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MONTENEGRO

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Restoring Sustainability and
Strengthening Efficiency of Public Finance

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ABBREVIATIONS AND ACRONYMS

AIA	Administration for Inspection Affairs		MIC	Middle-income countries
ALOS	Average length of stay		MLSW	Ministry of Labor and Social Welfare
CA	Contracting authority		MOF	Ministry of Finance
CAD	Current Account Deficit		MOI	Ministry of Interior
CAR	Capital Adequacy Ratio		MONSTAT	Statistical Office of Montenegro
CBCG	Centralna banka Crne Gore		MTBF	Medium-term Budget Framework
CEPEJ	The European Commission for the Efficiency of Justice		MTMA	Ministry of Transport and Maritime Affairs
CHU	MOF Central Harmonization Unit		NAP	National Action Plan
CIPFA	Chartered Institute of Public Finance and Accounting		NCD	Non-communicable Diseases
CIT	Corporate income tax		NHDR	National Human Development Report
COCOPS	Coordination for Cohesion in the Public Sector of the Future		NIC	National Investment Commission
COFOG	Classification of the Functions of Government		NMS	New Member States
CPB	Central purchasing body		NPL	Non-performing Loans
CPI	Consumer price index		NPM	New public management
CSW	Centers for Social Work		O&M	Operations and maintenance
DB	Doing Business		OECD	Organization for Economic Cooperation and Development
DPW	Directorate of Public Works		OOP	Out-of-pocket
DT	Directorate of Transport		PACT	Public Accountants Certification Training
EAM	Employment Agency of Montenegro		PAR	Public Administration Reform
EC	European Commission		PAYG	Pay-As-You-Go
ECA	Europe and Central Asia		PB	Program budgeting
EIB	European Investment Bank		PEFA	Public Expenditure and Financial Accountability
EPCG	Elektroprivreda Crne Gore AD Niksic		PFM	Public financial management
EPSAS	European Public Sector Accounting Standards		PFR	Public Finance Review
ESA	European System of Accounts		PHC	Primary health care
EU	European Union		PIFC	Public Internal Financial Control
EUROSTAT	Statistical Office of the European Union		PIM	Public investment management

FDI	Foreign Direct Investment		PIP	Public Investment Portfolio
FMC	Financial Management and Control		PIT	Personal income tax
FMS/MOP	Family Material Support		PPA	Public Procurement Administration
GCA	General Collective Agreement		PPL	Public Procurement Law
GDP	Gross Domestic Product		PPS	Purchasing Power Standard
GNI	Gross National Income		PROST	Pension Reform Options Simulations Toolkit
GoM	Government of Montenegro		SA	Social Assistance
GVA	Gross Value Added		SAI	State Audit Institution
HALE	Healthy life expectancy		SC	State Commission for the Control of Public Procurement Procedures
HBS	Household Budget Survey		SCD	Systematic Country Diagnostic
HIF	Public Health Insurance Fund		SCS	Senior civil servants
HIS	Health Information Systems		SDP	Secretariat for Development Projects
HR	Human resources		SEE	South East Europe
HRMA	Human Resource Management Agency		SEETO	South East Europe Transport Observatory
IA	Internal audit		SME	Small and Medium Enterprises
ICT	Information and Communications Technology		SPP	Single Project Pipeline
IFI	International financial institution		SRA	Strategic Relevance Assessment
ILO	International Labour Organization		SSN	Social Safety Net
IMF	International Monetary Fund		SSV	Services for Social Work
INN	International Nonproprietary Name		STA	Single Treasury Account
IPSAS	International Public Sector Accounting Standards		SWG	Sector Working Group
KAP	Kombinat Aluminija Podgorica		SWIS	Social Welfare Information System
LBFR	Law on Budget and Fiscal Responsibility		TFP	Total Factor Productivity
LFS	Labor Force Survey		UNDP	United Nations Development Program
LGU	Local government unit		UNESCO	United Nations Educational, Scientific and Cultural Organization
LLGF	Law on Local Government Finance		VAT	Value Added Tax
LMs	Line ministries		WB	World Bank
LSEPS	Law on Salaries of Employees in the Public Sector			
LTD	Loan-to-Deposit		WDI	World Development Indicators
M&E	Monitoring and evaluation		WEF	World Economic Forum
METR	Marginal Effective Tax Rate		WHO	World Health Organization

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The early findings of the report were presented to the Government on December 6, 2016 and the team remains grateful for the feedback and the comments received. This synthesis report updates the earlier report and outlines the remaining unfinished fiscal consolidation agenda based on the engagement under the various World Bank programs in Montenegro.

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EXECUTIVE SUMMARY

Benefiting from successful economic transformation after independence and the start of EU accession negotiations, economic activity in Montenegro has been solid, supporting the rise in incomes their convergence with the ones in the European Union. Inflation has been modest and kept in check. However, the import dependence of the growth model and the excessive reliance on the state to stimulate the economy have contributed to widening of external and internal imbalances as well as indebtedness.

There have been recent efforts at fiscal tightening, but more needs to be done to address structural rigidities and boost the commitment to the objectives of economic policies. This is particularly the case with respect to the medium-term budget plans, public sector restructuring, pension and health reforms, improvements of market competition, and the labor market.

Montenegro confronts today the need for further fiscal adjustment to turn the deficit into surplus and bring public debt below the Maastricht level. This would help creating the fiscal space for strengthening its convergence prospects with the EU and with the alignment with the rules in the eurozone, given the country's use of euro as the local currency. Fiscal and structural policies in an economy without monetary policy levers are of paramount importance to protect stability and competitiveness.

This Public Finance Synthesis Report is a summary of policy discussions over the last few years carried out under the various World Bank activities, including the Policy-Based Guarantee, the analytical work under the topic of Jobs and Growth and on pharmaceutical reform issues). While the Government has already taken major efforts to address some of the critical bottlenecks in the economy, this synthesis report summarizes and outlines pathways to further strengthen the sustainability, efficiency, and effectiveness of public finances in Montenegro.

INTRODUCTION

1. **Progress in negotiations with the European Union (EU) is opening up unprecedented opportunities for institutional upgrade of Montenegro.** The negotiations began in June 2012 and Montenegro is working on an ambitious timetable to join before 2025.[1] With regard to the economic criteria, Montenegro has made some progress and is moderately prepared to build a functioning market economy. Macroeconomic and fiscal stability were strengthened recently, but further efforts are required to address persistent challenges such as its high public and external debt.[2]

2. **The economy has been growing without interruption since 2013, inflation has been low or moderate, but revenue boost was not used to avoid growth in public debt**. Having tripled since 2006, in 2018 public debt approached 76 percent of GDP, which along with external debt at over 160 percent raises concerns about the long-term sustainability of the economy. Moreover, for the last 10 years Montenegro has been running a fiscal deficit of 4.7 percent of GDP on average, and the current account deficit (CAD) has been averaging 16.2 percent.

3. **Although growth has accelerated, much about Montenegro's current growth model raises concerns**. Because of the model's high import-dependence and the country's low export base, the trade deficit is high: exports of goods equal less than 10 percent of GDP, one of the lowest ratios among emerging markets. Since the global crisis, productivity has been either low or negative, which calls for acceleration of structural reforms. [3] The large presence of the state, low labor force participation, low productivity, and such rule of law weaknesses as unfair competition from the informal economy, affect the business environment negatively. With EU accession prospects closer, the country now needs to fulfill its Maastricht criteria commitments.[4]

4. **With unilateral euroization, Montenegro relies on fiscal policy and structural reforms to maintain flexibility, macroeconomic stability, and the ability to respond to shocks.** Yet progress on all fronts has been disappointing. The country has long been unable to address its twin deficits and has exhausted its buffers against shocks. Lack of commitment to fiscal targets (since 2011 the average deviation of the actual deficit from its original budget targets was 3.5 percentage points of GDP) and until recently, persistently overoptimistic growth projections have been undermining the credibility of macroeconomic policy. The recommendations in the government's 2019 Economic Reform Program also make it clear that a priority should be maintaining fiscal discipline in order to reduce public debt, improve the sustainability of public finances, and restore the competitiveness of the economy.

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[1] So far, three chapters (out of 33 for negotiations) have been provisionally closed and only one chapter (Competition Policy) has yet to be opened.

[2] EC. Montenegro 2018 Report https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/20180417-montenegro-report.pdf.

[3] World Bank. 2016. Systematic Country Diagnostic.

[4] There are four convergence criteria that were put in place to measure progress in countries' preparedness to adopt the euro. They focus on: (i) price stability; (ii) sound public finances, ensuring government is not under excessive deficit procedure; (iii) exchange-rate stability; and (iv) long-term interest rates.

5. **The country is now confronted by a double challenge: strengthening macroeconomic stability while fostering recovery of income convergence and competitiveness**. Reducing fiscal vulnerabilities is central to macroeconomic stability and lays the foundation for stable growth. To promote growth and competitiveness, structural reforms in two areas will be critical: (i) relieving the regulatory burden on the labor market and acting to improve the investment climate; and (ii) rationalizing public spending and reducing the excessive size and cost of the public sector. Without urgent attention to these policies, the country is threatened with losing the confidence of the private sector and crowding out its activity.

6. **This Public Finance Review is intended to help the Government of Montenegro make informed decisions on restoring the sustainability of public finance and exploring ways to make public spending more efficient, equitable, and effective:**

- First, it analyzes Montenegro's major fiscal weaknesses in areas such as the size and cost of public administration, local government finances, and health and social sector spending.
- Second, it analyzes ways to boost tax collection through limited tax policy interventions and strengthening the tax administration.
- Third, it analyzes institutional weaknesses and requirements for efficient public financial and investment management.
- Finally, it calculates that a fiscal adjustment of 2.8 pp of GDP will be needed over the medium term to stabilize and bring debt below 60 percent of GDP, which is now clearly a priority for the country with the renewed EU accession momentum.

Macro-Fiscal Developments

The Boom-Bust Cycle(s)

7. **Montenegro is a small open economy that experienced significant boom and bust periods over the past decade and a half.** Montenegro was one of the fastest growing non-oil exporting economies before the 2008 crisis. The boom period was marked by a significant reform push, rising employment and incomes. A comprehensive reform program geared toward privatization and a low-tax, pro-business environment during the pre-crisis years opened a space to massive capital inflows in tourism, real estate and banking. The economy grew on average by 5 percent in the period leading to the crisis, reaching a double-digit peak in 2007, driven by capital inflows that reached 46 percent of GDP. Employment increased in parallel with the economic activity, increasing by 17 percent between 2001 and 2008. Consequently, as household income increased, consumption as a share of GDP went up from about 70 percent in 2000 to 91.2 percent in 2008.

8. **The stimulus effect prompted by capital inflows was magnified by a rapid increase in government expenditures** to over 50 percent of GDP in 2008, explained in part by the transition to an independent state. Nevertheless, this dynamic resulted in significant external imbalances with large current account deficit reaching almost half of the country's GDP in 2008 (Figure 1) and external debt at 115 percent of GDP.

Figure 1. Current and Capital Account, Percent of GDP, 2005-18

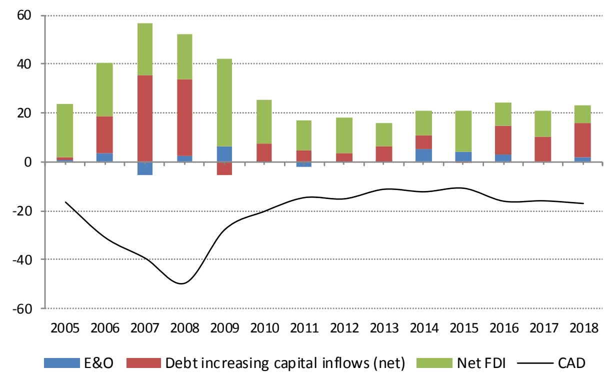
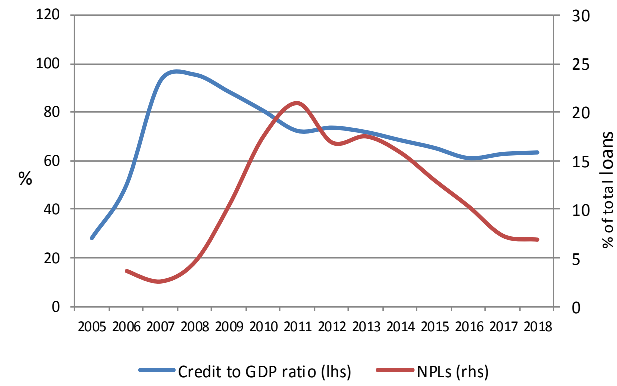


Figure 2. Credits and Non-Performing Loans, 2005-18



Source: CBCG, MONSTAT, World Bank staff calculations.

9. **As an import intensive economy, Montenegro was disproportionately affected by rising external imbalances.**[5] Most of the capital inflows that came in the country were used for debt creating imports of goods and services as aggregate demand expanded, especially through construction, tourism, and trade. Ample credit to households and business further aggravated the external imbalances. Private sector activities expanded backed by abundant credit flow from commercial banks, further adding to the rising imports. As a result of legal settings that permitted a higher bank multiplier in Montenegro, credit stock by 2008 grew 15 times compared to 2003, bringing the credit to GDP ratio to 90.7 percent, while the loan-to-deposit ratio reached 167 percent at its peak in April 2009. The consequence of this unbounded credit expansion was a legacy of extremely high non-performing loans that occurred in the aftermath of the crisis which hampered banks' balance sheets and their ability to lend for a prolonged period of time (Figure 2).

10. **As the country got overexposed to capital inflows, the onset of the global crises resulted in a painful rebalancing.** The boom period was followed by a bust with a reduction in external financing of about 35 percent of GDP between 2009 and 2014 causing a dramatic decline in credit to the private sector, a collapse in investment and, as a result, a severe fall in the GDP growth (from 7.2 percent in 2008 to –5.8 percent in 2009). An appropriate but large increase in the fiscal deficit—as government revenues declined but non-discretionary spending did not fall by the same amount—led to a doubling of public debt in only four years. The current account deficit shrank to 28 percent of GDP in 2009, as a contraction of domestic aggregate demand led to a major drop in imports. As a result of the intensive deleveraging process in the banking sector, credit fell sharply, by 21 percent between 2008 and 2011. Parent bank credit also became scarcer and borrowing from parent banks as a share of total liabilities fell from 20 percent in 2008 to 13 percent in 2012.

