with Europe and the world but with two airports, one of which is at the coast, and limited airline competition, its potential is yet to be fully exploited. Maritime transport industry is in infancy and the government has recently established a state maritime company with two cargo ships purchased from China as a nucleus of the future merchant marine industry, in part banking on the long tradition of sailing and maritime education and several thousand Montenegrin sailors working for foreign companies. All in all, the transport sector epitomizes Montenegro’s connectivity problem: good on paper but poor in practice, especially in winter and peak tourist season, suggesting considerable scope for quality improvements, better safety, and more efficient logistics in support of Montenegro’s overall strategy towards greater opening and integrations.

The Government Transport Strategy

According to Montenegro’s 2012 National Development Plan for 2013–2016, future economic growth and development will be based on three pillars: tourism, energy, and agriculture. The plan sees transport, housing, and construction infrastructure and environmental investments as prerequisites and thus targets for investment, the scale of which requires both public and private involvement. The Transport Development Strategy states that Montenegro’s transport system is to provide safe and secure traffic, maintain quality transport infrastructure, be effective in contributing to economic development, minimize harmful impacts to the environment, and be harmonized and support integration of the country with Europe. This is a reasonable statement of intent and in line with good international practice.

Effective implementation of the transport strategy would, however, require improvements to institutional arrangements and capacity directed at how the sector is organized and managed. The
aim would be to improve utilization of resources (financial and human) and deepen private sector participation in the provision and delivery of transport services. This in turn requires building up the overarching institutional framework to deepen its capacity for rigorous planning, analysis of sector priorities, and ability to interface with the private sector as an equal partner.

128. **Montenegro has ambitious plans to ensure the integration of the Montenegrin transport network with those of neighboring countries.** In particular, efforts are being directed at expediting work on the Bar–Boljare highway (to Belgrade, Serbia, and the pan-European Corridor X), the Adriatic-Ionian highway through Montenegro, and rail connection between the Port of Bar and Belgrade. Several road and rail projects linking Montenegro with Albania and Croatia are also considered to be of strategic importance. The planned investment on the two main highways is central to the latest transport strategy, with costs estimated in 2007 to be at least €2.8 billion (about 86 percent of 2011 GNI, World Bank Atlas method). With public debt (including guarantees) at about 59 percent of GDP and the need for reduction over the medium term in the fiscal deficit and public debt, it is unclear how projects of this magnitude could be financed short of a near-complete concession or perhaps significant phased EU support perhaps as part of the accession process.

129. **The large Bar–Boljare highway project that would provide alternative, efficient link between the North and Center and South makes regional, and social sense, but is disadvantaged by the very high construction cost arising from the terrain through which it passes.** Construction of this highway would support the government’s regional and social cohesion objective of the government, promote regional development within and beyond Montenegro, and help to make travel safer for tourists and take pressure off the main north-south road running through the canyon Platije, where there is no physical scope for expansion and travel is particularly difficult in the winter. The feasibility study for this project established its economic rate of return at about 6 percent, which is below the normal benchmark of 12 percent used for World Bank investment projects. However, it meets the test for EU investment projects, which is 5 percent. As a result, EIB has shown interest in supporting the project starting with its southern section. Relatedly, it is understood that work has started on the Podgorica road bypass section, with the next priority being a new section linking Podgorica to Bar. In contrast to the highway, which is of broader regional importance, the bypass, however, mainly serves local traffic around Podgorica and the extension to Bar rather than the northern sections so it could contribute to further deepening concentration of development within the central and southern zones.

130. **Although Montenegro is a member of the South East Europe Transport Observatory (SEETO), none of its planned investment lies on any of the core SEETO Trans-European Transport Network (TEN-Ts), though it is crossed by two routes of the SEETO core road and rail network:** Route 4, which runs from Bar via Belgrade to Vršac on the border with Romania; and Route 2, which connects Podgorica with the Durrës–Tirana highway in Vorë, Albania. The Port of Bar and the Podgorica airport are also defined as part of the core SEETO network. The government’s main motivation for its large projects is the need to improve connectivity particularly to Europe, and to boost tourism and trade.

**Select Issues**

131. **To effectively contribute to the National Development Plan, the transport sector will need to pay more attention to collaboration with other agencies, such as the ministries of Agriculture and Rural Development, Interior and Public Administration, Health, Education, and Spatial Planning.** This is necessary to promote improved rural access, road safety, and urban transport planning and provision. In all these areas, it would also need to deepen cooperation with municipalities. Any proposed
changes to institutional arrangements within the sector, particularly for roads, must be responsive to this crucial need.

132. **Recent reforms have been driven by the need to conform the transport sector to EU requirements and directives.** While reasonable progress has been made in establishing compliant legal arrangements, capacity building is needed for effective implementation. Reforms have been driven, particularly in rail, air, and maritime, by a focused attention on safety in operations. This has led to passage of legislation and signing of international agreements and protocols. But many aspects of these initiatives have yet to be accomplished, particularly those related to the conventions of the International Maritime Organization (IMO) and EU directives relating to shipping and maritime services, for which MTMAT will likely need technical assistance.

133. **The government has also adopted the Strategy for Public Administration Reform (2011–2016),** which provides for “structural adjustment of the public administration system to the best European standards; rationalization of public administration; its increased efficiency and savings; improvement of coordination inside public administration; its openness and accessibility; and the participation of citizens in performance of public duties.” Where this reform agenda stands in the transport sector, however, is not clear. For roads, it would imply more autonomy for the Road Directorate in the MTMATT perhaps its transformation into an agency with an autonomous board; introduction of social accountability frameworks into its service delivery mechanisms; and more effective application of user-pays principles. Incentives for personnel would also require attention to better attract and retain qualified and experienced staff. Given the increased complexity of transport tasks, particularly in relation to the privatization agenda, for the public sector over the medium term, it is critical to retain and promote qualified and high-performance staff, especially with salaries that are competitive with the private sector.

134. **Experience elsewhere indicates that local roads, particularly those in rural areas, are best improved in the context of promoting rural development.** This helps to leverage benefits by directly linking the traditional direct benefits of road investments, such as savings in travel times and costs, with benefits derived from better access to health, schools and other social facilities and new opportunities for local employment and income generation.

135. **There is a need to explore opportunities for green transport, particularly along coastal towns that are tourism centers.** For the coastal area, it would be useful to explore creating a special purpose executive agency to plan and implement green transport proposals in the context of green development. Consideration could be given to evaluating the feasibility of a short rail link between the airport in Podgorica and the Bar-Belgrade rail line. With improved passenger train service, the link could take some of the pressure off tourism-related road traffic from the airport during the peak season. The same approach can be used to promote agro-tourism: a well-developed network of walking trails and cycling lanes would be a powerful enabler of tourist activities. This, of course, would also enable local economic development by bringing tourists closer to the products of small-scale rural enterprises.

**E.4. Energy Connectivity**

136. **Montenegro has identified energy as one of three pillars for future economic growth, and has made good progress on energy reform.** A legislative and strategic framework has been put in place to support accelerated and rational use of the country’s substantial energy resources. Significant electricity supply reforms are in place, and the country has put far behind it the challenges of crisis management that confronted the sector just a few years ago.
But despite considerable progress, Montenegro is still facing multiple and pressing energy challenges, that prevent its better and more efficient service and connectivity with customers and the regional market, among them:

- A substantial electricity deficit and extremely high dependence on imported power—chronic underinvestment in generating capacity having been driven in large part by underpricing (no new energy facility has been constructed for many years).
- A tariff structure distorted by substantial subsidies to the largest energy consumer, high commercial but below-cost household tariffs, with the applied cost of capital for both transmission and distribution being below the true cost of capital.
- Outdated and deeply depreciated electricity infrastructure, with most of the technical equipment having reached the end of its planned service life and in some cases exceeding it by far.
- High energy intensity/low energy productivity—an inherited industrial structure substantially relying on high energy consumption and high household demand and inefficient consumption (particularly with respect to electricity for heating purposes).
- High transmission and distribution (T&D) losses—due to an under-maintained grid, significant non-payment and theft of electricity, and sizable (26 percent) technical and commercial losses from the T&D network (transmission losses of about 4 percent and distribution losses of about 22 percent) compared to average T&D losses of 6 to 8 percent.
- A market structure dominated by a monolithic entity, of which the government is the majority shareholder, that no longer efficiently serves the public interest—long-term electricity supply calls for structural reorganization and full commercialization of the electricity company of Montenegro (Elektroprivreda Crne Gore AD Niksic—EPCG) and rebalancing of the roles of the public and private sectors.

Market Structure

Montenegro’s energy sector is dominated by electricity company (EPCG), a vertically integrated holding company which manages generation, transmission, and distribution of electricity. According to the Montenegrin energy law, the accounts of functional EPCG units—generation, transmission, distribution, and supply—are unbundled in the company’s internal accounts. The costs of each functional unit are presented to the regulator separately for determination of tariffs. However, the auditing procedures are undertaken for the whole company. More importantly, the current functional unbundling in Montenegro is incomplete and falls short of the complete vertical separation that many countries have adopted and represents good international practice.

A2A Montenegro LLC, a company belonging to the Italian A2A Group, was established in December 2009 in Podgorica with the aim of undertaking energy activities in Montenegro. In 2009, it won the tender for privatization of the state electricity company, EPCG, of which A2A now owns 43.7 percent. Although the government retains majority ownership (55 percent), executive management of EPCG is in the hands of A2A.

Demand and Supply Imbalances

Montenegro’s energy sector is inordinately dependent on imported power—all that is required to meet demand for liquid and gaseous fluids and approximately one-third of electricity consumption. The lack of any major investment in new generating capacity in recent years coupled with the increasing
energy requirements of a modernized and growing economy and the large electricity consumption of the country’s aluminum company have resulted in a growing electricity deficit (Figure 19).

Figure 19: Montenegro: Electricity Balance, 2003–11

![Graph showing electricity balance](image)

Source: MONSTAT.

141. Improved operations at the thermal power plant (TPP) Pljevlja and favorable hydrological conditions (heavy rains in 2010) reduced the electricity deficit and corresponding electricity imports from 2007 to 2010 (Figure 20). However, a severe drought in 2011 has lowered rivers and led to electricity shortages throughout the Balkans. Shortages became especially acute in Montenegro. Early in 2012 a severe cold spell cut electricity production and necessitated further imports (Figure 20 and 21).

Figure 20: Electricity Imports and Exports, 2003–11

![Graph showing electricity imports and exports](image)

Source: MONSTAT.

Figure 21: Electricity Imports, 2006–2012

![Graph showing electricity imports](image)

Source: EPCG (2011) and MoE (2012).
142. **Electricity shortages pose a serious threat to Montenegro’s economic growth. Manufacturing has been stalling partly due to disruptions in the electricity supply.** Blackouts are not uncommon and were quite frequent from November 2001 through January 2002, when the weather was especially cold and hydropower electricity generation was curtailed by low water levels. The rotating blackouts led to extensive work stoppages all over the country (USAID 2002).

143. **The costs of electricity disruption have two components:**

- direct costs, which include the net value of production permanently lost, spoilage costs, process restart costs, damage to machinery, etc.; and
- indirect costs arising from the adjustments firms make in their operations to recover at least part of the output lost during and immediately after outages.

144. **While the direct costs may be limited, the less visible, indirect costs can be substantial.** As documented in the third chapter on flexibility in the Montenegro Investment Climate Survey, Montenegrin firms report non-marginal costs of outages (direct costs), but, more importantly, many decided to incur substantial costs in purchasing and maintain their own back up power generators. These generators not only increase the sunk cost of investments but also the variable costs of operation because they are more expensive to operate than relying on network electricity supply.

**Tariffs and Revenue Inadequacy**

145. **Inefficient and below-cost recovery tariff structures have been a major cause of the deterioration in electricity performance.** The failure of successive governments to prescribe adequate rate increases has subjected EPCG to considerable financial distress. Its chronic operating losses preclude investment in the sector and have led to dilapidated generation and distribution facilities.

146. **In addition to price levels, there are significant policy issues related to their structure.** In most other countries, distortions in the structure of electricity prices typically entail significant elements of cross-subsidization from industrial and commercial customers to domestic consumers (households). The problem is that Montenegro’s tariff structure contains a substantial implicit industrial subsidy to the KAP that is governed by a long-term contract. Moreover, Montenegro has the highest retail tariffs for commercial users in South East Europe. Tariffs for industrial customers are below the mean of the region’s values. Household charges are not particularly low by regional standards (Figure 22), but despite recent adjustments, they are still below costs, contributing to EPCG losses.
Figure 22: Average Electricity Prices by Customer Type, 2009

![Figure 22: Average Electricity Prices by Customer Type, 2009](image)

Source: Zametica (2010).

147. **The differential tariff subsidy to the KAP has imposed a very heavy fiscal burden on Montenegro’s economy—about 2 percent of GDP in 2006, down to about 1 percent in 2010.** The subsidy is supposed to be negatively related to the aluminum price. However, despite favorable aluminum prices in 2011, the aluminum company (Kombinat Aluminijuma Podgorica—KAP) has been running large arrears on its electricity bills. As the largest energy consumer in the country, the mounting receivables are now threatening the viability of the EPCG (IMF 2008, 2011, 2012).

148. **Revenue inadequacy has been a major factor in the effective decapitalization of the energy sector.** If it is to effectively address performance problems and inadequate investment, any policy must involve significant further tariff rebalancing. However, care should be taken that the rebalancing should does not seriously conflict with social equity. Raising the price of electricity could seem like a lump-sum tax bearing heavily on the poor, the elderly, and those with large families.

149. **Not surprisingly, the movement for cost-reflective electricity tariffs often encounters political pushback.** In January 2012, for example, thousands protested in Podgorica against an electricity price increase of 6.7 percent—EPCG had originally requested an increase of 15 percent. The protesters demanded that the government withdraw its decision to increase the price, that senior officials of the Regulatory Agency for Energy resign, and that the State Prosecutor to investigate “dubious privatizations.” Spreading to other parts of the country, the protest continued into the Spring. In response, the government formed a working group to analyze the impacts of tariff increases on standards of living (Remikovic, 2012). It should be noted, however, that despite the price adjustments of recent years, prices to households in Montenegro are still low by regional and European standards (Figure 23).
Given the critical role of the network utilities in general, and electricity in particular, in Montenegro’s future economic development, it is imperative that removing electricity pricing distortions be part of any national economic reform program. Clearly, the fact that commercial customers are paying much more than household customers cannot be explained by differences in the cost of serving them. Thus, there is probably a cross-subsidy embedded in the structure of prices from commercial to residential customers, which conflicts with efficient use of limited resources to support economic progress, and social equity. Businesses that are overcharged for their electricity service tend to pass their costs on to consumers in the form of higher prices. This means that electricity service to domestic household customers—especially those who live in big houses and consume significant amounts of electricity—is effectively being subsidized by a kind of sales tax that falls on all citizens, including those of modest means who consume little electricity.

As a matter of policy, however, there are good reasons to avoid too abrupt price changes. Abrupt and substantial price changes carry large and unnecessary adjustment costs for consumers and firms alike. Even optimal prices, if instituted too fast and without sufficient notice, can be damaging, creating public disenchantment with the reform process and a real danger of policy reversal. This does not, of course, mean that the necessary tariff rebalancing should simply be postponed. On the contrary, policy makers need to plan early for a smooth and deliberate transition to efficient pricing levels and structures.

In recent years, there has been a movement to realign prices with costs, reduce cross-subsidization of electricity, and replace the remaining cross-subsidies with direct budget subsidies (IMF 2010). Tariffs in Montenegro, as in other countries in the region, have been increasing (Figure 24), but some of the increases are clearly long-needed adjustments due to past policies that did not allow for cost-reflective pricing. However, prices have also been affected by the lack of transmission and generation capacity and consequent tightening of the demand-supply balance. More efficient utilization of transmission and generation capacities and a generally better functioning wholesale market would ease the upward pressure on prices. Unfortunately, the historic drought in 2011 led to significant regional
electricity shortages and thus exacerbated the already tight demand-supply balance and concomitant pressures on prices.

**Figure 24: Average Retail Electricity Price (All Customers)**

![Graph showing average retail electricity price for different countries over years](image)

*Source: Zametica (2010).*

### Improving Energy Efficiency

153. **The Montenegrin economy has high energy intensity**—energy used per unit of gross domestic product. In 2001 Montenegro’s energy intensity was estimated at 0.77 toe (ton of oil equivalent)/US$1,000 of GDP (in 2000 US$). It then declined to 0.48 in 2005 but is still 2.5 times higher than the average for OECD Europe (IEA 2008). 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 in the household and 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.

154. **The demand-supply imbalance can be immediately reduced through lowering demand by increasing the efficiency with which electricity is used.** There is significant scope for rationalizing energy usage given Montenegro’s very high energy intensity. Indeed, significant energy and financial savings could be achieved by deploying more efficient technologies, better organization, and improved insulation of buildings to prevent thermal losses—most of which require relatively modest expenditures and investments.

155. **In pursuance of the EU Directive on Energy End-Use Efficiency and Energy Services (Directive 2006/32/EC), Montenegro has adopted a national indicative energy savings target of 9 percent of final energy consumption (FEC) by 2018** (an average yearly reduction of 1 percent). However, KAP’s energy consumption has been excluded from FEC in the context of the directive, because technological constraints prevent KAP from achieving significant energy savings. Including KAP in calculation of the 9 percent national target would have required other consumers to actually save up to 15.7 percent, assuming KAP does not achieve any savings, and 13.5 percent, assuming that KAP achieves 3 percent savings for the period (MoE 2010).

---

8 Measured by purchasing power parity (PPP), energy intensity is much lower at 0.26 toe/$US$1,000 than it had been—but still 40 percent higher than the average for OECD Europe.
156. **Policy measures for promoting more efficient utilization of energy could contribute to a more reliable electricity supply, market competitiveness and environmental protection.** Such measures could also be a factor in creating new business opportunities, promoting grass-roots entrepreneurship, and increasing employment, as well as having other social benefits, both local and national. Increasing energy efficiency may be the least costly and most productive option for addressing Montenegro’s tightening electricity demand-supply balance. With relatively modest investment, more rational selection of technological options, and better organization, significant energy and financial savings could be achieved.

157. **Benefits of the South East Europe Regional Electricity Market**

South East Europe (SEE) is comprised of countries with

- rapidly growing energy demand;
- large but unevenly distributed hydro resources;
- potential complementarities in their primary energy resource endowments;
- electricity supplies that have not kept pace with demand and are interrupted with increasing frequency;
- many electricity suppliers in moderate to severe financial distress; and
- substantial environmental challenges associated with electricity production.

158. **The availability and reliability of electricity supplies are major macroeconomic policy issues—these countries have set very ambitious economic growth goals, the success of which depends in part on reliable and reasonably priced electricity.** National policies and institutions for energy and power sector governance, while improving (in some cases markedly) over time, are not yet sufficient to overcome embedded structural and institutional weaknesses. Last but not least, using fuel combustion to generate power has created well-known problems of human health and environmental damage.

159. **There are substantial potential gains from increased regional integration of the electricity sector and from increased availability of imported natural gas for power generation.** Significant benefits of regional integration of electricity systems in SEE arise from

- exploiting complementarities and comparative advantages in primary energy endowments and thus facilitating more efficient utilization of generating resources (especially the region’s huge hydro resources) to increase access to lower-cost supplies;
- making possible economies of scale for new generation capacity through larger projects to serve a more integrated system;
- reducing supply risks and reliability costs through multiple links between system loads and cross-country generating resources, and through sharing generation reserve margins;
- reducing environmental costs by increasing the availability of and access to cleaner affordable sources of supply (hydro, natural gas) and reducing system balancing challenges by increased use of intermittent renewables (wind, solar);
- providing the technical and policy basis for increased operational efficiency and competition, and hence increased economic efficiency, in particular by expanding the size of the market to increase prospects for competitive entry of generation sources;
• supporting advances in domestic policy reforms within the sector, notably by reinforcing requirements that regulatory commitments be credible and by increasing gains from policies that enhance economic efficiency.

**An Agenda for Policy Reform in the Energy Sector**

There is compelling evidence that competitive restructuring and privatization, when designed and implemented well, can significantly improve electricity performance.

160. **Need for "radical" solutions.** Incremental reforms may have been successfully implemented in countries with mature electricity systems supported by well-functioning institutional arrangements. An incremental approach to electricity reform may not be the right prescription for a country like Montenegro where an efficiently expanding electricity supply could fuel the country’s future economic growth and prosperity. And where business users will increasingly need high quality and reasonably priced electricity services in order to be able to effectively compete in international markets. In the face of substantial investment requirements to fulfill the sector strategic economic potential, far-reaching reforms that contemplate a substantial role for private entities in the provision of core electricity services should not necessarily be viewed as a radical program for reform; instead they may involve a sensible, even a conservative, response to the need for new investment and improved sectoral performance.

161. **Eliminating government’s ownership control of EPCG.** The experience from several countries clearly demonstrates that fluctuating political interference has very profound and damaging consequences for the performance of electricity and other infrastructure sectors. Indeed, there is strong evidence to suggest that the politicization of public electric utilities’ business has arguably been the single most determinant of poor operating performance. It is increasingly argued by electricity sector experts that with workable markets, private market participants investing their own funds can better balance risks and rewards than central planners. Investment driven by market incentives rather than bureaucratic preference tends to serve the public interest better. The long-term solution to the problems of bureaucratic ineffectiveness, political interference, and lackluster electricity supply growth in Montenegro may require radical structural change—complete privatization, with the government giving up its majority ownership in EPCG and limiting its role to formulating national energy policy and implementing an effective and independent regulatory regime.

162. **Unbundling EPCG.** The primary virtue of vertical separation as a policy option in the electricity sector is that it may permit active or potential competition to reign among electricity generators and downstream retailers—with corresponding assurance of efficient selection among them for provision of their services at efficient prices. At the same time, separation may create serious coordination problems, loss of economies of scope, and otherwise unnecessary transactions costs. Indeed, it is frequently argued that due to large economies of coordination, vertical separation of transmission and generation will lead to inefficient investments. If the vertically-integrated EPCG were a well-run company facing no political intrusion and a sensible tariff policy then the loss of coordination economies (with vertical separation) would most likely exceed the benefits of competitive entry into montenegro’s small electricity system. However, since there is a well-defined national ambition for the energy sector to be a strategic pillar if future economic growth, then entry into hydro, renewables, and other technologies would be facilitated by a decentralized/unbundled market structure—and indeed the benefits of competitive entry could easily exceed the costs due to the loss of coordination economies. Moreover, vertical separation may induce greater transparency in the sector’s operations. For these reasons, further unbundling of EPCG—moving beyond the current incomplete functional unbundling and towards vertical ownership separation—is likely to improve sectoral performance and serve the public interest.
163. **Further tariff rebalancing.** One of the key elements in protecting the public interest is the avoidance of any residual regulation which effectively prevents the achievement of financial viability by the operating electricity entities. The public is hardly be well served by a set of regulatory rules which condemn the electricity utilities to an inability to raise capital for modernization and expansion and which, consequently, result in systems that are increasingly decapitalized (as is the case with Montenegro’s generating facilities) and are characterized by service deterioration. Therefore, avoiding impairment of financial viability should play a crucial role in any rational program of electricity regulation in Montenegro. Despite the expected public opposition, electricity tariffs must be further rebalanced and realigned with underlying costs. Such rebalancing is an indispensable precondition for facilitating efficient entry into the generation segment of the market—and consequently for fulfilling the electricity sector’s enormous economic potential.