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[5] Imports played a key role in reducing the growth in good times and preventing a steeper fall in bad times. A steep fall in imports in the bust years partially compensates for the negative impact on growth of a fall in household consumption and investment. On the other hand, in good times rising imports subtract from growth as Montenegrin exports are very import-intensive. Thus, changes in global commodity prices will disproportionally impact consumption, investments and competitiveness of the local economy.

11. **Then, after a brief recovery in 2010–11, Montenegro was hit by a second recession, this one triggered by the sovereign debt crises in Europe.** The government again turned to fiscal stimulus and by 2015, public debt had reached a new peak of 74 percent of GDP and external debt was at 171 percent; the high twin deficits left Montenegro without buffers to respond to new shocks. In 2015 the fiscal deficit rose above 7 percent of GDP. Aiming to connect the underdeveloped North of the country with the fast-developing coastal region and to stimulate the growth that had lost traction, in 2015 the government embarked on a major public-sector investment, the Bar-Boljare highway, valued at 23 percent of GDP (Box 1). Leading into the 2016 general elections, it also boosted personal consumption by introducing mothers' benefits[6] and raised public sector wages by 10 percent and the minimum pension by 20 percent. This reduced poverty to less than 5 percent,[7] but there were no sustained improvements in the labor participation rate. With these interventions public debt became not only unsustainable but also set to increase fast through the medium term (Table 1).

Table 1. Montenegro: Main Economic Indicators, 2010-18

	2010	2011	2012	2013	2014	2015	2016	2017	2018*
Real sector, inflation and exchange rate									
GDP growth (%)	2.7	3.2	-2.7	3.5	1.8	3.4	2.9	4.7	4.9
Domestic demand (% growth)	-2.2	-2.3	-1.6	1.3	2.6	3.1	9.3	8.2	6.0
Unemployment rate (period average)	19.6	19.7	19.8	19.5	18.0	17.6	17.7	16.1	15.2
Inflation (period average)	0.5	3.1	4.1	2.2	-0.7	1.5	-0.3	2.4	2.6
Broad money (% growth)	3.5	2.3	8.4	4.4	9.1	11.3	9.5	13.7	1.9
Private sector credit (% growth)	-5.1	-9.3	-0.1	1.0	-0.1	1.5	1.0	9.7	8.3
Government finance (% of GDP)									
Revenues	42.2	39.5	40.9	42.3	44.6	41.5	42.5	41.4	42.4
Expenditures	46.7	44.6	46.2	47.6	47.7	48.8	45.3	47.0	46.2
Fiscal deficit	-4.6	-5.1	-5.3	-5.2	-3.1	-7.3	-2.8	-5.6	-3.8
Primary deficit	-3.6	-3.7	-3.4	-3.1	-0.8	-4.9	-0.7	-3.2	-1.8
Public debt and guarantees	50.7	57.2	65.4	65.9	67.1	73.7	71.4	70.0	75.7
External sector (% of GDP)									
Current account balance	-20.3	-14.8	-15.3	-11.4	-12.4	-11.0	-16.2	-16.1	-17.2
Net FDI	17.7	11.9	14.5	9.6	10.2	16.9	9.4	11.3	7.1
Gross external debt	142.6	145.4	156.4	156.3	162.3	171.0	162.5	160.5	168.3

**preliminary.*
Source: CBCG, MOF, MONSTAT, World Bank staff calculations.

[6] Amendments to the Law on Social and Child Protection in 2015 stipulated that mothers with (i) three children and 25 years of work and a social insurance record or (ii) more than three children and 15 years of work and insurance, were entitled to a monthly benefit equivalent to 70 percent of the average net wage in the previous year (€336 in 2016). Mothers with three or more children who have been registered as unemployed with the Employment Agency for at least 15 years were entitled to 40 percent of the average net wage (€192 in 2016).
[7] Measured as consumption below the international middle-income-country poverty line of $5.5/day 2011PPP.

Box 1. The Bar-Boljare Highway

The largest investment in Montenegrin history, the Bar-Boljare Highway, is a three-phase project to connect the port of Bar to the Serbian road network to the north, passing through the underdeveloped northern region. The 160-kilometer highway will also provide a link to Pan-European Corridor XI.

In October 2014, the Government and the China EXIM Bank signed the financing contract for construction of a 41 km section of the highway valued at the equivalent of €687 million (the loan is in USD without the exchange rate hedge). This followed the February signing of a construction contract with the China Roads and Bridges Corporation amounting to €809.6 million—23 percent of that year's GDP (the payments are fixed to the 2014 exchange rate to USD). The Law on Highways enacted by Parliament in November 2014 allows for a full tax exemption of civil works, labor, and highway-related imports for the Chinese construction companies, which increases the highway cost. Recent plans to construct adjacent roads and noncontracted work add to total project costs.

Work, which began in 2015, is scheduled to end in 2020. Domestic firms are expected to contract about 30 percent of the total cost. It is estimated that about 4,000 new workers will be employed over the course of construction. The IMF estimated that total GDP including the highway in 2023—the year with the largest difference—would be about 4¼ percentage points of 2014 GDP higher than without it. Growth thereafter would be slightly lower because the higher capital stock would imply larger depreciation. However, the investment cost and the maintenance thereafter led to rise in debt and taxes to avoid fiscal crisis which offset the growth benefits of such a large investment.

12. **The need to reduce vulnerabilities remain.** In fact, there are signs of the resumed overheating since 2017, as domestic demand grew by 7 percent on average a year, credit growth averaged 9 percent, and current account deficit grew above 17 percent of GDP as import intensity of the public stimulus remains high (Figure 3 and Figure 4). Both public and external debt continued to remain high (75.7 and 168 percent of GDP, respectively).

Figure 3. Current Account and Trade Deficit, Percent of GDP, 2012-18

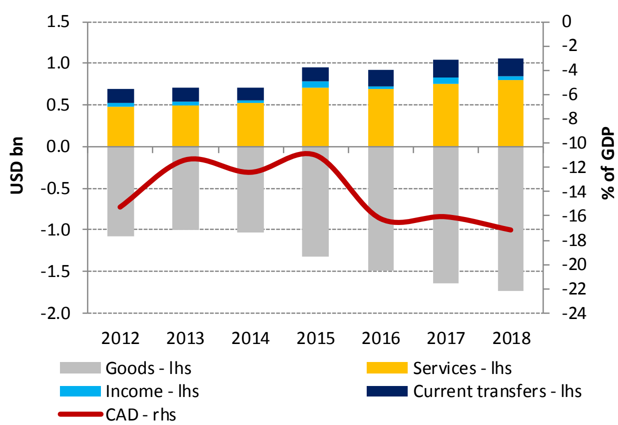
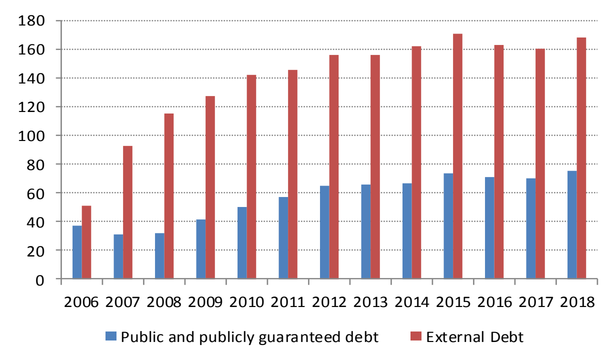


Figure 4. External and Public Debt, Percent of GDP, 2006-18



Source: CBCG, MONSTAT, MOF, World Bank staff calculations.

13. **The capital inflows declined after the bust period, along with the FDIs**. While comparatively, FDIs remained high at around 9 percent of GDP on average over the last three years, they decline compared to even the after-crisis years of almost 15 percent of GDP a year. Today, FDIs cover roughly 40 percent of the current account deficit of above 16 percent of GDP. The rest comes in form of debt-creating capital inflows, therefore leading to a rise in external debt. This

external vulnerability is amplified by the relatively slow pace of structural reforms, current volatility in global markets, and the lack of commitment to stabilize public finances. Lower capital inflows may put further pressures on the private sector and households. Finally, much of the financial inflows to Montenegro are still coming towards the real estate, which poses a risk to balance-of-payments stability.

14. **Banking sector health has improved, but financial conditions remain tight and weaknesses in non-systemic banks require action.** In general banks are well capitalized as buffers appear adequate, even though with some heterogeneity across different banks. There are 15 banks operating on the market, although two have recently been put under bankruptcy. Liquidity in the sector is high. However, profitability still remains low as operating costs for banks are high. With deposits on the rise, driven mostly by corporate savings, the loan-to-deposit ratio reached 85 percent by end- 2018—moving up from its lowest level in January 2018 of 82 percent. Lending has surged in 2018 after growing modestly in the past three years, leading to decline in the non-performing loans from 16.5 at end 2012 to 6.7 in 2018. The creation of the asset management companies under the so-called "Podgorica approach" has been a welcomed development but would need to be complemented by additional measures to strengthen enforcement, allow the exit of unviable corporations and remove the legal and regulatory bottlenecks that are still seen to hamper the disposal of impaired assets by banks.

15. **The sustained output expansion has helped increase employment somewhat, but the low employment and participation rate remain a concern.** Average growth in 2013-18 was 3.5 percent, largely backed by buoyant growth in construction, trade, and tourism. The return of economic growth was translated into labor market gains as the activity and employment rates started increasing; yet, they remain well below the EU average. Unemployment rate in 2018 declined to 15.2 percent, while employment and participation rate remain low—at 47.5 and 56 percent, respectively. The employment response to growth is low–a one percent employment growth results from a 1.6 percent real growth. This suggests there are structural impediments to a stronger labor market response.

16. **A decline in unemployment has been helped by wage moderation.** Wage moderation since 2010, as a response to low potential growth, coupled with increased labor productivity, led to a decline in unit labor costs (Figure 5). Restrained wage growth reflects, in part, greater labor market flexibility, including the prevalence of fixed-term contracts that echo the changing structure of jobs in fast growing sectors. However, the mismatch of labor supply and demand as well as the excessive public sector size continue to exert wage pressures.

17. **Potential growth has slowed down post-crisis.** Economic activity largely concentrated in tourism, real estate, energy and hard commodities (aluminum and steel) left the country vulnerable to changes in commodity prices, terms of trade and geo-political developments. Capital inflows to real estate and non-tradable had been one of the main drivers of growth but resulted in significant external imbalances. In 2015, the government decided to stimulate development through large public sector investments in transport sector that further widened fiscal and external vulnerabilities, given the rise in imports (Figure 6). Despite this stimulus, the potential growth has slowed down from 3.8 percent in the period of 2001-08 to 2.4 percent in 2009-18.

Figure 5. Wage and Productivity, 2008-18, 2008=100

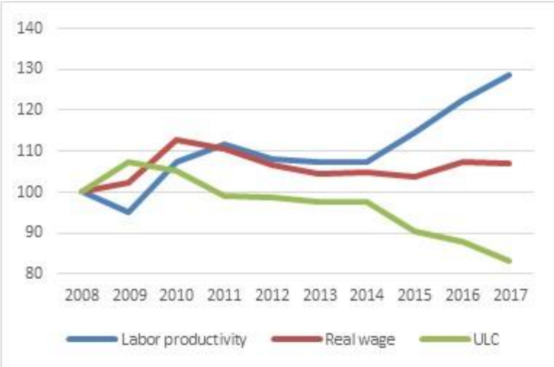
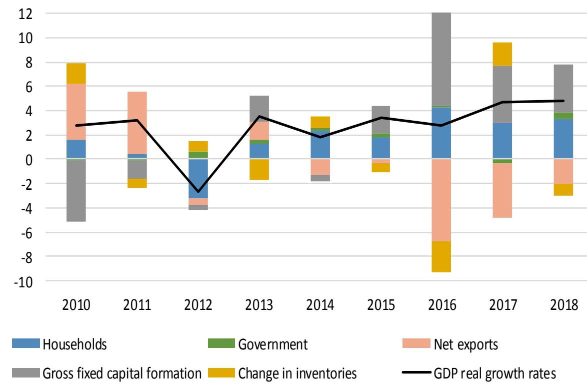


Figure 6. Contributions to Growth, 2010-18



Source: CBCG, MONSTAT, World Bank staff calculations.

The Fiscal Challenge

18. **Pro-cyclical fiscal policy before the bust and the effects of the crisis depleted Montenegro's fiscal buffers.** In 2006-08, the years of a large positive output gap, Montenegro's government spending grew, amplifying the already large positive effect of massive capital inflows. Although some of the revenue windfall in this period was used to repay debt, much of the extra revenues were not used to build a contingency reserve fund. Instead, a concomitant rise in spending to 50 percent of GDP by 2008 left the country exposed to shocks. Following the global crisis onset, economy contracted sharply in 2009, so did the revenues (by 6 percentage points of GDP in one year). Through a freeze in public sector wages, staffing rationalization, and restraint in operations and maintenance costs and the capital budget, the government cut total public spending by 5 percentage points of GDP by 2011; yet, revenues fell even further by additional 4 percentage points of GDP as liquidity issues and lack of financial discipline led to doubling of tax arrears to close to 6 percent of GDP over the same period. While spending adjustment happened slowly it was even reversed after 2011 as contingent liabilities in a form of guarantees issued to aluminum industry got called.

19. **Fiscal consolidation resumed in 2013-2014, but again slipped in 2015.** Using a freeze in public sector wages, staffing rationalization, and restraint in operations and maintenance costs and the capital budget, the government managed to maintain expenditures largely on the same level. At the same time revenues started increasing as a result of higher VAT and contribution payments. This dynamic resulted in a declining deficit level to 3.1 percent of GDP in 2014, the lowest level since the outbreak of the crises in 2009.[8] Nevertheless, this process was once again interrupted in 2015. Driven by a surge of capital investments for the Bar-Boljare highway, fiscal deficit swelled to 7.3 percent of GDP in 2015, and the newly introduced fiscal rule was breached. The government has also accumulated sizable payment arrears, estimated at close to 6 percent of GDP at end-2015. Of this, around 80 percent were municipalities' accumulated arrears which adversely affect private sector liquidity and payments discipline and have also impacted banks' abilities to reduce their NPLs.

[8] These outcomes may serve as a good example for the fiscal consolidation that is rapidly needed in the coming period.