164. **Significant hydro expansion.** It will be exceedingly difficult, if not outright impossible, to achieve the government’s ambitious energy plans without a more aggressive deployment of the country’s significant hydropower resources. It is true that hydroelectric facilities, unless carefully located and managed, can disrupt natural river flows with adverse impacts on the health of important, in-stream ecosystems. However, these environmental and social impacts can be mitigated by careful strategic planning and rational resource management. Moreover, these valid concerns have to be balanced against the increasing anxiety about climate disruption and the urgent need for generating employment opportunities in Montenegro.

165. **Regionalizing regulatory policy.** In a region that includes small countries like Montenegro, regional policy coordination and regulatory cooperation, and ultimately the creation of a regional electricity regulatory agency might represent a pragmatic approach to dealing with the problem of limited domestic regulatory capacity and the high fixed costs of regulation. Furthermore, regionalization of regulatory policy could advance domestic electricity reform, enhance regulatory credibility, and help Montenegro overcome its commitment problems (largely due to the long history of administrative intervention under the old regime).

### E.5. Information and Communication Technologies

166. **Information and Communication Technologies (ICT) offer huge opportunities for a small country like Montenegro.** ICT can help strengthen the country’s competitiveness, investment climate and innovative capacity, and position Montenegro as a vibrant innovation hub linking the Balkans (and Montenegro’s industries) to the rest of Europe and global value chains for tourism, industrial manufacturing and other sectors.

167. **Today, networks create competitive advantage as much as size.** Leveraging ICT growth pillars like high-speed broadband, Open Data, ICT-enabled jobs and Cloud Computing9 will enable Montenegro to create new networks to drive business growth and exports while fueling co-creation of innovative public services and applications. This will have tangible domestic impacts: (i) strengthening Montenegro’s regional/global competitiveness by enabling better citizen/business-facing services; (ii) accelerating skills development and employment prospects, especially for youth; and (iii) driving growth

---

9 Ubiquitous, convenient, on-demand network-based access to a shared pool of commodity and configurable IT application resources and computing and storage infrastructures.
of an “Apps Economy” focused on high-priority sectors such as tourism, agriculture and financial services.

E.6. ICT for Growth

168. **New models of growth in frontier and emerging markets, much like in the developed world, are increasingly dependent on the effective and widespread use of ICT**, particularly services and applications that depend on high-speed internet, i.e. broadband.

169. **ICT and more specifically broadband technology drive economic growth and have cross-cutting economic and social impact.** A World Bank study on the impact of broadband concluded that, on average, an increase of 10 percent in broadband penetration can over the longer term lead to increases of 1.21-1.38 percentage point increase in GDP.\(^{10}\) Broadband offers enormous opportunities to help raise the standard of living, quality of life and business competitiveness. It can help revolutionize education, health care and the delivery of government services. Broadband also enhances opportunities for social networking, community organization and a more active engagement in the civic, political and democratic life of nations.

170. **Compared to the rest of the region, Internet connectivity in Montenegro remains slow due to lagging competition.** While mobile broadband market remains by far the most dynamic segment in Montenegro—with penetration rates of 10.4 percent, surpassing the EU-27 average of 8.1 percent\(^{11}\)—connections with download speeds below 2 Mbps still prevail. The market was liberalized, yet broadband competition remains weak. Nearly 80 percent of all broadband connections are supplied over main operator’s network. There is a lack of Local Loop Unbundling (LLU) in practice; the number of Internet Service Providers (ISPs) remains among the lowest in the Balkans; and the country lacks an Internet Exchange Point (IXP).

171. **Despite some progress in the area of development of policy and legislative frameworks related to Montenegro’s Information Society\(^{12}\), the overall environment for broadband infrastructure development may be considered as unfavorable.** This is in part due to high municipal taxes, time consuming process to obtain construction permits and impeding investments in infrastructure development and subsequently development of the broadband market as a whole. As a result, fiber optic development in the country is marginal and among the lowest in the region. There is an urgent need therefore to work towards both increased competition and introducing policy and regulatory reforms in the sector aimed to lower the costs of and increase access to new broadband infrastructure.

Cloud Computing: Platform for Growth and Innovation

172. **Enabled by broadband, Cloud Computing is fast becoming an essential foundation for finding new scale and efficiencies in technology infrastructure.** For Montenegro, Cloud Computing can be a strategic growth pillar by:

---


(1) Maximizing economies of scale for ICT infrastructure across public services, allowing a relatively small government by size to access world-class ICT infrastructure at far lower costs than conventional provision. Other governments are reporting per-server cost reductions of 90%.13

(2) Reshaping the marketplace for ICT services, allowing government to better leverage the local SME sector and access a wider range of agile, cost-effective and responsive ICT application suppliers. The Phase 2 Procurement for the UK G-Cloud14 awarded contracts to 458 suppliers, of whom 75% are SMEs.

(3) Transforming and reducing the costs of service delivery by government and businesses, especially in key sectors like tourism and trade.

With Cloud infrastructure in place, major tourist destinations like New York City and London are offering innovative apps to support tourists visiting their cities while also promoting local businesses. New York City alone hosts 68 third-party public transport apps that tourists and residents can use.

**ICT for Jobs**

173. ICT-enabled job creation and economic integration can be very important for boosting Montenegro’s competitiveness and diminishing its economic distance to global growth points15.

174. ICT is a growth sector and a net job creator.16 The McKinsey Global Institute, in an analysis of 13 economies worldwide, found that the Internet helped create 2.6 jobs for every job destroyed.17 ICT-enabled jobs expand beyond geographical boundaries by the very nature of ICT, attract youth due to low entry barriers, and are resilient during economic downturn—for example as the countries of Greece and Spain were suffering a severe economic downturn in 2011, earnings from ICT contractors in those countries grew by 122 percent and 142 percent, respectively.18

175. ICT industry jobs cut across sectors and include application development, content provision, and call center operations. Dongier & Sudan find that in India, for example, IT and IT-enabled services, which expand across sectors “directly employ 2.01 million people in jobs that pay 50 to 100 percent more than comparable service sector jobs.”19 Emerging, ICT-enabled trends are reshaping the labor market, including micro-work20, ICT-enabled contracting, online gaming related work, and opportunities around the growing apps economy. These trends can help boost Montenegro’s traditional growth areas such as tourism and diversify the economy into other sectors leading to cross-cutting job creation.

---

13 The 90% reduction in per-server costs was a UK Government figure based on £11,000 per server under the HMRC Aspire contract and <$1000 per equivalent server on Amazon EC2. Savings also come from much higher utilization of cloud servers – the typical corporate dedicated server is only 5% utilized.

14 Government cloud computing.


17 Internet matters: the net’s sweeping impact on growth, jobs and prosperity, McKinsey Global Institute, 2011


Open Data: Fuel for Growth, Innovation and Job Creation

176. Global momentum around Open Data is real and growing as countries realize its potential as a driver of innovation, competitiveness and improved services. Open Data provides “raw material” for business innovation and creation of new jobs in an Apps Economy. For the Government of Montenegro, Open Data can fuel growth in multiple ways:

(1) Stimulating skills development and accelerating job creation, especially in service sectors, resulting in new jobs, investments and tax revenues. In the US, open weather data has led to 400 new, value-added service businesses.

(2) Changing the service delivery paradigm by empowering businesses, civil society and individuals to co-create and deliver services. This creates jobs while also rapidly improving public services. In the UK, FixMyStreet\textsuperscript{21} created a new channel for street maintenance by public agencies, handling 200,000 reports and the repair of 65,000 potholes.

(3) Industry-wide transformation in specific sectors. For example, governments in US, UK and Taiwan are making open health data available to drive health service improvement and pharmaceutical innovation. This is creating an entire new ecosystem of services and startups while also producing actual improvements in healthcare outcomes.

Recommendations for greater ICT connectivity

177. The development of broadband infrastructure to bridge the urban-rural divide and increased competition in broadband to lower the cost of Internet, coupled with the introduction of cloud computing, open data and skills development in partnership with the private sector can help Montenegro emerge as a more robust, competitive economy.

178. To maximize the potential of ICT-enabled growth and ICT-enabled job and enterprise creation, Montenegro could undertake a number of concrete measures: to (i) strengthen the telecom regulatory body and promote competition in the sector; (ii) bridge the broadband divide between rural and urban areas and work towards development of more favorable environment for the investments into infrastructure development; (iii) strengthen its policy for skills development to equip its talent pool with skills for ICT-enabled economy and supporting cross-sectoral collaboration and skills acquisition; (iii) produce a government Cloud Computing strategy and action plan in partnership with the private sector and encourage the creation of an ICT innovation ecosystem based on open data; (iv) establish a full-scale Open Data initiative as part of Open Government Partnership action plan and encourage and facilitate the growth of an Open Data ecosystem in the private and civic sectors through a program of targeted interventions to stimulate innovation and engagement from the developer and business communities.

F. Policy Coordination and Decision Making

179. Although the crucial role of infrastructure in facilitating economic integration has long been recognized, some important propositions are not as widely recognized:

1. Welfare gains from economic integration can be realized through deeper forms of regional integration that entail harmonization of laws.

\textsuperscript{21} A facility for citizens to report maintenance problems in public streets and other places and to track action by public authorities.
2. Reforms that reduce cross-border transaction costs and improve the performance of infrastructure services are arguably more important in creating an open, unified regional economic space than trade policy reforms narrowly defined.

3. All economies benefit from the more rational use of resources that arises from coordination of regional infrastructure development.

180. **For these reasons the framework for regional economic integration in several parts of the world, including the EU, entails coordination of policies in core infrastructure industries such as transport, telecommunications, and electricity.** Infrastructure development is integrated into many regional treaties to provide the framework for aligning sector policies, designing regional master plans, building a portfolio of synergistic projects, harmonizing regulatory regimes and investment codes, and mobilizing investment. Increasingly, nations are moving away from integration strategies based solely on formal trade agreements and toward strategies that include at least some integration of infrastructure policies.

181. **Disparities of regulatory treatment across borders introduce distortions that hinder both trade and regional investment patterns.** Similarly, market restructuring in infrastructure industries is more effective if it is accompanied by parallel reforms and reciprocity across countries. Otherwise, significant differences in market structures and regulatory policies can become barriers to cross-border trade. Hence, regulatory harmonization has become an important component of regional economic integration.

182. **Like other transition economies, Montenegro has a history of politicized economic decisions and economic activity.** The heritage of socialism is apparent in the present economic structure in the specialization and focus on industrial production of aluminum and other metals and the disregard for market prices, most particularly in the subsidized energy used by the aluminum factory. This heritage has contemporary consequences for connectivity with world markets. It is also apparent in a sustained culture of reliance on politics and policies, if not acquiescence or support, of government in economic decisions. On numerous occasions during field consultations, prospective entrepreneurs commented that “we would go ahead with this project if we knew that the government would support our decision.”

183. **The past socialist system relied extensively on worker self-management.** The economic system was not decentralized but workers exerted influence within the factory. The cultural persistence of worker self-management can be inhibiting for foreign investors, including multinational firms. There have been situations where workers in privatized metal firms have evicted managers put in place by the foreign owners. The workers would not accept subjugation to the authority of the managers—and the private owners.

184. **Under socialism and in particular worker self-management, informal activity was common.** The very low labor force participation rates in Montenegro indicated by official statistics, as interviews and other research established are associated with disincentives for formal activity because of the high social contributions taxes that increase the cost of formally employing labor. Economic activity and living standards in Montenegro attest to significant unrecorded employment and incomes in excess of official data.

185. **Connectivity requires a change in political culture from the previous close interface between government and economic activity.** It has been observed that a focus on government as the core economic decision maker affects attitudes to educational choice, and a presumption that nothing can be achieved without government cooperation or acquiescence. This view hinders connectivity by requiring

---

22 On politicized economic choice in the context of transition to a market economy, see Hillman (1991), part II.
that people who want a productive outlet for their abilities and initiative seek permission and assurance from political and bureaucratic decision makers.

186. **There should be a clear separation between working for the government and seeking personal gain through business decisions.** Evidence of the clear separation will encourage the foreign investment and multinational activity that is a requisite for the connectivity that will result in a degree of openness that Montenegro needs.

187. **If government, through planning and policy intervention, could facilitate connectivity, the task of policy advice would be straightforward.** Government cannot, however, directly implement or “command” connectivity. The role of government is and should be indirect, in

- setting correct incentives for educational choice
- setting correct incentives for formal market participation,
- setting correct incentives for entrepreneurship and investments,
- ensuring complementary infrastructure for private economic activity to succeed by following the signals provided by competitive markets, and
- setting and enforcing a “firewall” between political office and business, especially regulatory activity, in order to reduce conflicts of interest and disincentives for multinational activity and investments.

**G. Country Models for Montenegro in Connectivity**

188. **Who can Montenegro emulate in its quest to expand its connectivity, exports, and openness in order to accelerate growth?** Other countries offer models of different policies and measures that Montenegro can learn from” Switzerland has similar topography to the mountains of Montenegro. Its experience points to possibly useful transport policies. Like Montenegro, which is a natural point of access for Serbia to the sea at the port of Bar, Switzerland is a transit area, with trucks carrying produce through the mountains that separate the north and south of Europe. Expansion of the road system to accommodate trucks resulted in environmental damage in Switzerland. The preferred solution, also undertaken in Switzerland, is dedicated freight trains that substitute for truck traffic or carry the trucks themselves. In Montenegro, passenger tourist road traffic would be significantly redirected if there was a reliable and efficient rail link from the airport in Podgorica. With the distance of airport to rail of barely a few kilometers, such a project could be a low-cost, high-impact example of enhancing Montenegro’s internal connectivity in an environmentally responsible way.

189. **Slovenia is a small country that has had success in connectivity.** Slovenia has had sponsors within the EU that have promoted its economic success, but even before membership, Slovenia invested heavily in transport infrastructure that had made it second to none in the former Yugoslavia. Slovenia’s success was also achieved against the background of past worker self-management, which suggests that old incentives can be overcome.

190. **In Estonia**, limited government intervention and political interference have put the economy on the road to success based on private-sector initiative. Other small countries can also provide examples, although some small countries (e.g., Ireland and Iceland) have run into significant economic problems following periods of prosperity, also providing important policy lessons.
191. There is one other Mediterranean country, however, that has achieved high income, is a member of the OECD, and moreover in the late 1980s had an economic system similar in many ways to Montenegro’s previous system. Like Montenegro, Israel has a significant tourist sector and there is recognition that tourism is not a source of income that relies on technology and human capital. In Israel, as in Montenegro, other natural resources are limited. Also, Israel trades only in a limited way within its region, where incomes are low, and instead trades with developed economies and with China and other economies in Asia that have a comparative advantage in Israel’s imports. As potentially for Montenegro, the economic success of Israel is explained by underpinnings of competitive advantage rather than comparative advantage. The economic success of Israel, similar to Finland, demonstrates the importance of education and human capital, and the availability of labor for knowledge-based industries at competitive wages for domestic and multinational firms.23

H. Policy Agenda for Greater Connectivity

192. The analysis suggests elements of the remaining policy agenda for greater connectivity. The overarching objective for Montenegro, integration into the EU, defines the entire institutional integration agenda. But there are a number of specific issues Montenegro must resolve to make that integration more efficient. In what follows, we outline the central issues related to connectivity and suggest policy recommendations.

193. Montenegro’s export base is small and narrow, and exports do not figure prominently on the policy or the private sector agenda. To unlock export potential, the analysis suggests, there is a need for a much more export-oriented growth strategy with specific actions as follows. This will require a multipronged approach of policy measures and the engagement of many stakeholders in Montenegro’s exports.

Export Expansion and Diversification

- Move exports (goods and services) to the top of the government’s policy agenda with an explicit strategy that combines the objectives of improving the environment for exports, reducing barriers to trade, and greater connectivity. A high-level government official should be personally responsible for the strategy and periodically report on its progress and any needed adjustments.
- Establish a multistakeholder forum (government, private sector, and research) devoted exclusively to monitoring performance and constraints, and improving Montenegro’s exports.
- Use Montenegro’s missions abroad and domestic and international forums more aggressively for export promotion, trade forums, and promotion of FDIs with export content.
- Dismantle nontariff barriers and promote export certifications of Montenegrin firms.
- Encourage banks to provide more regular and greater access to credit for exporting firms.
- Encourage private sector associations to monitor and report to the government on constraints to exports.

23 Although it has more than 10 times more people than Montenegro, Israel is regarded as a small country. The model for economic success based on education and human capital, and initiative is described by Senor and Singer (2009).
• Disseminate to private sector and business associations the findings of the CEM product space analysis showing export opportunities.

• Adopt a strategy and a monitorable action plan to change the preferences of Montenegrin students and the courses available to them to emphasize the skills and knowledge required by the private sector. Work with schools and universities to put much greater emphasis on math, science, and foreign language skills and practical skills in as computer and other technical areas.

• Actively seek multinational firms that would make Montenegro base for regional operations, especially in the areas of comparative and competitive advantage identified above (e.g., tourism, energy, food, forestry).

• Measure the speed of movements at border crossings and reduce remaining trade restrictions, especially nontariff barriers, and bureaucratic barriers that slow movements across borders with Montenegro’s neighbors.

**Infrastructure Connectivity**

194. Though as yet Montenegro is neither internally nor externally well-connected, this major constraint to its development can to a large extent be overcome by investing in the relevant infrastructure: transport, energy, and ICT. Specifically, the analysis above suggests the following policy agenda.

**Transport**

• Put more emphasis on enhancing the quality of the existing network and improving maintenance, and—especially—road safety, rather than emphasizing new investments.

• Expand the sources of financing for transport expansion in strategic areas, through, e.g., concessions, PPPs, and additional financing that may become available from EIB, EBRD, and the World Bank for infrastructure.

• Adopt an explicit program for improving rural and internally connecting roads linking currently isolated parts of the country.

• Continue improving rail connectivity by attracting foreign investments, and consider connecting the airport by rail to the Bar-Belgrade main rail line.

**Energy**

• Gradually but deliberately move the tariff structure toward cost recovery, and rebalance tariffs to reduce cross-subsidization.

• Accelerate the tenders on small and mini-hydro power plants.

• Strengthen Montenegro’s links with regional energy markets.

• Accelerate realization of the undersea cable to Italy.

• Remove constraints to entry and competition into the solar and wind sectors.

**Information Communication Technologies**

• Partner with the private sector to draw up an explicit action plan to jump-start cloud computing, and encourage the creation of an ICT innovation ecosystem based on open data.
• Strengthen the telecom regulatory body and promote competition in the sector.

• Bridge the broadband divide between rural and urban areas and work toward a more favorable environment for investments in infrastructure.

• Strengthen the skills development policy to equip the talent pool with skills for an ICT-enabled economy and support cross-sectoral collaboration and skills acquisition.

• Establish a full-scale open data initiative as part of the Open Government Partnership action plan and encourage and facilitate growth of an open data ecosystem in the private and civic sectors through a program of targeted interventions to stimulate innovation by and the engagement of the developer and business communities.

The Role of Government

195. **Connectivity in a market economy requires a change in political culture:** There should be a clear separation—an enforced firewall—between holding a government office and seeking personal gain through business decisions. This goes beyond the issue of corruption, which itself should be rooted out as a matter of priority in governance reforms. Credible evidence of a clear separation between politics and business will encourage the foreign investment and multinational activity that are necessary to bring about the openness that Montenegro needs for prosperity.

Learning from the Success of Others

• Organize at the level of government and relevant ministries systematic thematic study tours led by the private sector as well as government officials for successful exporters and prosperous small countries aimed explicitly at improving Montenegro’s connectivity.

• Systematically discuss lessons learned within the government and with other stakeholders to forge consensus and formulate action plans to implement lessons from other countries. Lithuania is an example of very successful broadband connectivity. Estonia offers many lessons in greater connectivity following transition to a market economy. Ireland offers an example of how a small country with few resources can make itself a highly attractive place to do business, innovate, and invest. Finland is a prime example of the power of top-notch education and links with the private sector. And Israel is an example of how a small country can mobilize human capital, technical skills, and links with business and multinational firms to better connect with the world markets.

196. **Finally, even with a stable macroeconomic environment, sustainable fiscal and financial sectors, and greater connectivity, Montenegro will still need to do much better on the third pillar of the policy agenda advocated in this report—flexibility—if the country is to realize its development aspirations.** Without a better legal and regulatory environment and its manifestations of investment climate at the firm level, and if product market regulation continues to be rigid, the response of foreign and domestic investors will be weak and foreign investments limited. Without much more efficient labor markets, growth will not translate into the large-scale job creation needed for sustained improvements in living standards.
PART III: FLEXIBILITY

197. Since change is an inevitable characteristic of economic conditions, the ability to respond flexibly to change matters greatly to economic outcomes. And because both government and the private sector benefit from flexibility in setting and achieving economic objectives, the cost of adapting to changing conditions should be kept as low as possible. It is therefore crucial to dismantle to the extent possible policy and institutional barriers to change and keep the costs of doing business as low as possible. To encourage new activities incumbent producers should not be given domestic monopolistic advantages, and access to domestic and regional markets should be unimpeded. There should also be no barriers to exit when producers can no longer be profitable. Taxpayers should not be asked to pay for private business risks. Subject to quick review of environmental impacts, construction permits should be relatively easy to acquire, as should bank credit, subject to reasonable collateral requirements. It should also be easy to obtain electricity and other utility connections. Registration of change of property ownership should be quick.

198. In many ways Montenegro is relatively flexible in adapting to new opportunities and to change, but there is still considerable scope for improvement. Among its areas of strength are regulations on starting a business, product market regulation, freedom of retail distribution, and absence of regulatory limitations on the number of competitors in a product market. However, in the construction sector particularly, access to electricity, registering property, enforcement of contracts, acquiring permits, and the costs of access to “communal services” heavily restrict flexibility, as is confirmed by the results of the World Bank’s Doing Business Indicators and the new Investment Climate Survey Assessment. Though a considerable amount of red tape has been cut in terms of paying taxes and tax rates have been lowered, the informal sector remains large. An important benefit of increased flexibility in doing business is the incentive it offers to move economic activity from the informal to the formal sector. Workforce skills are also important: flexibility is enhanced if employees do not define themselves as narrowly specialized. Policies should ensure that worker benefits are readily transferable between employers.

199. Basically, too, flexibility relates to the extent to which the state dominates economic activity. Although Montenegro is slightly below the OECD average in application of command and control regulation, a legacy of the previous economic system is the presence of a few remaining public enterprises that are subjected to bureaucratic decision making, which is less flexible than decision making based on private profit and loss. Montenegro also needs to score better on conformity of domestic regulations with international standards, which is an impediment to flexibility through external markets.