20. **A new fiscal consolidation program was adopted in December 2016, as public debt surged further.** While fiscal deficits remained swollen by capital spending on the large highway project, the introduction of lifetime benefits for mothers of three and more children in 2015, coupled with a spending spree ahead of the 2016 elections, required an urgent reaction ahead of the large refinancing (at the time over 16 percent of GDP a year in 2019-21). A fiscal consolidation package included revenue and spending reform measures amounting to 3 percentage points of GDP in savings:

- *On the revenue side*: (i) a rise in excises on oil, tobacco, sugary drinks, and alcohol; (ii) an introduction of a new excise on coal; (iii) a reduction in VAT exemptions; (iv) an increase in the VAT rate (from 19 to 21 percent); and (v) collection of tax arrears and fiscalization.
- *On the spending side:* (i) initially a 25-percent reduction of the amount of the mothers' benefit, but then abolishment of the benefit with a rise of means-tested child benefits by 20 percent); (ii) an 8 and then additional 6-percent reduction in wages of public sector officials; (iii) a one percent reduction of civil servants' wages, except for lower grades, that was returned in 2019; (vi) a reduction of public sector wage bonuses; and (vii) an introduction of the centralized procurement.

21. **Unlike EU countries, Montenegro did not capitalize on the high growth period to reduce deficit and debt**. On the contrary, deficit expanded recently and became more volatile suggesting challenges and a lack of commitment to fiscal targets. Deficit remained high over a protracted period of time, at 4.6 percent of GDP on average since 2010, clearly showing that fiscal challenges are paramount (Figure 7). Two-thirds of the debt stock growth since 2008 is explained by the primary deficit. At the same time, EU countries, including the small states, as well as the Western Balkan neighbors improved their fiscal positions and started reducing its indebtedness (Figure 8). Such countercyclical approach of the comparator countries bodes well for preventing overheating of the economy and building the fiscal reserves for periods of low growth.

Figure 7. General Government Deficits, Percent of GDP, 2010-18

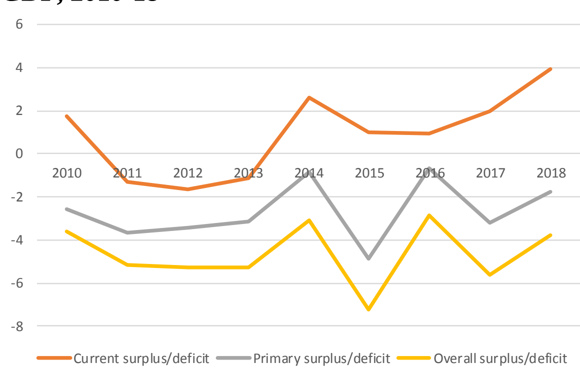
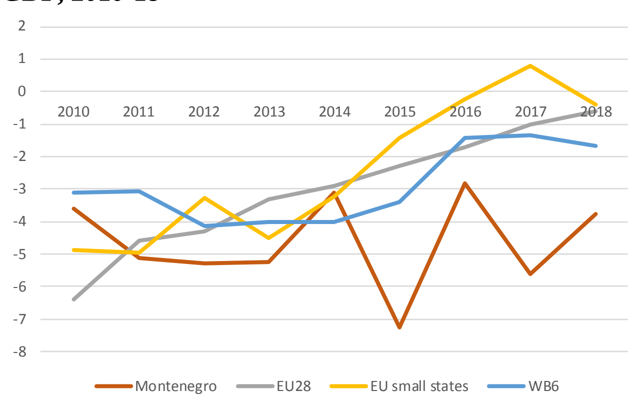


Figure 8. Deficit in Montenegro and EU, Percent of GDP, 2010-18



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

22. **Comparative data reveal that Montenegro had the highest debt increase among the relevant comparator countries since the global crisis**. On average, EU28 countries have in the last ten years increased its public debt by 19 pp of GDP, while Montenegro's debt expanded by over 43 pp of GDP. Its level of debt is now close to the EU28 average and well above the EU small

states levels (54 percent of GDP). Moreover, the number for Montenegro does not include government arrears that amounted to 3.7 percent of GDP in 2017. Debt is not only high but growing; meanwhile, EU is using this period of stronger growth to reduce indebtedness. Debt expansion has also increased interest payments, in contrast to EU countries. Montenegro allocates today more of its GDP for interest payments than EU (Table 2).

Table 2. General Government Debt and Interest Payments, Percent of GDP

	General Government Debt			Interest Payments	
	2008	**2018**	**Difference**	**2008**	**2018**
Bulgaria	13	22.6	9.6	0.8	0.7
Czech Republic	28.3	32.7	4.4	1.0	0.8
Estonia	4.5	8.4	3.9	0.2	0.0
Croatia	39	74.6	35.6	2.0	2.3
Latvia	18.2	35.9	17.7	0.6	0.7
Lithuania	14.6	34.2	19.6	0.7	0.9
Hungary	71.6	70.8	-0.8	4.0	2.5
Poland	46.3	48.9	2.6	2.1	1.4
Slovenia	21.8	70.1	48.3	1.1	2
Slovakia	28.5	48.9	20.4	1.3	1.3
EU28	**60.7**	**80.0**	**19.3**	**2.7**	**1.9**
Albania	55.1	70.7	15.6	2.9	2.2
Bosnia & Herzegovina	20.2	36.7	16.5	0.1	0.9
North Macedonia	23.0	48.4	25.4	0.6	1.2
Serbia	25.2	55.5	30.3	0.6	2.1
Montenegro	**32.3**	**75.7**	**43.5**	**0.8**	**2.0**

Source: EUROSTAT, MoF.

23. **Debt denominated in foreign currency is increasing and represents a vulnerability**. Foreign-currency debt amounts to one-fifth of the total and consists largely of debt issued in USD. The authorities are committed to hedge the USD-denominated debt to euro, as elaborated in the government's debt management strategy. Accomplishing this is important, given the euroization of the economy and the appreciation of USD due to its monetray policy. The share of fixed-rate debt has declined over the last several years, as the authorities took advantage of low short-term rates to cut costs. Rising foreign interest rates, reflecting hikes of official rates by foreign central banks and a less benign international environment, are slowly increasing the vulnerability of Montenegro's government debt to adverse shocks, however.

Table 3. General Government Debt Structure, Percent, 2014-18

	2014	2015	2016	2017	2018
Currency Composition[1]					
Euro	95	88	88	84	82
Foreign currency[2]	5	12	12	16	18
Structure of Interest Rates[1]					
Fixed	60.6	73.8	80.8	78.3	74.6
Floating	39.4	26.2	19.2	21.7	25.4

Note: 1/ Central government debt, 2/ Predominantly USD

Source: MOF, staff calculations

24. **The Government's medium-term fiscal framework for 2019-21 suggests commitments to a fiscal surplus once large capital investment ends in 2020** (Table 4)**.** The Ministry of Finance also announced a set of fiscal measures to achieve current spending consolidation between: (i) public sector wage system rationalization; (ii) further harmonization of the excise tax on cigarettes; (iii) stricter sanctioning of tax non-payers and fight against informal economy; (iv) new pension indexation and streamlining early retirement options after 2020; and (v) improving the regulatory framework for public procurement. As a result of these measures, reduction in current expenditures equivalent to around 1.5 pp of GDP is already anticipated for 2019 –albeit undefined –in the Government's fiscal framework. However, historically government deficit targets are missed by a large margin (2-3 percentage points of GDP on average per year since 2008) due to over-commitments and contingent liabilities, such as guarantees or payment of court suits.

Table 4. Government Medium-Term Fiscal Framework, Percent of GDP, 2016-21

	Outturn 2016	Outturn 2017	Outturn 2018	Projection 2019	Projection 2020	Projection 2021
Total Revenues and Grants	**42.5**	**41.4**	**42.4**	**42.5**	**41.8**	**40.9**
Current Revenues	**42.0**	**40.7**	**41.7**	**41.3**	**40.9**	**40.1**
Tax Revenues	37.3	37.2	37.8	37.1	36.7	36.1
Nontax Revenues	4.7	3.5	4.0	4.2	4.2	3.9
Grants	**0.4**	**0.7**	**0.7**	**1.1**	**0.8**	**0.8**
Total Expenditure and Net Lending	**45.3**	**47.0**	**46.2**	**45.4**	**41.6**	**38.6**
Current Expenditure	41.1	38.7	37.8	36.3	34.8	33.8
Wage Bill1/	12.7	12.3	11.7	11.5	11.0	10.6
Other purchases of goods and servi	5.6	5.4	5.6	5.0	4.8	4.6
Interest payments	2.2	2.4	2.0	2.1	1.8	1.7
Subsidies and current transfers	20.7	18.7	18.5	17.8	17.2	16.9
Capital Expenditure	**4.2**	**8.3**	**8.5**	**9.2**	**6.9**	**5.0**
Net Lending	**0.0**	**0.0**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Current Surplus/Deficit	0.9	2.0	4.0	5.0	6.2	6.3
Primary Surplus/Deficit	-0.7	-3.2	-1.8	-0.9	2.0	3.9
Overall Surplus/Deficit	**-2.8**	**-5.6**	**-3.8**	**-3.0**	**0.2**	**2.2**
Total Financing	3.3	5.3	3.8	3.0	-0.2	-2.2
Domestic financing (net)	2.8	-1.7	-6.2	5.2	-3.1	-1.1
Privatization receipts minus purchases	0.3	0.2	-1.0	-0.6	0.2	0.2
Foreign financing (net)	0.6	5.1	9.5	-2.8	1.5	-2.4

Source: MoF, MONSTAT, World Bank staff calculations.

25. **Public debt is projected to level off in 2019, as the fiscal consolidation comes to effect and the highway construction is coming to an end** (Figure 9). Under the government medium-term fiscal scenario, public debt will stay at 75 percent of GDP in 2019 before declining to 69 percent by 2021. However, there are a number of additional risks to this scenario, as per the debt sustainability analysis.

26. **Medium-term fiscal risks and vulnerabilities are significant.** Higher public and external debt are highly sensitive to shocks, and public sector arrears of more than 4 percent of GDP and government guarantees at 5 percent are sizable. The largest risk comes from a potential growth shock. If growth stagnates in the 2019-21 period instead of expected over 3.5 percent average

growth per year, public debt to GDP ratio would stay at around 73 percent of GDP even after the end of the highway stimulus program. Given the large part of the debt is in US$, a 15-percent euro depreciation would push public debt close to 72 percent of GDP by 2021, while a combined shock of higher interest rates, depreciation, call on liabilities, and a slower growth might lead the debt above 82 percent of GDP by 2021 (Figure 10).

Figure 9. Public and Publicly Guaranteed Debt, Percent of GDP, 2006-21

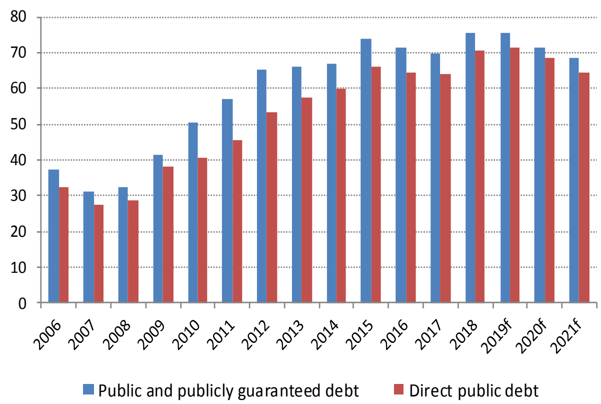
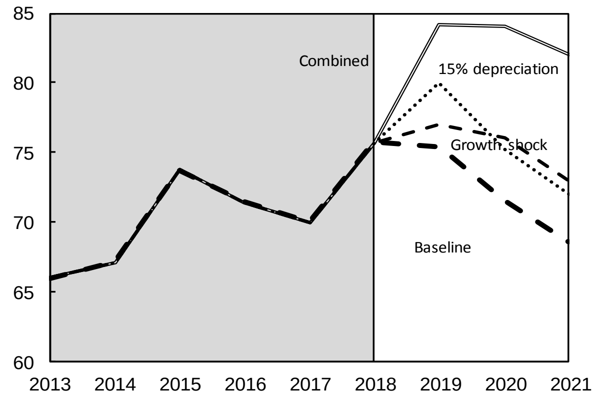


Figure 10. Public Debt Sustainability, Percent of GDP



Source: Eurostat, MOF, staff calculations

27. **Even without additional shocks, public financing needs would remain high in the medium term and would require careful debt management**. In 2018 the government used a liability management operation to reduce the pressures of refinancing Eurobond redemptions in 2019–21. Still, through that period borrowing requirements are expected to average more than 9 percent of GDP a year. Although sovereign credit rating currently stands at four notches below the investment grade, positive spillover effects from the European Central Bank's monetary easing improved financing conditions for external borrowing. However, financing conditions are expected to tighten, thus creating additional pressure on deficit and debt.

Figure 11. Spending in Montenegro and EU, Percent of GDP, 2018

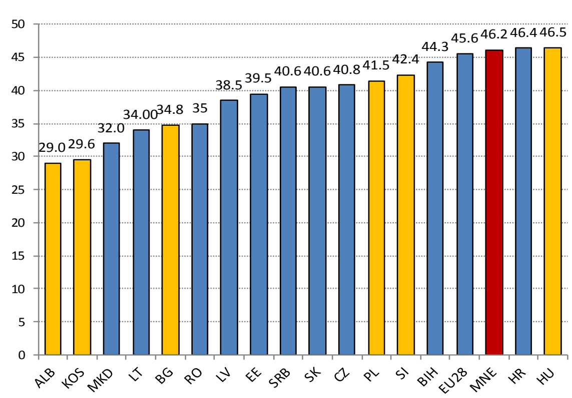
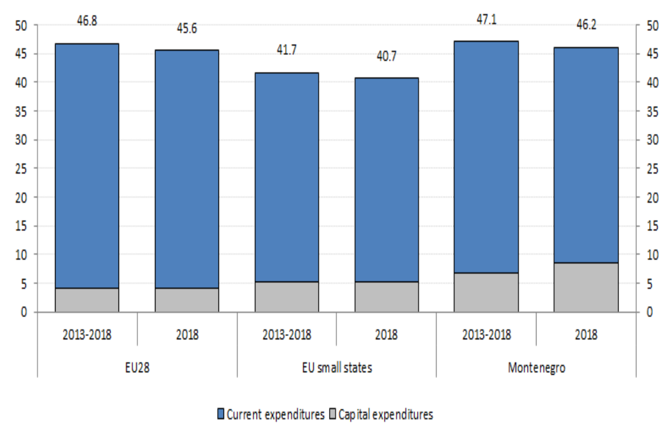


Figure 12. General Government Spending, Percent of GDP, 2013-18



Source: Eurostat, MOF, staff calculations

28. **Current revenue and spending patterns offer scope for rationalization.** At 46.2 percent of GDP in 2018, Montenegro's spending level continues to be one of the highest among emerging

and developing economies in Europe (Figure 11). It was 5.5 pp higher than that of the EU small states[9] (40.7 percent), and even higher than the EU28 average (45.6 percent). Both current transfers and capital spending are about 4 pp above EU small-state averages (Figure 12). Maintaining the high level of spending required increasing taxes. Montenegro today collects 37.8 percent of GDP in tax revenues and contributions, compared to less than 34.3 percent for EU small states. This makes it less competitive than peers as its exports to the EU face cheaper competition.