200. So how flexible is Montenegro’s environment for growth and jobs? This report answers this question by first presenting a multidimensional assessment of the environment for growth and jobs, using several diagnostic approaches. It first considers flexibility as a condition of dynamic growth (section A). It then assesses ease of doing business in Montenegro based on the Doing Business indicators for 2012 (section B), supplemented by detailed insights from the new Investment Climate Survey assessment of Montenegro’s firms and field firm interviews (section C), the first product market regulation analysis for Montenegro (D), and an analysis of labor market regulations (E). Taken together, these analyses suggest the structural reforms needed to enhance the climate for the growth of economic activity, investments, and jobs (See Box 6).
Box 6: Improving Flexibility: Remaining Reforms and Policy Recommendations

1. Further improving the environment for doing business and investment climate by
   - **Addressing urgently the biggest constraints on the Doing Business scale:** (i) Significantly reducing the cost of entry and operation in the construction and housing industry, (ii) consolidating multiple agencies or improving coordination, (iii) speeding up electricity connections, (iii) cutting red tape in registering property, and (iv) strengthening enforcement of contracts (H)
   - **Intensify efforts to formalize informal activity** by (i) strengthening the systems of penalties, rewards, and (ii) inspections of informal establishments, (iii) considering longer-term tax reform shifting the burden of taxes from labor (social security contributions) to consumption (value-added tax) to help stimulate employment, investments, and exports (H).
   - **Review and reduce the red tape and required documentation for exports and imports,** and establish benchmarks and monitor the performance and speed of goods and services crossing the borders (E).
   - **Carry out a comprehensive review of local taxes and fees, involving private business associations, with the view towards their reduction and simplification.** For example: (i) review and significantly reduce or eliminate the new municipal “access fee.” (E).

2. Improving Product Market Regulations by reducing state control (which is much higher than the OECD average)
   - **Downsize government portfolio of equity stakes.** Finding a final solution for KAP through privatization of government stake or any other method would imply significant change in the degree of state control in Montenegro. (H)
   - **Coordinate various institutional stake holders in the same companies:** consolidate public equity holdings, improve management and control systems, set transparent goals at company level, develop long term plans at company levels including privatizations, spin-offs, etc., make members of supervisory and management boards accountable (H)
   - **Speed up separation, restructuring and privatization processes in selected network sectors,** in particular with regard energy production; begin to prepare railway for post EU entry conditions (H), and reducing barriers to entrepreneurship (Montenegro’s score is better than the OECD average)
     - **Extend one stop shops in order to involve permits and licenses issued by local authorities** (H)
     - **One stop shops are primarily info points now.** They should evolve into operational contact points which would actually execute issuing of permits and licenses, acting on behalf and in coordination with respective public bodies (H)
     - **Ease access to one stop shops for foreign investors and companies** (E)
     - **Assess Montefarm’s impact on drugs’ market** (E)
     - **Reduce significantly the costs of construction permits,** in particular: (a) costs of studies, (b) costs of ecological permits, (c) costs of utilities (H)

3. Improving labor market and regulated regulations
   - **Eliminate the maximum duration of fixed term contracts** (E).
   - **Gradually increase the early retirement age towards OECD average** (H)
   - **In medium term, reduce social security contributions as tax on labor employment and shift the tax burden onto consumption taxes** (H)

Source: Summary of the section on policy agenda at the end of this chapter.
Note: H=hard but high priority; E=easy measure that should be implemented immediately
A. Flexibility as Precondition of Dynamic Growth

201. **One of the key insights of recent research on small states and dollarized/euroized economies like Montenegro’s is the central importance of flexibility:** Montenegro’s euroized economy must have a high—not just average—degree of regulatory, institutional, and labor market flexibility in order to deal with the inevitable external and domestic shocks. Without flexibility, in economies that do not have their own domestic currency external shocks are bound to translate into much more volatility in incomes and employment, thus undermining the potential benefits of financial integration into wider monetary areas (Bogetić 2000, De Soto 2002, Favaro 2008, World Bank 2000). Also, international studies have shown a strong link between greater flexibility resulting from regulatory reforms and growth (Djankov 2006, Haidar 2009) and the most recent study (Haidar 2012) using Doing Business indicators in 175 countries finds that an improvement in an average reform results in faster economic growth by 0.15 percent—a significant growth dividend of reforms. Finally, the World Bank’s recent report on Golden Growth (Gill, Reiser et al. 2012) stressed a key point related to the flexibility on which this CEM expounds: labor and other government regulation are major areas that determine whether countries like Montenegro can become more competitive and accelerate convergence with the European core. Chapter I above emphasized that in Montenegro, macroeconomic stability is heavily dependent on fiscal policy. But sound fiscal policy, though very important, is not enough to ensure robust growth and job creation. Crucially important as well are the investment climate and the business and regulatory environment for both domestic and foreign investment, entrepreneurship, and exports.

202. **To ensure durable prosperity, Montenegro should aim to be more than just the highest-income country in the Western Balkans, as it is today—and that will require it to be much more flexible.** It could become a dynamic location where people with modern skills and entrepreneurial drive will want to stay, come, and start a business that grows beyond the country’s borders and the region. Many other countries have started with more unfavorable conditions than Montenegro and done well. For example, FYR Macedonia has achieved the status of being the 23rd country in ease of doing business. Contrary to some perceptions, the first trust experiments in Montenegro conducted under the research umbrella of this study, document high level of trust and social capital in Montenegro, which could be a basis, with the right mix of policies and institutional reforms, for dynamic growth of entrepreneurship (Bjørnskov et al. 2012). Looking to the north, Ireland transformed itself from an underdeveloped to an extremely entrepreneurial and innovative economy in less than a generation. Finland and Israel have shown what small countries can achieve by relying on top-notch education combined with links with research and business. The point is: it can be done.

B. The Legal Environment for Doing Business

203. **Montenegro has made steady, significant improvements in the ease of doing business there.** Doing Business indicators measure the complexity and cost of regulatory processes and the strength of a country’s legal institutions that apply to firms at different stages of their life cycle and ranks countries on 11 different dimensions.24 Montenegro improved its ease of doing business ranking from 57 in 2011 to 51 in 2012; its 2012 ranking was the second highest in the Balkans, following FYR Macedonia but higher than Croatia and Bulgaria, Czech Republic, Hungary, Poland, and Romania in the EU1025, as well as

---

24 Doing Business (2013) covered 185 countries and 11 topics: (i) starting a business; (ii) dealing with construction permits; (iii) getting electricity; (iv) registering property; (v) getting credit; (vi) protecting investors; (vii) paying taxes; (viii) trading across borders; (ix) enforcing contracts; (x) resolving insolvency; and (xi) employing workers. The first 10 topics are incorporated into the aggregate ease of doing business ranking.

25 EU10 comprises Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.
Greece, Luxembourg, and Italy in the EU15. The regulatory climate for doing business in Montenegro is now superior to the Western Balkans average—although trailing FYR Macedonia, the regional doing business champion—and on par with the average for EU10 plus Croatia as illustrated by comparisons with “frontier” rankings (Figure 25). Still, it lags behind EU15 countries.

**Figure 25: Distance to the Frontier in the Ease of Doing Business**

![Graph showing distance to the frontier for various countries over time.](image)

*Source: Doing Business (2013).*

204. Compared with the frontier performance of the best countries, however, Montenegro still has far to go to improve the environment for doing business (Figure 26 - Figure 27), viewed through the prism of “competing with the best.” As an aspiring country, Montenegro should be targeting a top 25 ranking in most of the doing business dimensions. That this is possible is attested by FYR Macedonia,
another small Western Balkans country, which is —ranked 23rd in the world in ease of doing business. So what are the areas of strength and weakness in Montenegro’s environment for doing business?

**Figure 27: Mean Rankings in the Ten Areas Measured by Doing Business, 2012**

![Graph showing rankings in ten areas for doing business, 2012. Diagram includes rankings for starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency.]

**Areas of Strength**

205. Montenegro’s environment for doing business has several areas of comparative strength, among them ease of getting credit, protecting investors, resolving insolvency, trading across borders, starting a business, and ease of paying taxes.

206. Montenegro scored particularly well, ranked the 4th, on ease of getting credit. This index reflects the strength of legal rights, the depth of credit information, and public registry and private bureau coverage. Even though there is no private bureau in Montenegro and public registry coverage is only 25.2 percent—not the highest among comparators—Montenegro scored 10 on strength of legal rights (0-10) and 5 on depth of credit information (0-6).
207. Montenegro’s ranking in the area of protecting investors was 32 in 2012, falling slightly due to improvements in other countries. Otherwise, the scores in the sub-areas remained unchanged.

208. Montenegro also improved its score in the area of resolving insolvency as well as its ranking, 44th in 2012. The time spent to resolve insolvency decreased from a consistent 2 years until 2011 to 1.4 years in 2012. The recovery rate increased from 43.3 percent in 2011 to 48.3 percent in 2012 after falling for two consecutive years after the crisis.

209. In the area of trading across the borders, Montenegro was ranked 42nd in 2012. Even though the number of documents required to export and import both decreased from 7 to 6 in 2010, costs to export and to import have increased steadily to US$855 per container to export and US$915 to import in 2012.

210. Montenegro’s ranking in starting a business fell from 47 in 2010 to 58 in 2012 due to improvements in other countries. Otherwise, the number of procedures, the time required, and the cost to start a business have all declined since 2007/08.

211. Montenegro’s scores in the area of paying taxes have improved significantly since 2008/09, to 81st in 2012. The number of tax payments a year decreased from 89 in 2009 to 29 in 2012, and time spent to pay taxes declined from 372 hours a year in 2011 to 320 in 2012. The total tax rate declined from 32 percent of profits in 2008 to 22 percent in 2012.

Areas of Weakness

212. Montenegro’s main doing business problems seem to be concentrated in certain areas important for the construction and housing industry. Concerted government action will be needed to deal with these remaining issues as a group of related problems for the business climate. Specifically, major problems have to do with access to electricity, registering property, enforcement of contracts, and—most important—construction permits and related constraints, as on access to and cost of communal services.

213. Montenegro was ranked 69th in getting electricity in 2012, a very slight change despite decreases in the cost of getting electricity, which was 490 percent of income per capita in 2012. The number of procedures and the time required to get electricity have not changed. This firm- and user-level picture of electricity is broadly consistent with the detailed analysis of the energy connectivity in chapter 2 above. In sum, both sector level and firm level analysis indicate considerable scope to improve the performance of the energy sector in Montenegro (primarily electricity).

214. Montenegro’s ranking in registering property was 117 in 2012, a slight fall from 2011 due to improvements in other countries. All three measures that constituted this index—number of procedures, time required, and cost of registering a property were high in Montenegro compared to comparators.

215. In 2012 Montenegro was ranked a dismal 135 in the area of enforcing contracts. The ranking reflects the time and the number of procedures required as well as the cost of enforcement. Montenegro’s score changed in none of these areas, and the 49 procedures required is the highest among comparators.

216. Montenegro’s worst score was in the area of dealing with construction permits, where it was ranked at 176. Although the cost of getting a construction permit has been going down since 2006, it is still tremendously high—1170 percent of income per capita, comparable only to Bosnia and Herzegovina and Serbia among comparators. Otherwise, Montenegro does not stand out in terms of the number of procedures required and the time spent to get a permit even though the time latter increased from 250 days in 2006 to 267 days in 2012.
C. Insights from the Montenegro Investment Climate Survey (MICS) 2012 and Field Interviews

217. While the comparative Doing Business Indicators measure mainly the legal and regulatory aspects of the investment climate, firm enterprise surveys (investment climate assessments) measure the “view from the ground”: how constraints are perceived and ranked by businesses. Country-focused investment climate assessments (ICAs) are therefore an important complement to the doing business indicators. The CEM team, in close collaboration with the Montenegro Chamber of Economy, therefore launched in Spring 2012 the latest, representative enterprise survey, the results of which are reported here. This survey is quite comparable to previous Business Environment and Enterprise Performance surveys (BEEP). Table 8 gives ratings for the top six obstacles (see Box 7). The insights from this survey are complemented with observations from field interviews with over 30 business managers representing different sectors of the economy and scale of enterprise.

Table 8: Montenegro Investment Climate Survey (2012): Top Six Constraints

| Constraint                  | Average Severity
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Access to finance</td>
<td>1.9</td>
</tr>
<tr>
<td>Electricity</td>
<td>1.3</td>
</tr>
<tr>
<td>Tax rates</td>
<td>1.3</td>
</tr>
<tr>
<td>Informality</td>
<td>1.2</td>
</tr>
<tr>
<td>Quality of labor force</td>
<td>1.2</td>
</tr>
<tr>
<td>Tax administration</td>
<td>0.9</td>
</tr>
</tbody>
</table>


Box 7: Montenegro Investment climate survey (MICS 2012) methodology

MICS 2012 was an enterprise survey designed by the World Bank in close collaboration with the Montenegro Chamber of Economy, which conducted the survey in Spring 2012. It was the first post-crisis World Bank enterprise survey in Montenegro.

MICS attempted to identify barriers to investment and growth of businesses in nine main areas: (i) infrastructure; (ii) sales and purchases (exports and imports); (iii) competition; (iv) innovation; (v) land availability and construction permits; (vi) crime; (vii) public-private sector relations (including corruption); (viii) access to finance; and (ix) labor. It is a successor to the BEEPS and is comparable with previous BEEPs in Montenegro (2008) and other countries.

The MICS sample covered 176 enterprises stratified by (i) sector (12 manufacturing and 7 others, including construction, trade, and tourism); (ii) size (small, medium, and large); (iii) regions (North, Central, and South). See www.enterprisesurveys.org for further information on sampling methodology.

Of the respondents, 87 percent were directors and board members who average 11–12 years with the company.

218. The insights from the investment climate survey and field interviews are quite consistent with the Doing Business Indicators, with similar problem areas that offer insights into needed
reforms. For example, despite progress in the Doing Business indicator on ease of paying taxes, the surveyed firms rank taxes and informality as two related constraints on to their operation and investments. Similarly, although getting credit is easier based on completed documentation, surveyed firms complain about access to finance, most likely because there is a lack of long-term finance on what they consider acceptable terms. This reflects current nonperforming loans in the banking system as well as judiciary and institutional weaknesses that, beyond high client credit risk, hold back more rapid credit recovery.

219. **These constraints are consistent with those reported in previous BEEPs, with two exceptions.** The most important change since the last BEEPS in 2008 is the score for “access to finance,” now at the top of the list of investment obstacles. This reflects the effects of the 2008-09 crisis in terms of higher interest rates, higher collateral requirements, and bank reluctance to lend). In addition, competition from the informal sector, not asked in the 2008 BEEPS, is identified in this assessment as a significant barrier to investment. All constraints are consistent with the independent views expressed by managers in field interviews, who gave somewhat more emphasis to informal sector competition and the unreliability and cost of electricity.

**Finance, Taxes, and Informality**

220. **Montenegrin firms surveyed in the MICS report that their operations are significantly affected by inadequate financing, the tax burden, and unfair competition from the large informal sector.** About 53 percent of the firms rated access to finance to be the worst obstacle and 70 percent ranked it among the top three. Even though the result is largely an outcome of the global crisis, small companies have a general problem with access to finance due to, e.g., lack of collateral, unreliable financial reports, and little access to external finance.

221. **Problems with access to finance manifest themselves in Montenegrin firms’ high use of internal financing for investments.** Because of a lack of favorable long-term financing sources and the high cost of finance, Montenegrin firms finance for 81.4 percent of their investments internally. The average share of internal financing for the Europe and Central Asian countries (ECA) is 60.2 percent. Montenegrin firms use bank financing for only 7.2 percent of their investments compared to 25 percent for ECA. The average value of collateral needed for a loan in ECA is 130.8 percent of the loan value; in Montenegro, 239.2 percent of the loan value is required. The latter is evidenced by lower penetration of bank overdraft facilities and a higher incidence of advance payments on goods and after-the-fact payments received for goods delivered relative to ECA averages. This also reflects a general problem of bad loans and financial indiscipline in the private sector, which makes banks very cautious about making new loans.

222. **At first, this finding seems to contradict the Doing Business ranking of Montenegro as 4th in getting credit among 185 countries.** However, the getting credit index in the Doing Business indicators measures only the complexity and costs of the regulations governing the process of getting credit in Montenegro. The MICS assessment of access to finance takes into account not only regulatory constraints but the total cost of external financing, including interest rates and collateral requirements.

223. **About 3 percent of the enterprises surveyed rated tax rates as the most important obstacle and 40 percent ranked it among the top three.** These results, however, must be interpreted with caution because the firm perceptions of “tax rates” most likely reflect less of the tax burden per se (Figure 28) than such other factors as the tax burden relative to the unfair competition from the informal sector.
224. Also, 1 percent of the enterprises surveyed ranked **tax administration** as the worst obstacle and 13 percent put it among the top three. In 2011 57 percent of the respondents were visited by a tax official and 1 percent had to deal with corruption. However, the number of tax authority visits in 2011 is lower than the ECA average. There are no visible differences by firm size in their ratings of tax administration.

225. The Doing Business indicators ranked Montenegro the 81st in the area of **paying taxes**. This ranking measures direct taxes and mandatory contributions that a medium-size company must pay plus the administrative burden of paying taxes and contributions. The tax cost borne by the Montenegrin firms has consistently declined from 31.6 percent of total profits in 2006 to 22.3 percent in 2012. The number of payments—how often a company has to file and pay taxes and contributions—also plunged, from 89 in 2009 to 29 in 2012. The number of hours it takes to prepare, files, and pay taxes and mandatory contributions fell from 372 to 320 in 2012.

226. Some 11 percent of the enterprises surveyed ranked **informality** as the worst obstacle and 36 percent ranked it among the top three. At least 50 percent of the respondents must deal with informal competition. The rate is much higher in the North (68 percent) than in the Central region and the South (45 percent). The rate also is much higher for small and medium enterprises. The outcome may reflect weaker institutions in the North.

C.1. The Informal Sector and Connectivity

227. **Because domestic economic activity is more easily hidden than export sales, informal activity is prevalent in tourism, the retail trade and catering, and small-scale services and agriculture, and a wide range of services that are not internationally traded.** Informality therefore confines economic activity and initiative to domestic activities and prevents the connections to foreign markets essential for overall connectivity. The reasoning is that “If I can make money locally without paying any taxes, why bother with exports that will attract the attention of the tax system?” Profits taxed will not only be those...
of exports but the presently untaxed profits from domestic economic activity. For reasons of connectivity alone, government policies that implicitly or explicitly, intentionally or unintentionally, encourage informal activity should be avoided. Policies that encourage informal activity include in particular high labor-market taxes and also government unemployment benefits or income received conditional on not being formally employed.

228. **Field interviews confirm the widespread concern of formal firms and government officials about the sizeable informal sector and about tax evasion and related tax fairness problems.** The informal sector seems to be concentrated in small scale tourism, retail trade, and technical and professional services. The main incentives for informality is the desire to evade social security taxes (an average of 33.8 percent) and VAT (17 percent). While these tax rates do not seem to be high by regional standards, compared with the zero taxes paid by competing informal businesses that are often visible “next door,” they provide sufficient incentives for informality. Moreover, penalties for noncompliance are inadequate and inspector checks ineffective.

Infrastructure: Electricity

229. Some 7 percent of the survey respondents found **supply of electricity** to be the worst obstacle and 32 percent ranked it among the top three. The annual cost of electricity outages in Montenegro is estimated at 1 percent of GDP—which is significant; particularly when growth is sluggish, it can be the difference between growth and recession. Periodic shortages of electricity driven by a tight energy balance, weather vagaries, and water accumulation in hydro-power plants are taking their toll on businesses. Supply interruptions average three to four a month. Though interruptions are distributed across the country, their duration and cost are higher in the North. Also, the averages hide more severe problems; some firms report that outages have a particularly high cost in their businesses.

230. **While the measured quality and reliability of electrical power is higher in Montenegro than in the ECA region as a whole, this may be because firms have learned to adjust to the difficult environment**—the survey also found that the incidence of self-generated power is estimated to be double the ECA average. Field interviews also found that business managers are concerned about the unreliable supply of electricity and many firms whose operations are highly time-sensitive cannot afford to be without a generator, which increases their costs of operation.

Quality of the Labor Force

231. **Overall, the Montenegrin workforce has more skilled workers (80.4 percent of total production workers) than the ECA average (74.1 percent).** The average education of Montenegrin production workers (score 4.9 on a 1 to 8 scale) is also higher than the ECA average (score 3.7). This is consistent with the view in chapter 1 that education in Montenegro could be the basis for further improvements and competitive advantage, but the issue is the quality and mismatch with the new skills demanded by the private sector.

232. **Indeed, some 3 percent of MICS respondents ranked education as the top constraint, and 25 percent ranked it among the top three.** The North seems to have smaller companies and a less educated workforce and to invest less in educating the workforce. The problem seems to be a mismatch between labor skills and job requirements.
How Investment Climate Constraints Affect Firm Productivity

Empirical analysis of the impact of various constraints on firm productivity using the MICS offers insights into improving the investment climate in Montenegro (Sonje and Galac, 2012). While the analysis is limited because for many variables and questions answers were not available for all firms, some tentative conclusions can be drawn:

- Differences in **transportation** of goods—own versus third-party—and **competition** in the firms’ main product market do much to explain productivity differentials among Montenegrin manufacturing firms. An increase in the number of competitors in the main product market decreases productivity; using own transportation has a positive effect.

- A few **firm characteristics** were also correlated with higher productivity:
  - Having an international certificate of quality/standards,
  - Having a web page, and
  - Employing more labor that uses personal computers.

- Firms that do more business with government, employ more skilled workers, employ more temporary workers, and pay higher wages to production workers are found to be less productive. On the face of it this unusual but statistically significant result suggest the existence of serious disincentives for labor-based gains in productivity. But, consistent with the paradox of solid formal education and weak preparation for private employment, the number of formally skilled workers does not seem to make much difference for firm productivity.

- The effects of firm export intensity on productivity are ambiguous. Because there were few exporting firms in the sample, as in Montenegro generally, no firm conclusion can be drawn from the data.
D. Product Market Regulation

Another major dimension of the business environment is product market regulation, which is found to be associated with higher GDP per capita and accelerated productivity growth when it fosters competition (Figure 29). Anticompetitive regulations act as disincentives to technology adoption and innovation and therefore productivity. They can also prevent allocation of resources to more efficient firms and sectors. Whether regulation is pro- or anti-competitive can be evaluated through a product market regulation (PMR) assessment (see Box 8).

**Figure 29: Productivity Acceleration and Regulation**

Percentage point change in the average MFP growth from 1985-95 to 1996-2007

Note: The ETRC indicator summarizes regulatory provisions in seven sectors: telecoms, electricity, gas, post, rail, air passenger transport, and road freight.