29. **Public spending is particularly excessive in areas such as public wages and current transfers:**

- The public sector wage bill at 12 percent of GDP is 1.8 percentage points of GDP higher than in EU28 countries and 0.8 pp when compared to the EU small states. On a positive note, the wage bill declined in the last two years, compared to previous periods. The public sector in Montenegro often is perceived as an employer of last resort, a phenomenon that is also seen in other EU small states.
- Current transfers standing at 5.5 percent of GDP are twice as high compared to other EU small states. These constitute transfers to institutions, individuals, NGO and health sector and had historically been elevated compared to peer countries.
- Capital expenditures increased sharply with the highway investments. Public investments are over 4 and over 5 pp of GDP higher than in the EU small states and EU28, respectively. Most of them are loan financed in addition, as opposed to grant funded as in the case of EU small states where the EU grants cover more than half of public investment budget.

Table 5. General Government Expenditures by Economic Classification, EU and Montenegro, Percent of GDP

	EU28		**EU small states**		**Montenegro**	
	2013-18	2018	2013-18	2018	2013-18	2018
Total Expenditures	**46.8**	**45.6**	**41.7**	**40.7**	**47.1**	**46.2**
Current Expenditures	**42.6**	**41.5**	**36.5**	**35.5**	**40.4**	**37.7**
Consumption	6.0	5.8	6.2	6.2	5.6	5.6
Wage bill	10.1	9.9	10.9	10.9	12.7	11.7
Interest	2.2	1.9	2.0	1.5	2.2	2.0
Subsidies	1.3	1.3	0.9	0.9	1.2	0.7
Social benefits	20.8	20.4	14.4	14.1	14.0	12.2
Current transfers	2.3	2.2	2.0	2.0	4.7	5.5
Capital Expenditures	**4.2**	**4.1**	**5.2**	**5.2**	**6.7**	**8.5**
Capital transfers	1.4	1.2	1.4	1.1	-0.1	0.0
Investments	2.9	2.9	3.8	4.0	6.7	8.5

Note: EU small states includes: Cyprus, Estonia, Latvia, Lithuania, Malta and Slovenia.
Source: Eurostat, MOF, and World Bank staff calculations.

[9] Estonia, Cyprus, Latvia, Lithuania, Malta, and Slovenia.

30. **Looking at the functional breakdown of spending, some distinct differences to the comparator groups prevail**:

- Spending on general public services is double that of the EU28 and EU small states, reflecting the inefficiency in service provision through fragmentation of administration and proliferation of state institutions instead of the focus on delivering services.
- Spending on public order and safety is double of the EU28 and EU small states, reflecting higher spending on police force and judiciary. Montenegro has the highest number of judges per capita within the EU.[10]
- Spending on economic affairs is also double of the EU28 and EU small states, resulting from subsidies to transport sector, debt repayments, and likely inclusion of environmental protection spending. This type of spending is likely to increase in the future as the country has to comply with EU standards as it advances through the EU accession negotiations.
- Health and social protection spending taken together is some 8 percentage points of GDP lower compared to the EU28 but is in line with the spending in EU small states. Social protection spending is likely to increase in the future as aging creates pressures on long-term care, health and pension costs.
- Education spending is slightly lower than in the EU28, but over one percentage point of GDP than in EU small countries. Considering that typically small countries had a disadvantage compared to large ones in terms of industrial capacity, investing in human capital is a key policy to boost country's comparative advantage.

Table 6. General Government Expenditures by Function (COFOG) in 2017, Percent of GDP

	EU28	EU small states*	Montenegro
TOTAL	**45.8**	**38.8**	**47.0**
General public services	5.8	5.4	10.8
Defense	1.3	1.4	0.9
Public order and safety	1.7	1.8	3.7
Economic affairs	4.0	4.2	8.8
Environment protection	0.8	0.6	0.0
Housing and community amenities	0.7	0.6	0.2
Health	7.0	5.0	4.7
Recreation, culture and religion	1.1	1.4	0.9
Education	4.6	5.3	4.2
Social protection	18.8	13.0	12.8

Note: EU small states includes: Cyprus, Estonia, Latvia, Lithuania, Malta and Slovenia. Cash spending for Montenegro.
Source: Eurostat, Ministry of Finance of Montenegro and World Bank staff calculations

31. **Montenegrin finances need to be brought back to a sustainable path**. While there are some revenue adjustment policies, most of the adjustment needs to happen on the spending side.

[10] CEPEJ. 2016.

Reducing the size of the state, local as well as national, and making social and health spending more efficient, would help stabilize finances and open up space for eventually reducing the tax burden. There are options for further enhancing revenue collection and adjusting some taxes to ensure fairness, efficiency and exhaustiveness criteria. Finally, much can be gained from better management of public finances and investments to increase transparency, allocation efficiency, and spending effectiveness. In addition to maintaining macro stability, fiscal consolidation is important for creating fiscal space for EU-related costs absorption and buffers for aging-related costs.

IMPROVING SECTOR SPENDING EFFICIENCY

Improving the Efficiency and Effectiveness of Public Administration

32. **Reducing the size of the wage bill and raising the quality of public services are essential elements of the country's fiscal consolidation agenda; it is also key for delivering its EU accession commitments.** Montenegro's general government wage bill, 12.3 percent of GDP in 2017, is 1.3 pp of GDP higher than the EU small-state average, and much higher than it was in 2009 (Figure 13). Further, at 26 percent, public employment in Montenegro is also above the EU small-state average of 21 percent average (Figure 14). In 2013, the government had approved an Internal Restructuring Plan designed to reduce total public employment by 9.5 percent in 2013–17. Instead, the central government reduced staff by less than planned while local jurisdictions hired significant number of employees. Minimal central government monitoring of public employment, weak human resource management, and surges in hiring before elections have largely been responsible for the excess staffing. In 2018, another attempt to pursue the staffing optimization plan had been launched with smaller reduction targets though and from much higher level of government employment. New laws on civil servants and state employees and on local self-government have been adopted to promote merit-based recruitment across the public service. However, it will take strong political will to effectively depoliticize public service, optimize state administration, and ensure efficient implementation of reforms and their financial sustainability.

Figure 13. Public Sector Wage Bill, Percent of GDP, 2009 and 2018

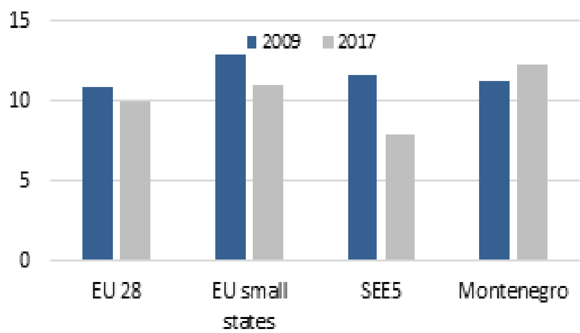
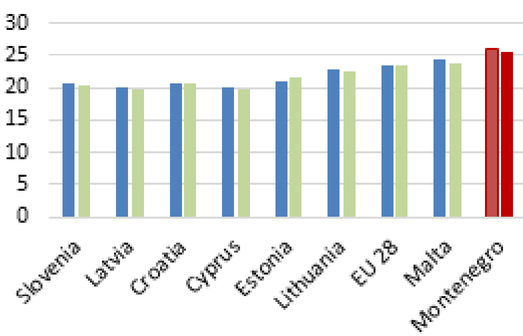


Figure 14. Share of Public Employment in Total Employment, 2017 and 2018



Source: Eurostat, MOF, staff calculations

33. **Although various measures of government effectiveness identify large performance gaps, bonuses for public servants are still large and delinked from performance**. Montenegro's rankings on governance effectiveness, control of corruption, and rule of law or regulatory quality are 20 pp lower than the EU small-state average (Figure 15). However, the

average gross wage in 2018 for the public servant was about 6 percent above the national average and 8.5 percent higher than the average private sector wage (Figure 16).[11] The appraisal system needs to be reinforced and to be made the basis for performance bonuses and promotion. Currently, the highest bonus is for seniority; it awards every year of service by a raise of up to 1 percent. Despite attempts to unify the wage policy, the State Audit Institution (SAI) found that three-fourths of municipalities gave arbitrarily high performance bonuses that contravened the salary law, which since 2017 requires that variable pay not exceed 50 percent of the average salary in Montenegro.

Figure 15. Selected Governance Indicators, 2017

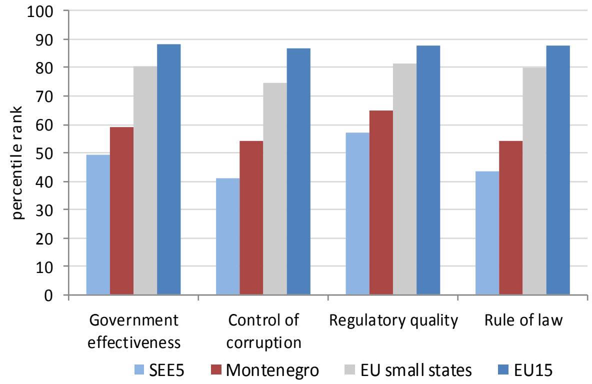
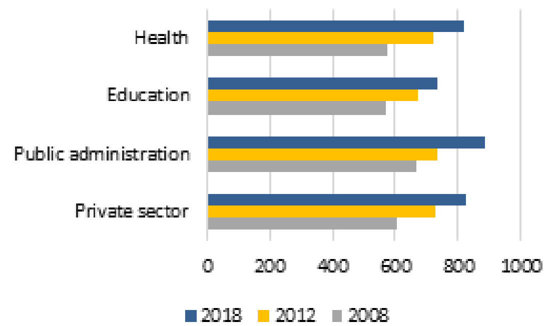


Figure 16. Public and Private Sector Gross Wages, EUR



Note: Health and education sector wages should be understood as primarily public sector wages, as public sector covers over 90 percent of the sector.
Source: World Bank, MONSTAT, staff calculations

34. **Reducing the size of the public employment is critical for fiscal sustainability but it is not sufficient to deliver the improvement in the efficiency and quality of public administration required of a future EU member state** Montenegro needs a multipronged approach, governed by a Public Administration Reform (PAR) Strategy and clear political and administrative leadership. What is required is for Montenegro to:

i. **Reinforce the appraisal and performance reward system.** This would mean abolishing the seniority bonus and relating performance and promotion to a transparent and rigorous appraisal system.

ii. **Support public administration reform along with a strategy for private-sector development.** Reducing government employment requires a parallel effort to create private-sector employment opportunities by improving the business and investment environment.

iii. **Carry out functional reviews and streamline the public administration** to reduce organizational proliferation and consolidate institutions whose functions are related.

[11] The Montenegro SCD (2016) also found that while public sector job offers a premium for lower pay grades, once corrected for job security, private sector pay is higher for professional and managerial posts. However, there is a strong preference for public sector jobs as it also offers access to housing and other privileges not offered by the private sector.

iv. **Organize horizontal public administrative functions** by analyzing delivery chains and promoting shared services both within and between sectors.

v. **Automate management of information for key functions,** especially financial and HR management, and back offices.

vi. **Amend the Law on Territorial Organizations to set stricter preconditions for forming a municipality**, taking into account especially financial viability. This might be coupled with the proposal to consolidate municipal utility services for more cost efficiency and lower service delivery costs.

vii. **Strengthen municipal governance** to promote coordination and collaboration within local governments and build capacity to monitor compliance with the law.

Strengthening Local Government Finances

35. **Municipalities are under significant fiscal pressure, which compounds the inadequacy of infrastructure and services in most towns, particularly in the North**. The vulnerability of cities stems from inadequate infrastructure, faulty planning, and a long history of under-investment. However, public expectations have been rising, making it critical to finance infrastructure and provide higher quality services. Municipal finance systems need to be restructured to be more responsive to residents and businesses.

36. **Montenegro has a single-tier local government system with the largest concentration of population in the capital city when compared to the Western Balkan countries.** With over 30 percent of Montenegrins residing in Podgorica, the average size of municipalities is small (less than 19,000 citizens). Of 24 municipalities as of 2018, one-fifth have less than 5,000 inhabitants, which raises concerns about their ability to provide the services their citizens expect given the low fiscal capacity (Figure 17). Decentralization has delegated to all of them the same functions and organizational requirements regardless of their size and capacity.