Source: OECD (2012).
Box 8: Product Market Regulation (PMR) Assessment Methodology

The structure of the PMR diagnostic approach is shown below:

The PMR diagnostic is composed of 18 basic indicators. These economy-wide and sectoral indicators are based on qualitative information that is coded by assigning a numerical value to each of the possible responses to a given question. The coded information is normalized over a scale of 0 to 6, reflecting increasing restrictiveness of regulatory provisions for competition. These data are then aggregated into low-level indicators at the bottom of the indicator tree by assigning subjective weights to areas of regulation. At each step up the indicator tree, higher-level (composite) indicators are calculated as weighted averages of lower-level indicators.


234. How does Montenegro score on the PMR diagnostic? It appears that Montenegro has less restrictive product market regulation than many middle income countries, including middle-income countries like Brazil, India, Indonesia, China, and South Africa (the BRIICS) and Croatia, but more restrictive regulation than most OECD countries, including small open OECD economies (Figure 30).
Montenegro performs worse than the OECD average in two areas in particular: state control (Figure 31), and barriers to trade and investment. In the latter, Montenegro also scores less than the average for the sample covering both the OECD countries and the BRIICS. Another area where Montenegro can improve its score is on barriers to entrepreneurship. In all three of these areas, however, Montenegro does better than neighboring Croatia. As in many areas of policy, this suggests that while Montenegro compares favorably with the rest of South East Europe, it still lags far behind the most flexible, dynamic OECD countries. Hence, the apparently solid PMR results should not be a reason for complacency but a call for sustained reforms.

State ownership in Montenegro (3.75) is higher than the averages for the OECD countries (3.1), the BRIICS, and Croatia (3.4). Including companies owned by local authorities would further darken the picture (Figure 32).
237. **The government does not have direct control over many business enterprises.** The Montenegrin government has special voting rights in the case of aluminum producer KAP. Removing these rights would improve Montenegro’s score.

238. **Public ownership is high and widespread in Montenegro.** In addition to the 24 sectors covered by the PMR assessment, in which the government has ownership interests in 15, government also holds significant equity stakes in other sectors, such as agriculture and food. Government involvement in particularly high in network sectors, electricity, rail and air transport, postal services, and telecommunications. Montenegro has completely privatized the telecommunications sector and has begun the privatization process in the electricity sector, which has already been unbundled. The government has a 70.6 percent ownership stake in transmission and a 55 percent in production, including imports. Rail and air transport and postal services (except courier services) are still in the initial stages of restructuring and privatization.

239. **While Montenegro is a market economy with dominant private ownership, the government’s economic footprint in the economy extends beyond its ownership interests.** Montenegro is only slightly above average in terms of the extent of regulations governing issuance of licenses and permits, 2 vs. 1.9 across the OECD countries, BRIICS, and Croatia (Figure 33). The OECD average is only slightly lower, 1.8. There is regulation on the “silence is consent” rule and there is a program of “one-stop shops” (single contact points) to get information on notifications and licenses. However, there is still considerable room for improvement, particularly in the area dealing with construction permits, where Doing Business ranks Montenegro 176 out of 185 countries. The dealing with construction permits ranking measures the number of procedures, the time, and the cost required for a small to medium-sized business to get all the approvals necessary for building a simple commercial warehouse and connect it to utilities (water, sewerage, and a fixed telephone line).
In other areas, the state footprint is much more limited (Figure 34). For example, in the area of price controls, Montenegro at 1.2 is only slightly above the 1.1 average for the OECD countries, BRIICS, and Croatia. However, the OECD average is lower, 0.9. Montenegro has price controls on three groups of retail products, gasoline, tobacco, and drugs, and on legal services.

At 1.6 Montenegro is slightly below the 1.7 OECD average in the use of command and control regulation (Figure 35). The average for the OECD countries, BRIICS, and Croatia is much higher at 2.1. This is consistent with the fact that Montenegro is a market economy with the dominant private sector that accounts for about 65 percent of GDP.
242. **Making information more accessible to foreign parties could be improved, particularly since Montenegro is seeking to attract foreign investors and visitors (Figure 36).** In the scale of communication and simplification of rules and procedures, Montenegro performs worse than the comparators: 0.75 against 0.4, the average across the OECD countries, BRIICS, and Croatia. The OECD average alone is 0.3.

Figure 36: Communication and Simplification of the Procedures: Montenegro in 2011 vs. Other Countries in 2007/08

243. **Montenegro performs well on ease of starting a business, scoring 1 against the OECD average of 1.7. The average for the entire group of comparators is 1.9.** The Doing Business ranking of Montenegro in the same area was 45 in 2011 and 58 in 2012 among 185 countries. Even though the number of procedures, the time required, and the cost of starting a business have all declined since 2007/08, Montenegro’s position shifted due to regulatory changes in other countries. Therefore, there is room for improvement (Figure 37).
Montenegro does not have administrative burdens that affect road freight and retail distribution. Montenegro scored very well in this area, 0.8, against an OECD average of 1.4 and the average for the OECD countries, the BRIICS, and Croatia together at 1.6.

Montenegro has no limitations on the number of competitors that may operate in a product market. It is the only country that does not regulate the number of competitors among the OECD countries as well as BRIICS and Croatia. Similarly, there are no any antitrust exemptions in Montenegro. Nor are there other legal barriers on firms that decide to enter the network sectors: telecommunications, electricity, gas, road freight, air and railway transport, and postal services. Services sectors are usually regulated in developed countries. The OECD average of barriers to entry in services is 3.2. The average drops to 3.1 when BRIICS and Croatia are added. Montenegro scores 1.4. Montenegro is also the only country among all its comparators that does not impose any barriers on foreign direct investment (FDI).

A simple average of effective tariff rates shows that Montenegro is an open economy with an average tariff of 4.9 percent, giving it a score of 1 (Figure 38). Even though tariff rates in Montenegro on average are lower than in the BRIICS other than Indonesia, its score is much higher than the OECD average of 0.1.
Even though there are no formal barriers to FDI in Montenegro, some discriminatory procedures might be imposed on foreign firms. In this area, Montenegro scores 0.7, which is the OECD average. BRIICS, except for South Africa, have more such restrictions. Montenegro’s score could be improved further by making the regulations more accessible to interested foreign parties.

Montenegro, however, scores poorly on regulatory barriers, which measures conformity of domestic regulations with international standards. At 2.3 Montenegro’s score is much higher than the OECD average of 0.3 and the 0.5 average across the OECD and the BRIICS (Figure 39).
E. Labor Market Regulations

What about the labor market? How bad is unemployment and what role does labor market regulations have in shaping unemployment outcomes? Chapter 1 looked at the issue of education as a factor of growth and chapter 2 discussed the issue of skills as part of the need to build competitive advantages and bridge the skills mismatch towards new types of high-wage jobs in information communication technologies and other sectors attractive to multinational companies that could be attracted by Montenegro’s comparative and locational advantages. In this chapter, we look at the other side of the human capital equation – the regulatory environment, the quality of which can be an important determinant of the economy’s ability to absorb and generate high-quality jobs. Like the other Balkan countries, Montenegro has low labor force participation and employment rates and high unemployment. In the second quarter of 2012, 57.8 percent of the working-age population (aged between 15 and 64) were active in the labor market and 20.1 percent of the labor force were unemployed. The employment rate in the same period stood at 46.2 percent and youth unemployment at 44.6 percent (Figure 40).

**Figure 40: Labor Market Performance, 2011**

<table>
<thead>
<tr>
<th>Percentage points</th>
<th>Labor force participation rate</th>
<th>Employment rate</th>
<th>Unemployment rate</th>
<th>Youth unemployment rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>80</td>
<td>Montenegro</td>
<td>Balkans excl. Albania, Kosovo, and Montenegro</td>
<td>Croatia</td>
<td>EU10</td>
</tr>
<tr>
<td>70</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>60</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>50</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>40</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Sources:** Eurostat and national statistical offices.

Labor demand has been weak since the crisis and is exacerbated by the investment climate and job-skill mismatches. Basically, growth has not been robust enough to increase the demand for labor and reduce the high unemployment rate (Figure 41 and Figure 42). However, labor market regulations, labor taxation, and pensions/social protection systems are also having an effect.
Figure 41: GDP Growth vs. Changes in the Unemployment Rate, 2006-11

Sources: World Development Indicators (2012) and MONSTAT.

Figure 42: Montenegro: Labor Demand, Unemployment, and GDP Growth, 2006-11

Note: Labor demand is calculated as employment plus vacancies as a percentage of population aged 15 and over.
Sources: World Development Indicators (2012) and MONSTAT.

251. **How does Montenegro compare in terms of the overall flexibility or rigidity of employment regulation?** On the surface, relatively well (Figure 43) is the answer. The median country in the
comparator groups (the Balkans, the EU10 = Croatia, and the EU15) scored 32.5; Montenegro scored 28.1.

Figure 43: Rigidity of Employment Index, 2012

Looking at the subindices, however, Montenegro performed worse than the median country in the difficulty of hiring scale (Figure 44), which is related to the limited duration of fixed-term contracts (Figure 47). Montenegro scored a 44.3 in this scale against the median country’s 33.3. The dismal performance came largely from the maximum length of fixed-term contracts. Montenegro was one of the eight countries with fixed-term contracts that last less than three years. Fixed-term contracts are preferable to permanent contracts because they give employers more flexibility in hiring decisions, and longer-duration fixed-term contracts further increases flexibility. The minimum wage as a percentage of value added was also higher in Montenegro than in the median country among comparators.

253. Redundancy costs as measured by the notice period (4.3 weeks) and severance pay for dismissal (6.9 weeks of salary) are not high in Montenegro (Figure 48). In the median country among the Balkan countries, EU10+Croatia, and EU15, the notice period is 6.7 weeks and severance pay is 6.3 weeks of salary.
254. Montenegro should look to Denmark as a model in the ease of hiring and flexibility of labor market regulations (Figure 47-Figure 48). Denmark has a very vibrant SME sector and low unemployment, which stayed down even during the global recession.
So even though Montenegro is only moderately strict in employment protection by the OECD standards, there is clearly still room for improvement. However, liberalizing the use of temporary contracts without eliminating permanent contracts creates duality and inequality in the labor market: insiders with permanent contracts and secure jobs vs. outsiders with temporary contracts and insecure jobs. Relaxing employment protection is therefore the preferred option.

Beyond labor market, other regulations also affect people’s incentives to participate in the labor market and firms to hire workers: pensions, social benefits, and social security (wage) taxes.

While pension reform has progressed, Montenegro’s current pension scheme creates incentives for early retirement and exit through disability. Workers are eligible to retire after 40 years of service. The early retirement period is much less than in the EU countries. Also, there is no pension penalty for early retirement and only a small bonus for late retirees. The rate of exit through disability is among the highest in the EU, and the hazardous occupations eligible for early retirement are numerous.

The Montenegrin social benefit system creates significant disincentives to work, but only for relatively few people. Family material support (FMS/MOP) benefit amount is calculated as the difference between the eligibility threshold and actual family income. Benefits are generous. The generous package of benefits is arguably creating disincentives for earning income because all earned income is taxed away (the actual amount received is the difference between the maximum benefit for which those with no income are eligible and the actual income of the family).

The tax and social benefit systems create significant disincentives for formal work (Figure 49). Among OECD and Western Balkan countries, the cost of formalizing is the highest in Montenegro. The tax burden on mini-jobs (e.g., part time jobs, internships, etc.) is higher in only four of the other
OECD/Western Balkan countries, and the minimum wage is almost the same as the unemployment benefit.

Figure 49: Montenegro: Tax/Wage Disincentives for Formal Work

F. Policy Agenda For Improving Flexibility

260. This analysis of Montenegro’s business, investment climate, product, and labor market regulations suggests a policy agenda for improving flexibility—an agenda focused tightly on the areas of weakness identified so as to get the biggest bang per reform buck. The proposed measures are based on good international practice and directed to turning weaknesses into areas of strength. Following the analysis above, they are clustered in three main areas: the business and investment climate, product markets, and labor market regulation.