Figure 17. Revenues and Spending per Capita (EUR

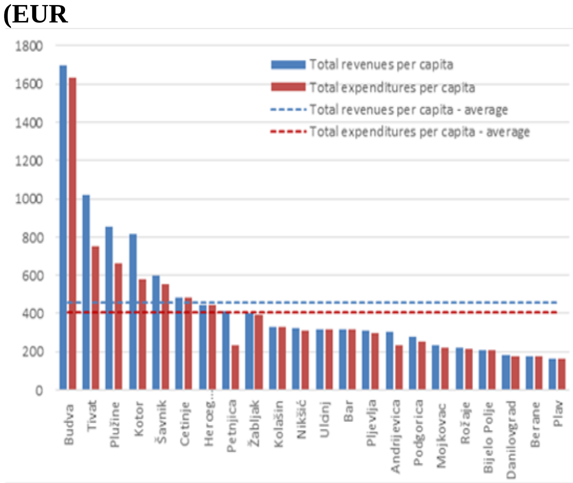
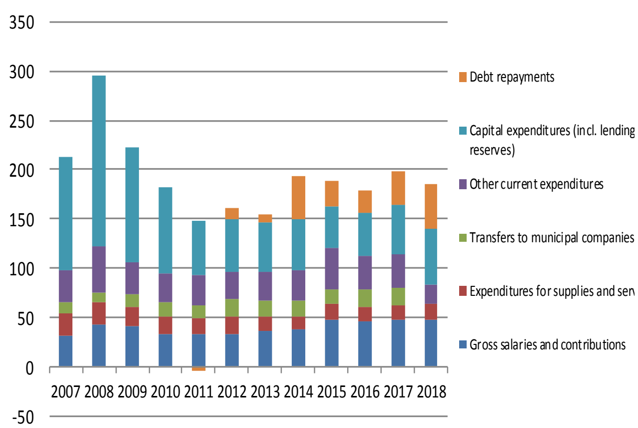


Figure 18. Local Government Spending, 2007-18, mill EUR



Source: MOF, staff calculations

37. **With spending by local government units (LGUs) at just 4.5 percent of GDP, Montenegro is still relatively centralized.** It has only partly decentralized management of social

and cultural services, so most local government spending goes for administration and local capital projects. While the income disparity between South and North is high, disparities in per capita spending are relatively low, suggesting that budgets, including equalization funds, are allocated relatively equitably.[12]

38. **However, confronted by insufficient own-source revenues, overstaffing, and excessive payrolls, some LGUs resorted to heavy borrowing and have accumulated arrears.** LGU revenues vary greatly, partly because property-related tax collection varies, and user charges are underexploited. Communal fees target local businesses but are often applied arbitrarily. Since the global crisis, mismatches between municipal fiscal capacity and spending have led to transfer-dependence and acute indebtedness. Liquidity shortages have been covered by short-term bank loans not tied to investment projects and by accruing arrears. The debt burden of some municipalities is unsustainable (Figure 18).

39. **Actions to address local fiscal imbalances have been only partly successful**. In 2010, 12 municipalities restructured both tax and nontax debts for a period of five years and formulated recovery plans. In 2013, initiatives were launched to set up new recovery plans, restructure debt owed to the central government, and facilitate the sale of assets. In April 2014, the Budget and Fiscal Responsibility Law mandated that local budgets cannot be approved without MOF monitoring and endorsement. Nevertheless, by 2016, nine municipalities had defaulted on current tax liabilities and four on repayment of reprogrammed debt, and seven had failed to obtain MOF approval before recruiting staff.

40. **The central government is by law responsible for overseeing municipalities, but it has not been doing so effectively.** For example, the MOF has never suspended Equalization Fund payments or imposed any other sanctions on LGUs that have not honored their reprogrammed tax debt obligations. The 2014 budget law introduced sanctions for LGUs running budget deficits but none have yet been applied. The employment control in LGUs have not been efficient either.

41. **It is unlikely that municipalities will be able to resolve their spending problems until they address their overstaffing.** For some, payroll expenses are excessive because they have been acting as employer of last resort when economic activity is weak. Political patronage and cronyism also play a role. Some LGUs have hired more staff than can be supported in the expectation of eventual financial relief from the central government.[13] And because the central government has in the past tolerated delayed payment of municipal social security contributions, LGUs have little incentive to economize. But staff reductions alone will not deliver enough improvement.

42. **The following could be considered:**

i. **Reform real estate tax collection.** This will require legalizing irregular settlements; giving local tax administrators access to central cadaster information to better assess real-estate valuations; and using cadaster innovations to enhance tax administration and to promote consistency between real estate transfer and property taxes. It will also be necessary to enforce registration of property in the cadaster.

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[12] World Bank-Austria Urban Partnership Program. 2018. Municipal Finance Review Update.

[13] World Bank. 2015. Montenegro: Options to Restore Fiscal Sustainability and Improve Spending Efficiency at Subnational Level.

ii. **Reduce overstaffing in municipalities and improve monitoring.** The LGs could for example, integrate their HR systems with the one of the MOF; in particular a payroll module, and personnel records.

iii. **Reinforce coordination and collaboration**, e.g., by sharing services among local governments or even with the central government.

iv. **Ensure that local tax-administration agencies have human, technical, and administrative resources they need or otherwise contract the MTA.** Local agencies and the MOF Tax Administration Unit could work together to collect taxes and educate residents on the importance of paying taxes to support municipal development and service delivery.

v. **Review expenditure assignments of financially distressed municipalities in line with their revenues** by, e.g., removing some functions away to larger municipalities and allocate revenue assignment accordingly. Further, the LGUs revenues could be strengthened by introducing better-regulated communal fees to ensure full cost-recovery; or eliminating deferred payment of the PIT surtax.

vi. **Enhance financial discipline of LGUs** by regularly collecting payroll taxes and other dues from LGUs; rigorously review new employment and draft budget proposals of LGUs; avoid bailout programs; and allow for increased central government transfers only subject to the restructuring program implementation.

vii. **Streamline intergovernmental transfers** by, e.g., basing the transfers on a simple formula that gives due weight to their needs, rights to minimum basic services, incentives to perform, and inter-jurisdictional equity; avoiding bail-outs and making hard budget constraints the rule; using equalization mechanisms to provide an incentive for raising own-source revenue by using tax potential and a standard tax rate as the main equalizing variables.

Making Social Benefits More Effective

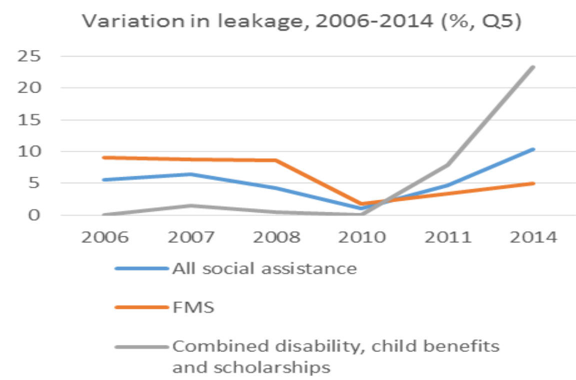
43. **On par with EU small states, Montenegro spends about 3 percent on social benefits**. While trending downward, social benefits are still quite generous, but the design of several programs has created significant disincentives to work, particularly for women. For example, the introduction in January 2016 of a lifetime benefit for mothers of three and more children that was equivalent to 70 percent (40 percent in case of unemployed mothers) of the average net wage in Montenegro in the previous year,[14] in effect discouraged many women to enter the labor market. The benefit also failed to achieve its fertility objective (the median age of beneficiaries was 55), discouraged formal work, and proved fiscally unsustainable. Its cost, at 1.9 percent of GDP in 2016 was more than five times the spending on poverty-targeted social assistance and almost double the total social assistance budget. Generous transfer amounts and eligibility based on unemployment registration created disincentives for formal employment when female

[14] Amendment to the Law on Social and Child Protection (Art. 54a and 54b), OG 42/15 of July 29, 2015. While receiving the mother benefit, women could not be employed or receive pensions. As part of the 2017 budget, the authorities reduced the benefit to €264 and €144 per month to rein in the cost.

employment rates were already low. In 2017, the benefit was abolished, but a large number of women continue to receive compensations.[15] At the same time, while around half of all social assistance reached the poorest quintile in 2015, the maternal benefit covered only 19 percent of that quintile and just 5.4 percent of the total population. The error of inclusion within the best targeted social assistance program (Financial Material Support) is the lowest (Figure 19), but this is also the least funded program.

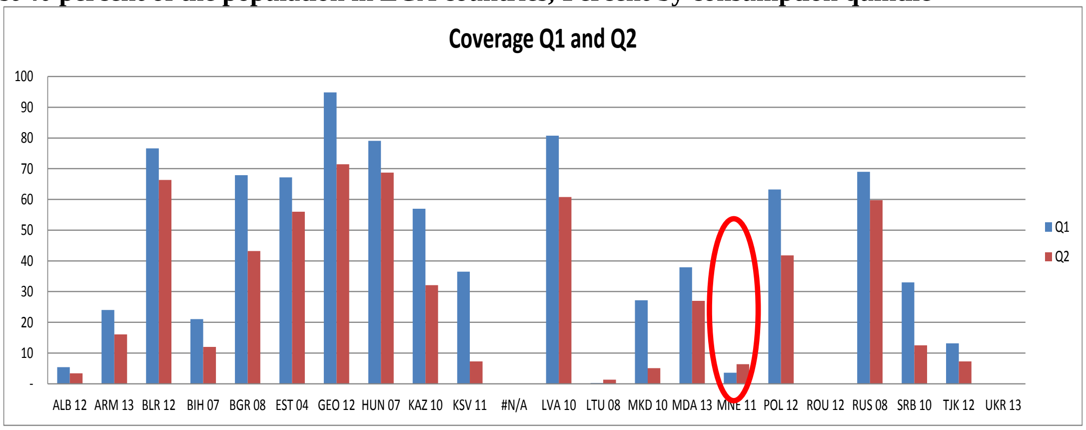
44. **The means-tested program coverage is low.** In 2015, the last year for which household budget survey data are available, all social assistance programs covered only 4.7 percent of the total population and 15.7 percent of the poorest quintile. Although there are no newer data, this percentage has likely not changed much. The coverage of the last resort social assistance program was similar: 4.1 percent of all population and 15.6 percent of the poorest quintile. Coverage is low compared to other Europe and Central Asia countries with similar design of social assistance and child protection (Figure 20).

Figure 19. Error of Inclusion, 2006-14



Source: MONSTAT, World Bank staff calculations.

Figure 20. Cross-country comparison of social assistance and child protection program coverage in the poorest 40 percent of the population in ECA countries, Percent by consumption quintile



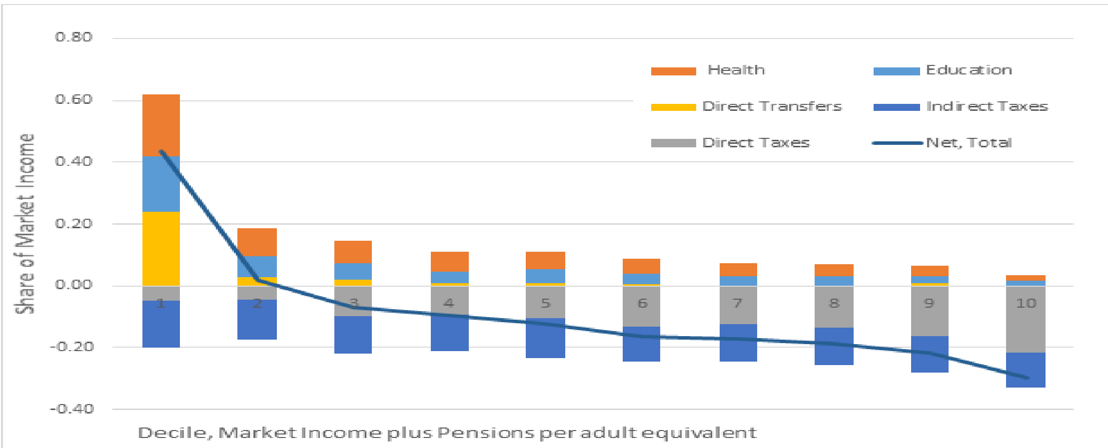
Source: World Bank ECA SPEED database.

45. **However, the overall distributional impact of taxes and social spending in Montenegro is high** (Figure 21). Social benefits should not be looked in isolation of other social

[15] Out of about 22,000 beneficiaries, nearly 64 percent had been unemployed, 22 percent were pensioners, and 14 percent had been employed. A Constitutional Court ruling in April 2017 proclaimed the mother benefit unconstitutional on the grounds of discrimination against other groups. The ruling gave the government three months to restore beneficiaries to a status no worse than the one they had when they became eligible for the benefit.

spending, taxes and service delivery. The Commitment to Equity methodology[16] using 2015 data shows that the net total benefit (including health and education service) is increasing income of the first decile by more than 40 percent. The shares for the first decile are very large because their denominators (pre-fiscal incomes) are small. Clearly, direct transfers have strong effects on the poorest population. In-kind health and education benefits are significant for most deciles, although they are declining gradually up the income distribution. Direct tax shares increase along the income distribution, while indirect taxes shares in income are rather flat. While reducing inequality, all taxes and social transfers (without health and education service) increases poverty[17] by more than 6 percentage points.

Figure 21. Distributional Impact of Taxes and Social Expenditures by Decile, 2015



Source: Younger and Draganic based on 2015 HBS.
Notes: The figure shows the size of taxes and social spending as a share of market income (including pensions as deferred income) for each decile.

46. **There is significant scope to rationalize spending on categorical benefits while strengthening the means-tested social assistance program:**

i. Spending on **disability benefits** could be reduced by tightening controls, improving quality and clarifying procedures for medical assessment, and improving transparency to avoid errors, differences in treatment, and fraud so that only people with severe disabilities who cannot take care of themselves benefit.

ii. Spending on **parental leave salary compensation** is regressively targeted to women who have incomes from work and a social insurance record. In most EU member states, such wage compensation is due by the employer or the social insurance fund as an element of the national social insurance system. In Montenegro, it is noncontributory. The arrangement whereby employers pay the benefit along with salaries and are reimbursed by the Ministry of Labor and Social Welfare (MLSW) is unnecessarily complicated. Stricter

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[16] http://commitmentoequity.org/
[17] Poverty rate is estimated based on EUR188/month poverty line, anchored on the real value of the 2013 official poverty line. MONSTAT did not publish the official poverty rate for 2015 at the time of the analysis.

MLSW audit and control is also necessary to avoid overreporting the wages in a short period of time ahead of the parental leave to maximize the benefit.

iii. **Avoid packing numerous different benefits into a single unit of assistance,** given the tradeoffs between benefit generosity and coverage and potential disincentives to work when receiving a relatively generous benefit package.

iv. At the same time, there is a need to **review the means test** to ensure that deserving low-income applicants do not become ineligible because of binary filters.

Strengthening Fiscal and Social Sustainability of the Pension System

47. **With a population that is aging rapidly, Montenegro has made serious changes to its pension system.** In 2004, it adopted a pay-as-you-go (PAYG) system to foster fiscal sustainability and align it with both the country's aging demographics and the labor market requirements. The retirement age was raised from 60 to 65 for men and from 55 to 60 for women; the calculation period based on the 10 best years was widened to full career in two-year increments; a pension points formula replaced the accrual formula; mid-point indexation of pension points and benefits (50:50 wage/price indexation) was adopted; and eligibility for, and control of, disability and survivor benefits were tightened. A follow-up reform in 2010 gradually increased the retirement age to 67 (for men by 2025, women by 2041) and changed the valorization and indexation of pensions.