The Business and Investment Climate

261. Montenegro must continue reinforcing what is functioning well in attracting investment while moving urgently to repair areas of weakness, which mainly lie in the depressed housing and construction industry, the informal sector, trade barriers, and the impact of local fees and taxes on investment. To that end, the government should address urgently the biggest weaknesses and constraints on the Doing Business scale with a menu of policy measures.

262. High on the policy agenda for addressing the weaknesses in the investment climate would be to significantly reduce the cost of entry and operation in the construction and housing industry:

- Comprehensively review and reduce regulation-related costs and the time required to complete construction: getting and making changes in construction permits, the excessive cost of communal services, and delays in getting utility connections on completed projects.
- Cut red tape in the land cadaster and speed up procedures for registration and transfer of property.
- Strengthen enforcement of contracts by revisiting creditor rights and facilitating out-of-court and accelerated settlements of contract disputes.
• Consider consolidating the agencies involved in the cadaster and construction to speed coordination, reduce the number of procedures, and increase efficiency in provision of permits and licenses.

• Institute mandatory public monitoring and measurement of the efficiency of public services involved in the construction industry (cadaster, agencies for construction, etc.) and impose explicit penalties for noncompliance with performance targets.

263. **Policy should also promote intensified efforts to formalize informal activity:**

• Reinforce the systems of penalties, rewards, and inspections of informal establishments, with particular focus on the tourism sector in the South and retail trade and tourism in the North where informality dominates.

• Continue monitoring and reinforcing compliance of producers of excised goods, especially those more recently introduced (e.g., carbonated drinks).

• Longer term, shift the burden of taxes from labor (social security contributions) to consumption (value-added tax) to help stimulate employment, investments, and exports.

264. **It is also crucial to reduce the red tape and documentation required for exports and imports,** set benchmarks and monitor how quickly and smoothly goods and services cross borders; set performance benchmarks and introduce penalties for underperformance.

265. **Because many businesses complain about the local impact of taxes on their operations and investments,** it will be necessary to carry out a comprehensive review of local taxes and fees, involving private business associations, with the view to reducing, simplifying, or eliminating them; an example is the new municipal “access fee.”

**Product Market Regulation**

266. **Improvements of product market regulation should focus on reducing state control in the areas where Montenegro lags behind OECD countries.** These relate to the size of the government’s portfolio in the economy and coordination of its stake in enterprises, further reducing barriers to entrepreneurship, making the one-stop shops for businesses more effective, and here again reducing the cost of construction permits—consistently identified as a major constraint in a variety of business and investment climate diagnostics, such as the latest Doing Business and the MICS. Specific recommendations in this area include the following.

• Downsize the government portfolio of equity stakes. Finding a final solution for KAP by selling the government stake or any other method would significantly change the amount of state control in Montenegro.

• Ensure that institutional stakeholders in the same companies coordinate their efforts: consolidate public equity holdings, improve management and control systems, set transparent goals for each company, draw up long-term plans for such activities as spin-offs and privatization, and ensure that members of supervisory board and management are held accountable.
• Speed up separation, restructuring, and privatization processes in network sectors, in particular those related to energy production; begin to prepare railways for conditions post-EU entry.

• Extend one-stop shops to cover issuance of permits and licenses by local authorities. At the moment they are primarily information points. They should evolve into operational contact points where permits and licenses are actually issued, and they act on behalf of and in coordination with public bodies. Also, ease access to one-stop shops for foreign investors and companies.

• Assess the impact of Montefarms on the pharmaceutical market.

• As noted in the discussion of investment climate, product market analysis also strongly suggests the need to reduce significantly the costs of construction permits, especially the costs of studies, ecological permits, and access to utilities.

The Labor Market

267. Finally, the government should continue refining labor market regulations so that they do not act as disincentives to opening up jobs, by allowing a variety of employment contracts and durations to make labor markets more flexible. It should also keep reviewing related tax, pension, and social safety net regulations from the perspective of the possible disincentives for employment. Specifically, policy should aim to:

• Eliminate the maximum duration of fixed-term contracts.

• Gradually increase the early retirement age to the OECD average.

• In the medium term, reduce social security contributions as a tax on employment and shift the tax burden to consumption taxes.
Annex 1: Montenegro Doing Business Indicators, 2006-12

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ease of Doing Business – Rank</strong></td>
<td>51</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Starting a Business – Rank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Procedures (number)</td>
<td>13</td>
<td>13</td>
<td>13</td>
<td>11</td>
<td>7</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Time (days)</td>
<td>24</td>
<td>24</td>
<td>21</td>
<td>12</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Cost (percent of income per capita)</td>
<td>6.7</td>
<td>6.2</td>
<td>4.4</td>
<td>2.6</td>
<td>1.9</td>
<td>1.8</td>
<td>1.6</td>
</tr>
<tr>
<td>Paid-in minimum capital (percent of income per capita)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Dealing with Construction Permits – Rank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>176</td>
</tr>
<tr>
<td>Procedures (number)</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>17</td>
<td>17</td>
<td>17</td>
<td>16</td>
</tr>
<tr>
<td>Time (days)</td>
<td>250</td>
<td>250</td>
<td>281</td>
<td>263</td>
<td>267</td>
<td>267</td>
<td>267</td>
</tr>
<tr>
<td>Cost (percent of income per capita)</td>
<td>2302.1</td>
<td>2141.7</td>
<td>1627</td>
<td>1336.9</td>
<td>1495.7</td>
<td>1469.9</td>
<td>1169.6</td>
</tr>
<tr>
<td><strong>Getting Electricity – Rank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>69</td>
</tr>
<tr>
<td>Procedures (number)</td>
<td></td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time (days)</td>
<td></td>
<td>71</td>
<td>71</td>
<td>71</td>
<td>71</td>
<td>71</td>
<td></td>
</tr>
<tr>
<td>Cost (percent of income per capita)</td>
<td></td>
<td>485.1</td>
<td>542.8</td>
<td>533.4</td>
<td>490.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Registering Property – Rank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>117</td>
</tr>
<tr>
<td>Procedures (number)</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Time (days)</td>
<td>71</td>
<td>71</td>
<td>71</td>
<td>71</td>
<td>71</td>
<td>71</td>
<td>71</td>
</tr>
<tr>
<td>Cost (percent of property value)</td>
<td>2</td>
<td>2.4</td>
<td>3.3</td>
<td>3.3</td>
<td>3.3</td>
<td>3.1</td>
<td>3.1</td>
</tr>
<tr>
<td><strong>Getting Credit – Rank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>Strength of legal rights (0-10)</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Depth of credit information (0-6)</td>
<td>0</td>
<td>0</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Public registry coverage (percent of adults)</td>
<td>0</td>
<td>26.3</td>
<td>27.6</td>
<td>26.7</td>
<td>26.4</td>
<td>25.2</td>
<td></td>
</tr>
<tr>
<td>Private bureau coverage (percent of adults)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td><strong>Protecting Investors – Rank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>32</td>
</tr>
<tr>
<td>Extent of disclosure (0-10)</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Extent of director liability (0-10)</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Ease of shareholder suits (0-10)</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Strength of investor protection (0-10)</td>
<td>6.3</td>
<td>6.3</td>
<td>6.3</td>
<td>6.3</td>
<td>6.3</td>
<td>6.3</td>
<td>6.3</td>
</tr>
<tr>
<td><strong>Paying Taxes – Rank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>81</td>
</tr>
<tr>
<td>Payments (number per year)</td>
<td>89</td>
<td>89</td>
<td>89</td>
<td>89</td>
<td>77</td>
<td>42</td>
<td>29</td>
</tr>
<tr>
<td>Time (hours per year)</td>
<td>372</td>
<td>372</td>
<td>372</td>
<td>372</td>
<td>372</td>
<td>372</td>
<td>320</td>
</tr>
<tr>
<td>Profit tax (percent)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>7.1</td>
<td></td>
</tr>
<tr>
<td>Labor tax and contributions (percent)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>12.8</td>
<td></td>
</tr>
<tr>
<td>Other taxes (percent)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2.4</td>
<td></td>
</tr>
<tr>
<td>Total tax rate (percent of profit)</td>
<td>31.6</td>
<td>31.6</td>
<td>31.8</td>
<td>28.9</td>
<td>26.6</td>
<td>22.3</td>
<td>22.3</td>
</tr>
<tr>
<td><strong>Trading Across Borders – Rank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>42</td>
</tr>
<tr>
<td>Documents to export (number)</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>6</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Time to export (days)</td>
<td>14</td>
<td>14</td>
<td>14</td>
<td>14</td>
<td>14</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>Cost to export (US$ per container)</td>
<td>645</td>
<td>645</td>
<td>775</td>
<td>775</td>
<td>775</td>
<td>805</td>
<td>855</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>-----</td>
<td>-----</td>
<td>-----</td>
<td>-----</td>
<td>-----</td>
<td>-----</td>
<td>-----</td>
</tr>
<tr>
<td>Documents to import (number)</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>6</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Time to import (days)</td>
<td>14</td>
<td>14</td>
<td>14</td>
<td>14</td>
<td>14</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>Cost to import (US$ per container)</td>
<td>760</td>
<td>760</td>
<td>890</td>
<td>890</td>
<td>890</td>
<td>915</td>
<td>915</td>
</tr>
<tr>
<td><strong>Enforcing Contracts – Rank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>135</strong></td>
</tr>
<tr>
<td>Time (days)</td>
<td>545</td>
<td>545</td>
<td>545</td>
<td>545</td>
<td>545</td>
<td>545</td>
<td>545</td>
</tr>
<tr>
<td>Cost (percent of claim)</td>
<td>25.7</td>
<td>25.7</td>
<td>25.7</td>
<td>25.7</td>
<td>25.7</td>
<td>25.7</td>
<td>25.7</td>
</tr>
<tr>
<td>Procedures (number)</td>
<td>49</td>
<td>49</td>
<td>49</td>
<td>49</td>
<td>49</td>
<td>49</td>
<td>49</td>
</tr>
<tr>
<td><strong>Resolving Insolvency – Rank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>44</strong></td>
</tr>
<tr>
<td>Time (years)</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>1.4</td>
</tr>
<tr>
<td>Cost (percent of estate)</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Recovery rate (cents on the dollar)</td>
<td>41.8</td>
<td>42.8</td>
<td>43.7</td>
<td>43.7</td>
<td>43.4</td>
<td>43.3</td>
<td>48.3</td>
</tr>
</tbody>
</table>
REFERENCES

Montenegro CEM draft background papers and notes (2012)

“Ensuring Macroeconomic Sustainability for Long-Term growth in Montenegro” [Sanja Madžarević-Šujster, Milenko Popović]


“Increasing Montenegro’s Export Potential and Export Sophistication,” [Israel Osorio-Roddarte, Željko Bogetić]


“An Analysis of Product Market Regulations and Constraints on Foreign Direct Investments in Montenegro,” [Velimir Šonje and Toma Galac].

“Montenegro—A Note on the Recent Evolution of Poverty and Inequality,” [Kenneth Simler and La-Bhus Jirasavetakul]

“Labor Market Regulations: Constraints and Remaining Agenda,” material based on the technical assistance on labor market regulations [Jan Rutkowski]


“Reducing Montenegro’s Other Trade Barriers: Issues and Remaining Policy Agenda,” [Arye Hillman and Israel Osorio-Roddarte]


“Innovation and Investment Climate in Montenegro,” [Murat Şeker]


Other References