48. **Although it again raised the retirement age, the 2010 reform created incentives for early retirement that eroded the previous progress in improving the system dependency ratio.**[18] Early retirement windows undermined the positive fiscal impact of a higher retirement age and distorted labor market outcomes. Most OECD countries limit early retirement to at most three years and raise the early retirement penalty above what is actuarially neutral in order to penalize early departure from the labor force. Montenegro's 2010 introduction of an actuarially neutral five-year early retirement option tilted incentives in the wrong direction and the number of early retirees has since surged. Changes in 2010 to the indexation formula also led to declines in the pension replacement rate,[19] which in 2009 was already at the average for all transition economies.

49. **Montenegro's pension system is costly, but socially unsustainable:** in the long run pension adequacy is likely to erode. In 2017, pension spending engaged 9.9 percent of GDP, of which only 6.8 percent was financed by contributions; the rest was financed by general taxes. The contributor coverage at 68 percent, numerous early retirement options (70 percent of new beneficiaries are early retirees), and an unfavorable system dependency ratio (1.7 insured per pensioner)[20] have produced a large pension deficit despite a relatively modest replacement rate (Figure 22) and a contribution rate of 20.5 percent. Nevertheless, the current valorization and

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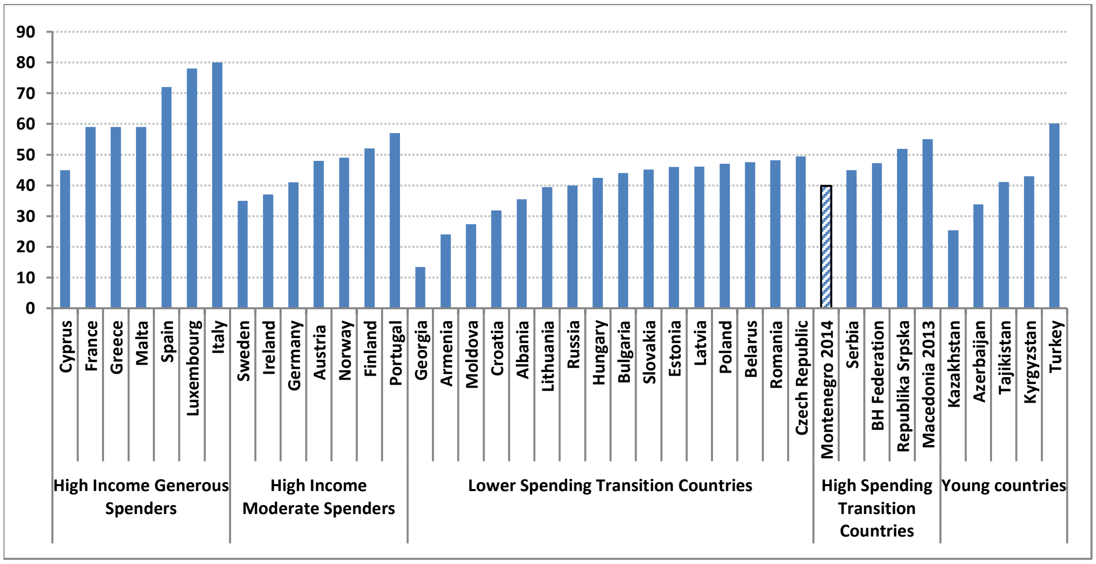
[18] Ratio of pension contributors to pension recipients.

[19] The pension replacement rate—the average gross pension benefit relative to the average wage—measures how effectively a pension system provides retirement income to replace earnings. A higher replacement rate implies more adequate pension income.

[20] The golden standard for system dependency ratio is 4 (insured per pensioners).

indexation pattern (75 percent CPI and 25 percent wages for both) would, under baseline fiscal assumptions, reverse the fiscal strain but eventually erode pension adequacy.

Figure 22. Pension Replacement Rates (2009); Montenegro (2014), Percent



Source: Word Bank, staff calculations

50. **Given an aging population and low labor participation, the pension system will face further pressures.** A high-quality pension system is one that provides sufficient income for contributors once they retire. Its financial viability requires that contributions are adequate and that participants have incentives to continue working while they remain productive. Montenegro has made significant progress along these lines, but recent changes have eroded that progress. The government could therefore consider the following:

i. Consistent with international good practice, **adopt 100 percent wage valorization and 100 percent price indexation**.

ii. **Reform early retirement policy** by (a) abolishing penalty-free retirement with 40 years; (b) adopting a penalty rate for early retirement that rises above its actuarily neutral level of 5 percent to disincentive the early exit from the labor market; and (c) reducing the five-year window to no more than two years.

iii. **Tighten further the privileged pension** categories and disability assessments.

Making the Health System More Efficient

51. **On basic health outcomes such as life expectancy and maternal and infant mortality, Montenegro's performance has been good**. But, as is typical in the region, the health system is hospital-centric and not well-integrated—a pattern particularly inefficient for an aging population. The current system does not adequately promote primary and secondary prevention or ensure coordination of care, which are both critical for managing and treating chronic noncommunicable diseases (NCDs) cost-effectively. Until recently, hospitals were financed through line-item budgets and had little control of their own finances, which exacerbated inefficiencies. The case-based payment system, Diagnosis-Related Groups (DRG) has been introduced in January 2019,

which can help adequately fund the hospital performance. However, strong monitoring system needs to be put in place to control for overbilling, rise in co-morbidities, and other accounting errors that may lead to an explosion of costs for the national health insurer.

52. **The accountability for hospital management needs to enhance**. Hospital managers have little authority to hire, reward, discipline, or reallocate staff within their facilities, which limits staff productivity. However, they also have little accountability for managing hospital finances. Arrears are common and continue to accumulate. They hover around 1 percent of GDP, without even considering delayed maintenance; because hospitals have little funding for capital investment and regular maintenance, many must cope with obsolete equipment, further undermining productivity.

53. **As the population ages, NCDs and morbidity will continue increasing, with attendant need for additional health and long-term care services (LTC)**. About 4.7 percent of GDP is allocated for health spending, and once arrears are added to cash spending, at 5.1 percent Montenegro is roughly on par with small EU states. However, an aging population means fewer contributors to the system and more call on health services. By 2050, there will be 80,000 fewer working-age adults, and life expectancy at 76.9 years is already close to that of the EU Central and Eastern countries. At the same time, technological advances and innovative therapies will require more resources for treatment.

54. **Pharmaceuticals are a major driver of both health spending and arrears.** With no managed-entry agreements (MEAs) or other cost-containment tools, the value of the Montenegrin pharmaceutical market reached 1.8 percent of GDP in 2016. Arrears added 1 percent before government used general taxes to clear some of them. In 2016 alone, public spending on medicines jumped by 10 percent.[21] A major driver of pharmaceutical spending has been reimbursement for treating indications not yet approved for reimbursement in many other countries, and for drugs that are not on the reimbursement list at all, which should be forbidden.

55. **Among the goals of the 2018 reforms were to both contain pharmaceutical spending and expand access to medicines.** Among the reforms were (i) introduction of the positive drug list that covers both brand names and international nonproprietary names (INNs) and specifies maximum drug prices; (ii) opening the market for contracted private pharmacies to dispense prescription medicines to patients and be reimbursed from the Health Insurance Fund (HIF); (iii) introduction of MEAs and other new procurement modalities negotiated between the MoH and pharmaceutical companies which helped secure large discounts for expensive drugs, and (iv) introduction of measures to support rational prescription of medicines, including the development of clinical protocols and special software to support their implementation in health institutions.[22] While in 2018 public spending on pharmaceuticals declined in relative terms to 1.4 percent of GDP, the total public expenditure on medicine has increased by 15 percent compared to the previous year. The considerable growth of public expenditures on medicines is a consequence of

[21] The largest increase was in ATC code L—antineoplastic and immunomodulation agents (up 16 percent to €13.5 million) which elsewhere are usually subject to cost-containment measures in other countries, including risk-sharing and MEAs with the objective to share financial risks and uncertainty between the payer and pharmaceutical companies.
[22] The MoH negotiated three types of MEA: (i) agreements with confidential discounts for expensive treatment; (ii) outcome-based agreements that link payment to therapy results (e.g. for treatment of hepatitis C); and (iii) agreements for rare diseases when the treatment could be cancelled if health status does not improve within the agreed period.

rising volume of prescriptions, switching of patients from older and cheaper therapies to more expensive products, and improved availability of medicines to population.

56. **In the short term, fiscal consolidation makes it imperative to identify efficiency savings in such areas as medicine costs, payment arrears, hospital utilization rates, and sick-leave benefits**. In particular, measures to:

i. **Sustain and expand on reforms already underway to achieve cost savings on pharmaceuticals, while building up monitoring of prescription and dispensing practices.** Rational prescription of medicines will be important, such as drafting clinical protocols and monitoring applications[23] to support their use by health institutions. Seventeen new clinical protocols were already approved by the MoH Commission for Quality Control and published. Additional clinical protocols now being drafted focus on treatment of terminal stages of cancer, which requires highly expensive medicines. More efforts are needed to incorporate these protocols into daily clinical practice and establish a sound system for monitoring prescribing practices and drug use in health facilities. Further, it is important that MEAs have financial risk-sharing provisions to better control the rise in spending on medicines. Early in 2018 the MoH introduced over 100 one-year MEAs that regulate confidential discounts on published prices in order to decrease spending and keep the pharmaceutical budget under control, but it has not negotiated any risk-sharing provisions.

ii. Introduce better control of admissions and **rationalize bed use**.

iii. Tighten **control over prescription of sick leave**.

iv. **Reduce treatment abroad.**

v. **Sustain provider payment reforms already initiated.** The provider payment reforms already initiated or envisaged are in the right direction: capitation for primary care and case-based payments for secondary and tertiary care. These reforms need to implement and efforts made to move away from restrictive, line item budgeting so as to give facilities greater flexibility in making resource allocation decisions.

vi. **Introduce service delivery reforms to address the dual challenges of a rising burden of NCDs and an aging population.** While such reforms can save costs in the long run, the implementation of such reforms will imply significant additional cost to the system. Specifically: (a) build up the quality and coverage of primary and preventive care, through, e.g., better screening and treatment of chronic diseases and promoting healthy behaviors, for a healthier population and reduced costs over the long term; (b) rationalize the hospital network to reduce excess use of hospital services and convert any excess bed capacity into long-term care facilities; (c) create payment incentives to promote coordination of care; (d) promote greater use of ambulatory care and day-care surgeries; (e) strengthen adherence to clinical guidelines and protocols; (f) improve monitoring of the quality of care and

[23] A software solution that promotes adherence to the prescribing guidelines in line with these protocols was successfully piloted at the Podgorica University Hospital Center hematology and rheumatology departments and then scaled up to other departments.

outcomes at all levels of the health system through a strengthened and integrated information system.

vii. **Continue with and strengthen provider payment and purchasing reforms already initiated through c**apitation and performance at primary level, DRGs at secondary and tertiary level.

57. **Over the medium term, review of the national health policy is likely to be necessary**. Before the current Health Strategy expires in 2020, this year the government and the WHO plan to conduct a health sector diagnostic. Assessment of the state of primary health care is already completed, and the main findings point to the need to give priority to primary care prevention and management of chronic conditions in order to improve health indicators, decrease disability and disease complications, and reduce unnecessary hospital care. A partial shift away from hospital-centric service delivery for specified interventions can also support cost effectiveness. Finally, addressing obesity and habitual use of tobacco and alcohol e via excise policy and public health campaigns would reduce the incidence of NCDs.

BOOSTING REVENUES AND ENHANCING TAX ADMINISTRATION

Expanding the Tax Base

58. **Montenegro's total revenue-to-GDP ratio is high relative to peers and has been trending upward since 2012.** For 2013–18, revenues averaged 42.2 percent of GDP, surpassing emerging and developing Europe as a whole by a wide margin and the EU small-states average by 2 pp (Figure 23). There is evidence that Montenegro is collecting taxes in excess of its economic capacity (i.e., what it can afford given its economic characteristics). VAT collection is especially high even though the VAT rate has only recently been increased to 21 percent (Figure 24). At the same time, Montenegro's pressing need for fiscal consolidation limits its ability to reduce taxes.

Figure 23. Tax and Social Contributions, Percent of GDP, 2017

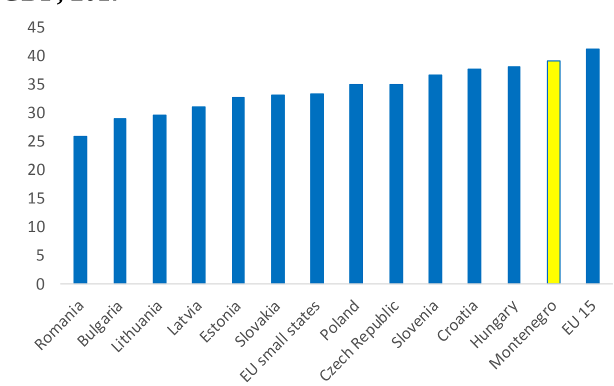
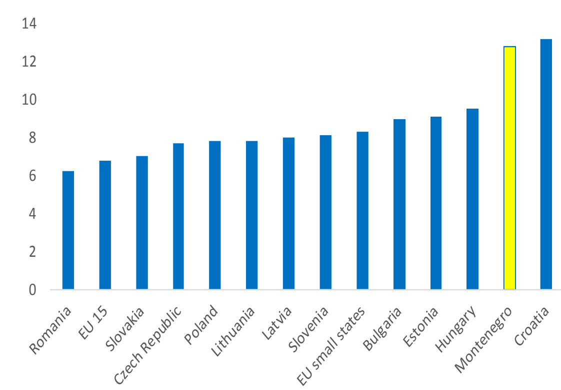


Figure 24. VAT Revenue, Percent of GDP, 2017



Source: Eurostat, MOF, staff calculations

59. **Montenegro continues to make extensive use of tax exemptions.** The most widely used are those for construction of the Bar-Boljare highway, and for luxury hotels and restaurants. Tax expenditures are a concern, not only because of their cost but also because they disproportionately benefit the well-off; because they are arbitrary undermine trust in tax administration and

government; and result in resource misallocations that can undermine productivity growth. [24] Meanwhile, at 9 percent the corporate income tax (CIT) rate is among the lowest in the region.

60. **There are also subsidies in the form of tax expenditures provided by the local governments.** For example, there are employment subsidies for employers who at the hire particular classes of workers. Local governments give exemptions from real estate taxes for registered agricultural producers—legal persons and entrepreneurs who specialize in the production, finishing, packaging, or processing of agricultural products produced in Montenegro. At the same time, Montenegro has one of the highest employee social security rates in the region, with employees transferring a significant share of their wages to pensions, health insurance, and unemployment insurance. With employer contributions relatively low, this has resulted in a significant tax wedge[25] that, other things being equal, has a negative impact on employment. Excises for tobacco, alcohol, fuel products, and sugary drinks are currently below EU levels; raising them would not only better align them with the EU but—more importantly—would disincentivize consumption of goods with negative externalities.

61. **Tax policy should be reformed as a package:** increases in some rates and decreases in some exemptions are intended to be offset, at least in part, by decreases in other rates to achieve a more neutral tax regime that is growth- and job-friendly. Such a package could include:

i. An immediate moratorium on the extension of current exemptions, review of tax exemptions generally, and where feasible, phasing out current corporate tax exemptions.
ii. Publishing a list of all tax exemptions with estimates of their cost in foregone revenues.
iii. Rebalancing the current tax structure by reducing payroll taxes[26] while phasing out a variety of subsidies for businesses.
iv. Restricting use of the lower VAT rate to basic foods and applying the standard rate to hotel accommodations, services provided in marinas, and admissions to theatres, shows, exhibitions, and amusement parks.
v. Raising excise taxes on coal, alcohol, tobacco, and sugary drinks to better align them with EU standards.

62. **On the revenue policy side, the authorities might also strengthen the tax policy coordination.** There is a department for taxes and customs within the MoF; however, it needs to strengthen the policy and analytical focus for taxes and customs and lead the policy reform agenda in this area across various entities, including the MTA, the Customs Administration, the Directorate for Economic Policy and Development, and other institutions working on areas affected by tax and custom policies.

[24] International Monetary Fund, "Upgrading the Tax System to Boost Productivity", Chapter 2, Fiscal Monitor: Achieving More with Less", April 2017.
[25] The difference between what employees take home in earnings and what it costs to employ them.
[26] In the World Bank report of 2019, Montenegro Jobs and Growth Agenda, the recommendation is to introduce progressivity through personal deductions or family allowances targeting low income groups and levying personal income taxes after social security contribution deductions. This would improve the labor market position of low-wage workers with dependents.

Modernizing Tax Administration

63. **Montenegro's *Doing Business* scores illustrate relatively high compliance costs for taxpayers** (Figure 25 and Figure 26)**.** In recent years Montenegro has taken major steps to modernize revenue administration by reforming its legal framework, organizational structure, and IT resources. Nevertheless, its effectiveness and efficiency of tax administration are still undermined by organizational, human resources, and IT challenges, as compliance is undermined by the magnitude of tax arrears. Although a major effort has been made through tax reprogramming, bankruptcy initiations, and write-offs to reduce them from the peak of almost 16 percent of GDP in 2015, tax arrears are still about 9 percent.

Figure 25. Number of tax payments, 2018

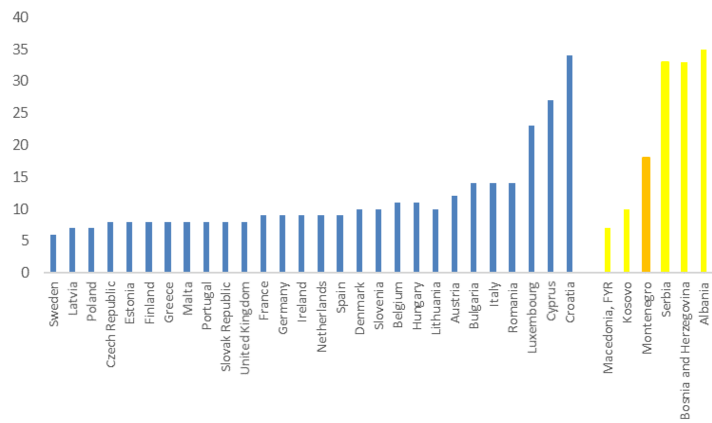
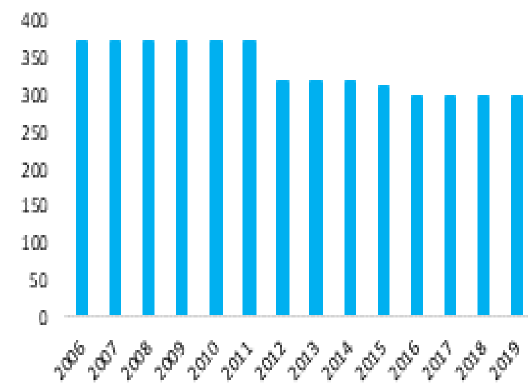


Figure 26. Time to comply with tax legislation (hours per year)



Source: Doing Business, World Bank

64. **On the revenue administration side, the authorities might:**

i. Enhance the strategic focus, planning, and analytical and monitoring capacity of the MTA to support modern compliance management.
ii. Invest in staff training, taking into account the need for new competences and the aging of the current workforce.
iii. Improve the legal framework to ensure consistency with MTA operational needs and international best practice.
iv. Either charge for collecting local government revenues or transfer the collection of property taxes to the local self-government.
v. Expand the use of electronic filing and e-payment to reduce the costs of compliance.
vi. Introduce risk management and modern approaches to conducting audits and thus strengthen compliance. MTA is collecting large amounts of data which should be used to inform tax audits.
vii. Upgrade the IT system and infrastructure to support modernization of such core functions as taxpayer registration, tax audit, and collection, while reducing compliance costs.
viii. Reinforce the enforcement and collection functions to reduce arrears and improve compliance.
ix. Expand the scope and quality of channels for interaction with taxpayers—Internet, call center, e-mails, telephone, etc.

x. Set service delivery standards and monitor performance.

Strengthening the Public Finance Foundations

Enhancing Public Financial Management

65. **Public financial management (PFM) in Montenegro has become more effective and transparent over the last several years.** The Single Treasury Account (STA) was established in 2010; it now processes the vast majority of the receipts and payments of governmental entities. The Central Bank (CBCG) as the government's agent is operating the STA; the small number of accounts maintained in private banks are reconciled with the STA daily. The legal framework governing budget management is in place, as is the nascent framework for fiscal responsibility, building on the fiscal rule introduced in 2014. The medium-term budget framework (MTBF) provides projections for the budget year and the next two but as yet is largely provisional; medium-term targets seem to be peripheral to preparation of annual budgets in the following two years. Program budgeting was introduced in 2008, but over time the program budget remained only at the level of presenting the program structure, without the objectives and performance indicators for the programs being determined; therefore, no mechanism or practice for measuring performance has been instituted.

66. **Institutions for oversight and scrutinizing the use of public funds are in place.** Over the past several years the State Audit Institution (SAI) has made substantial progress and continues to build its capacity. It regularly improves its audit methodology, coverage of audited public expenditures, and the types of audits it performs. Montenegro has also provided for enhanced oversight of public expenditure via the Parliament Budget and Finance Committee, which reviews the draft law on the final account and the related audit by the SAI, which are then sent for information to the plenary assembly. The Public Internal Financial Control (PIFC) framework was established in 2008 and is gradually being strengthened. A large number of public entities have introduced internal audit function and, more slowly, financial management and control.

67. **Montenegro's public procurement system has a solid foundation, and broad coverage (spending subject to procurement at about 12 percent of GDP in 2017).** It is well-organized, and responsibilities are clearly defined. The public procurement portal, launched in May 2015, facilitates access to guidance documents, regulations, statistics, and other information. In 2018, the government also launched centralized procurement to achieve savings from economies of scale by standardizing and building up the purchasing power of the government as a whole.

68. **However, there is scope to further improve PFM.** The medium-term budgetary framework and program budgeting need to be made more meaningful so that they add value and serve their purpose of improved planning and management of budget funds to use them more effectively and measure results. The Law on Budget and Fiscal Responsibility prescribes that the annual budget starting from 2020 will include budget ceilings for two following years to the budget year, but the commitment to these ceilings will have to be enforced. The fiscal responsibility framework has not been enforced in any year since its introduction. The commitment to fiscal targets—deficit and debt, has been weak (Figure 27 and Figure 28). Deviations from the deficit targets were on average 3.5 pp of GDP over the 2010-18 period, while debt targets were overshoot

by over 9 pp of GDP. Over the last two years, growth projections have turned to be more conservative that could keep the future deviations lower.

69. **To enhance the quality of financial information and create preconditions of more efficient management of public funds Montenegro needs to adopt accrual accounting and budget reporting.** Currently, quarterly and annual financial and budget reports provide primarily financial information related to revenue and expenditures. Because not even a partial balance sheet is being prepared, there are no data on nonfinancial and financial assets. Liabilities due and unsettled are published only in the audit report. The Law on Public Sector Accounting is planned to be adopted in June 2019, and it introduces government's accrual accounting and financial reporting. The implementation of the law will be a challenge for many public sector entities given the lack of asset registry.

Figure 27. Fiscal Deficit Projections and Actuals, 2010-18

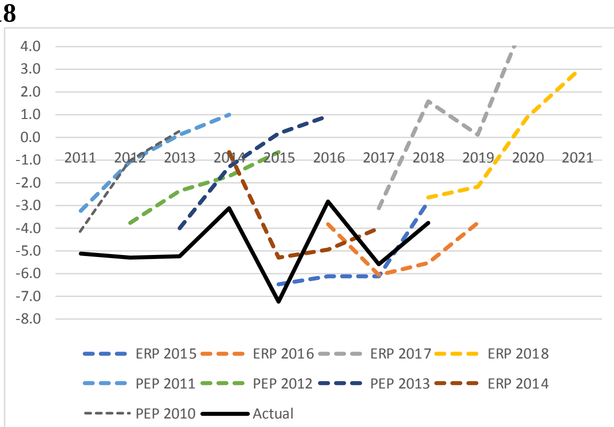
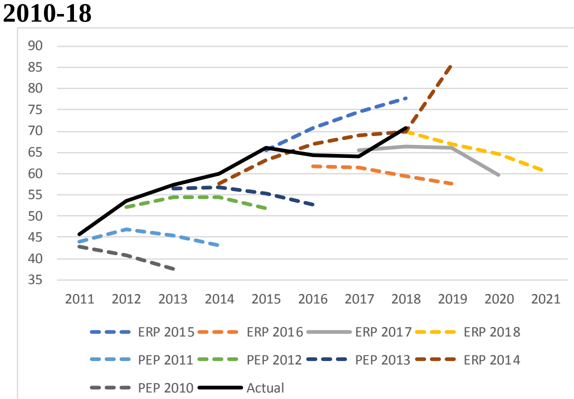


Figure 28. Public Debt Projections and Actuals, 2010-18



Source: Eurostat, MOF, staff calculations

70. **LGU treasuries are independent of the central treasury, they also execute** LGU budgets independently. Efforts to extend the SAP application to local governments did not succeed; LGU software does not include such features as hard controls to ensure spending goes no higher than the budget allocations and to manage multi-year commitments. The result of such system is suboptimal budget planning and execution of LGUs.

71. **A number of public procurement areas could be improved.** First, there is a need to fully align the Public Procurement Law with the *acquis* by removing exemptions from its application and introducing more efficient procedures. It is also crucial to enhance the procurement monitoring system, e-procurement, and the remedy system; reduce fragmentation of contracting authorities (currently every budget user is a Contracting Authority), and put in place framework agreements to maximize the gains from centralized procurement.

72. **Action to strengthen control environment is also required.** EU acquis Chapter 32 on Financial Control has been opened with a conclusion that Montenegro is moderately prepared on financial management and control, and good progress was achieved especially on internal and external audit. However, managerial accountability is not yet fully embedded in the management culture, and responsibilities are rarely delegated. Further strengthening of financial management and control, as well as both internal and external audit are the means towards maximizing efficiency of the use of public funds.

73. **The authorities might consider the following recommendations to strengthen PFM:**

i. Improve the credibility of the MTBF by adding a table reconciling projections from previous years.

ii. Align the fiscal rule with the EU Directive, strengthen compliance with the fiscal rule and the role of the fiscal watchdog.

iii. Progressively reinforce medium-term and program budgeting, and introduce a spending review process as part of the budget cycle to assess value for money for selected programs.

iv. Introduce accrual accounting and reporting, with by-laws to prescribe in detail financial reporting standards, forms of reporting, a chart of accounts, an asset registry, and IT support.

v. Fully harmonize the procurement legislation, strengthen monitoring and reporting, and address shortcomings in the remedy system.

vi. Create incentives for LGUs to use the central government Treasury system; or assess how well LGU treasuries comply with sound PFM.

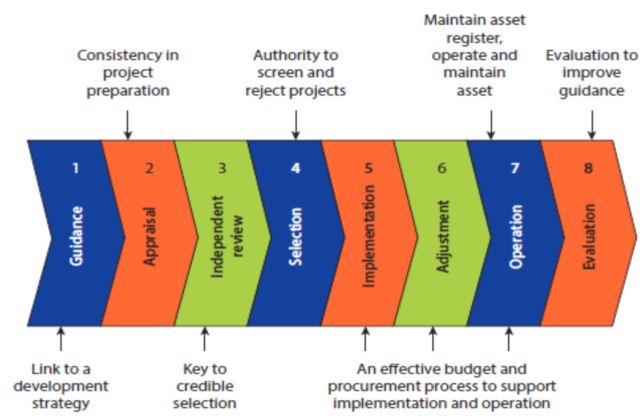
vii. Strengthen financial management and control, external and internal audit systems, rules, and reporting.

Strengthening Public Investment Management

74. **A lack of clear national regulation and investment guidelines has undermined the quality and efficiency of core public investment management (PIM) functions.** There is little or no assurance that projects would be effectively screened for their consistency with government policies using rigorous appraisal tools and independent review. The responsibilities of various stakeholder are not clear, creating ambiguity about project approval processes. There are also gaps in project management and monitoring, especially for centrally-funded projects. The Decision on Preparation of the Capital Budget was amended in June 2018 partly to remedy these challenges. The amended Decision brought about improvements in project content and the application, criteria, and evaluation process. Yet so far there is no methodology in place that covers all phases of the PIM cycle and defines procedures, processes, and institutional roles. Among areas that should be covered are prioritization, evaluation, and selection of capital projects; implementation procedures, monitoring, and project reporting; and ex post evaluation of results.

75. **Montenegro is missing important international good practice steps in the PIM cycle** (Figure 29)**.** Its formal project appraisal process is not based on

Figure 29. PIM Diagnostic Scheme: Eight Must-Have Features



Source: World Bank 2014.

systematic analysis of project viability and financial sustainability. The Ministry of Transport does insist on technical documentation of engineering feasibility and the costing of construction when projects are prepared, but although feasibility studies and cost-benefit analyses are required for projects costing more than €5 million, no agency requires a formal analysis of a project's ultimate economic viability, financial sustainability, and environmental and social impacts. Nor is there any requirement that projects submitted for budget financing be assessed to determine value for public money. The PIM strategy needs a common appraisal process and methodology applied consistently to all projects, irrespective of the funding source.

76. **The MOF attempts to direct resources to finishing projects already underway.** Because maintaining existing capital stock is not always prioritized over new infrastructure spending, budgets do not explicitly take into account the operations and maintenance (O&M) costs of completed projects. Lack of a monitoring system also makes it difficult to identify necessary adjustments. It is therefore not surprising that in Montenegro project course corrections are relatively rare. There are no systemic procedures for cancelling poorly performing projects or those that for any reason become unnecessary. Moreover, there is no formal ex post central government assessment when a project is completed.

77. **There is much that Montenegro can do to streamline the process of project approval, preparation, and execution.** Potential reform priorities would be to

i. Establish a streamlined and coordinated process and guidelines to help the MOF departments in charge of transport and other public investments to more explicitly prioritize project selection to weed out projects not directed to national or sector priorities and to ensure that budget ceilings are respected.

ii. Allocate responsibility clearly and draft procedures for project screening, monitoring, and reporting.

iii. Establish and keep current a comprehensive MOF database of capital investment projects.

iv. Put in place a multiyear program to build staff knowledge and skills within core central government units in such critical PIM areas as project screening, appraisal, and M&E.

v. Apply a rigorous appraisal methodology to all projects, complete with economic and cost-benefit analyses and projections of financial sustainability. This should be a precondition for inclusion in the PIP.

vi. Improve coordination between the MOF and line ministries for more efficient M&E of capital projects. Procurement and internal controls need to be upgraded. A government-wide manual should be created to guide project managers in organizing, managing, and reporting on project progress through completion.

vii. Require regular reports on project progress (or lack thereof), replete with data on disbursements, total estimated costs, and information on delays.

viii. Specify performance indicators early in project design to guide regular monitoring.

ix. Require completion reports for every project, and ex post review for at least publicly-funded investment projects, perhaps by creating a special unit with responsibility for contracting external reviewers to provide unbiased, independent review, or by expanding the role of the SAI.

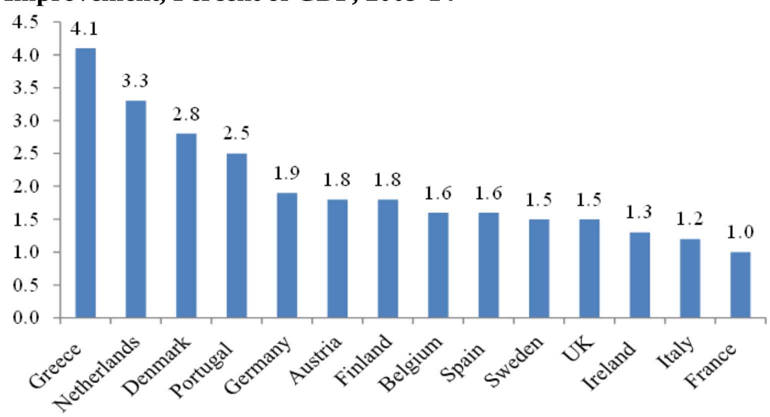
RESTORING SUSTAINABILITY AND POLICY PRIORITIES

78. **To achieve debt sustainability, the government will need to turn the 1.8 percent primary deficit in 2018 to a balance in 2019 to prevent further growth of debt.** This will require bringing in more revenue and/or a reducing primary spending. The adjustment is urgent, but necessary to bring public debt below 60 percent of GDP by 2025. If not undertaken, deepening vulnerabilities and much higher borrowing costs will seek much stronger adjustment later. The adjustment must be bolder and made without delay: To bring debt down to 60 percent, Montenegro will need to achieve a primary surplus of about 1 percent of GDP. Thus over the medium term, the total adjustment would be about 2.8 pp.

79. **Montenegro's spending and revenue pattern suggests that over the medium term a fiscal adjustment of 2.8 pp of GDP would be feasible**. While revenue measures identified could push up revenues with little adverse impact on growth and employment, more fiscal space should be created on the spending side. The international experience is clear: austerity programs based on spending cuts are much less costly for growth than those based on tax increases.[27]

80. **In recent years several EU member countries have undertaken fiscal consolidation.** Corrected for the cycle, between 2009 and 2013 Greece averaged an annual primary deficit reduction of 4.1 pp of GDP, the highest in the developed world in recent years (Figure 30). During that period Latvia had a similar experience. While arguably in both countries such rapid adjustment had a high social cost, the adjustment required in Montenegro would be similar to recent consolidation episodes in Croatia and Ireland.

Figure 30. Average Annual Cyclically Adjusted Primary Balance Improvement, Percent of GDP, 2009-14



Source: Eurostat, World Bank staff calculation.

81. **By not reducing its fiscal vulnerabilities, Montenegro may see further deterioration in investor sentiment, resulting in higher financing costs, unaffordable long-term borrowing, or both.** This would intensify recessionary trends and require much more urgent and deeper fiscal consolidation. While revenue and tax administration measures can contribute to consolidation objectives, the adjustment will need to be

[27] Alesina, A. et al. 2019. Effects of Austerity: Expenditure- and Tax-Based Approaches. Authors calculated that expenditure-based plans of a 1 percent of GDP reduction imply an output loss of about 0.25 pp of GDP that lasts less than two years. In contrast, tax-based austerity plans to bring in an additional 1 percent of GDP generate losses of more than 2 pp and last 3–4 years.

made predominantly through spending measures, both short-term and structural. These measures are designed not only to reduce the fiscal deficit and public debt to sustainable levels but also to improve the efficiency of the public sector, create fiscal space for the productive use of funds, and thus make the economy more competitive.

82. **Given its aspirations to join the EU, and then the Euro Zone, Montenegro needs to demonstrate its commitment to ultimately meet the Maastricht criteria.** Even more urgent, the Budgetary Directive[28] in the new body of the *acquis* should be transposed into national law and enforced before accession negotiations close. The pressing consolidation demands, and enhancement of the national budgetary framework are closely intertwined—the goal of both is to bring about lasting improvements in the quality of the country's fiscal outcomes.

83. **To maintain market access and limit the risks to public finances, policies on the expenditure and revenue sides will need to be pursued.** A rationalization of public sector employment, savings on operational costs, prioritization of public investment decisions, further revenue mobilization and a reduction of tax expenditures are among the efforts that could have a sustained positive impact on fiscal balances in the medium term and help reverse the growing public debt dynamics. The estimated fiscal savings based on the international benchmarking budget cost items is provided in Table 7. Such measures, if well designed, could bring the necessary adjustment of well over 2 percent of GDP. Strong political will is needed, however, to implement such an ambitious program of fiscal consolidation. Such program could create much needed long-term macro-fiscal conditions for higher levels of growth and employment creation. Alternative paths of smaller fiscal adjustment are possible, but there is the risk that market sentiment may turn quickly, especially as international interest rates start increasing.

Table 7. Estimated Fiscal Savings, Percent of GDP

Policy area	Short term savings	Medium term cumulative savings
Public wage bill	0.5% with basic wage harmonization	2% of GDP through staff downsizing
Health	Improving efficiency and funds allocation from pharmaceuticals and hospitals to primary care	
Pensions		1% of GDP
Social benefits	1% of GDP through means-testing mother benefits	Eliminate error of inclusion
Local government	Improving efficiency and clear arrears	
Public investment	1% of GDP	3% of GDP

[28] Council Directive 2011/85/EU is an important component of the legislative package on the strengthening of economic governance (also known as the 'six-pack'). This Directive provided the first opportunity for the EU to set minimum requirements for budgetary frameworks, providing legal certainty to the country-specific recommendations issued under the European semester process.

Public procurement	0.5% of GDP	
Tax revenues	0.5% of GDP through collection and excises	2% of GDP through rationalizing exemptions

Table 8. Summary of Sector Policy Priorities

SHORT-TERM MEASURES	MEDIUM-TERM MEASURES
Improving Efficiency and Effectiveness of Public Administration	
• Strengthen the appraisal and performance reward system, abolish, the seniority bonus and instead relate performance and promotion to a transparent and rigorous appraisal system. • Support reform of the public administration with a strategy for private-sector development. • Automate management of information for key functions, especially financial and HR management. • Amend the Law on Territorial Organizations to set stricter conditions for forming a municipality, emphasizing financial viability.	• Streamline administration to reduce organizational proliferation and consolidate institutions with related functions. • Organize horizontal public administrative functions by analyzing delivery chains and promoting shared services both within and between sectors. • Strengthen municipal governance to reinforce coordination and collaboration within local governments and to build capacity to monitor compliance with the law.
Strengthening Local Government Finances	
• Build up the revenues of financially distressed municipalities by, e.g., introducing better-regulated communal fees to ensure full cost-recovery; eliminating deferred payment of the PIT surtax; and raising the central government contribution to the Equalization Fund by, e.g., allocating to it a share of VAT or CIT revenue. • Streamline intergovernmental transfers by basing them on a simple formula that gives due weight to needs, rights to minimum basic services, performance incentives, and interjurisdictional equity • Avoid bail-outs and ensure that hard budget constraints are the rule; and use equalization mechanisms to provide an incentive for raising own-source revenue by using tax potential and a standard tax rate as the main equalizing variables.	• Reform collection of real estate taxes, allowing local tax administration access to central cadaster information for better assessment of real-estate valuations; use cadaster innovations to enhance tax administration and promote consistency between real estate transfers and real estate taxes; and enforce registration of property in the cadaster. • Ensure that local tax-administration agencies have the human, technical, and administrative resources they need, and that local agencies and the MOF Tax Administration Unit work together to collect taxes; and educate residents on the importance of paying taxes to support municipal development and service delivery. • Reduce overstaffing and reinforce coordination and collaboration, e.g., by sharing services within local governments.
Strengthening Effectiveness of Social Benefits	
• To avoid errors, differences in treatment, and fraud, tighten disability controls, streamline procedures for medical assessments, and improve transparency. • Review the means test to ensure that deserving low-income applicants do not become ineligible.	• Reform spending on parental leave salary compensation. • Expand the community-based care services. • Avoid packaging different benefits into a single unit of assistance and capping them; instead eliminate disincentives to work if the benefit package becomes excessively generous.
Strengthening Fiscal and Social Sustainability of the Pension System	
• Adopt 100 percent wage valorization and 100 percent price indexation. • Reform early retirement policy by (1) abolishing penalty-free retirement with 40 years' service; (2) adopting a penalty rate for early retirement that rises above the actuarily	• Tighten again the privileged-pension categories and the disability assessment.

SHORT-TERM MEASURES	MEDIUM-TERM MEASURES
neutral level (to a 7 percent); and (3) reducing the five-year window to no more than two years.	
Making the Health System More Efficient	
• Support rational prescription of medicines, including the development of clinical protocols and monitoring applications. • Include financial risk-sharing provisions into MEAs to better control spending on medicines. • Strengthen control over prescriptions for sick leave, enforce timely payment of liabilities, and rationalize use of hospital beds.	• Review the national health policy. • Improve primary health care prevention and management of chronic conditions. • Shift to outpatient care for specified interventions. • Address obesity and tobacco and alcohol use, using excise policy and public health campaigns to reduce the incidence of NCDs.
Boosting Revenues and Enhancing Tax Compliance	
• Declare a moratorium on extending tax exemptions and review them all. Where feasible, phase out any corporate tax exemptions. • Publish a list of all active tax exemptions with estimates of their cost in revenues foregone. • Restrict use of the lower VAT rate to basic foods and apply the standard rate to accommodations in hotels, services provided in marinas, and admission to theatres, shows, exhibitions, and amusement parks; • Raise excise taxes on coal, alcohol, tobacco, and sugary drinks to align them more closely with EU standards. • Enhance the strategic focus, planning, analytical, and monitoring capacity of MTA to support modern compliance management. • Improve the legal framework to ensure consistency with MTA operational needs and international best practice. • Strengthen enforcement and collection functions to reduce arrears and improve compliance.	• Rebalance the current tax structure, reducing payroll taxes and phasing out various targeted subsidies to business. • Invest in training of staff. keeping in mind the need for new competences and the aging of the current workforce. • Expand the use of electronic filing and e-payment to reduce compliance costs. • To further strengthen compliance, introduce risk management and modern tools and specify approaches for conducting audits. • Upgrade the IT system and infrastructure to support modernization of core functions, such as taxpayer registration, and ensure a sustainable increase in compliance and reduction of compliance costs. • Expand the scope and quality of channels for interaction with taxpayers—Internet, call center, e-mails, telephone, etc. • Set service delivery standards and monitor performance.
Enhancing Public Financial Management	
• Improve the credibility of the medium-term budget framework by including a table that reconciles projections from previous years. • Align the fiscal rule with the EU Directive, reinforce the role of the independent fiscal watchdog. • Introduce accrual accounting and reporting, with by-laws to prescribe financial reporting standards in detail, forms of reporting, chart of accounts, asset registry, and IT support. • Fully harmonize the procurement laws, intensify monitoring and reporting, and address the remedy system.	• Progressively strengthen use of medium-term and program budgeting, and introduce as part of the budget cycle a spending review process to assess the value for money for selected programs as part of the budget cycle. • Give LGUs incentives to use the central government Treasury system or assess how well their treasuries comply with the functions needed for sound PFM. • Build up external and internal audit systems, rules, and reporting.
Strengthening Public Investment Management	

SHORT-TERM MEASURES	MEDIUM-TERM MEASURES
• Establish a streamlined and coordinated process and guidelines to help the MOF and its departments in charge of transport and other public investments to clearly set priorities for project selection and to ensure that budget ceilings are respected. • Establish clear responsibility and procedures for project screening, monitoring, and reporting. • Establish and keep current a comprehensive MOF database of capital investment projects. • Identify a common, rigorous methodology for appraisal of all projects, complete with economic and cost-benefit analyses and projections of financial sustainability, as a precondition for inclusion in the PIP. • Design a multiyear program to build staff knowledge and skills within core central government units in such critical PIM areas as project screening, appraisal, and M&E.	• Improve coordination between the MOF and line ministries to foster more efficient M&E of capital projects. Upgrade procurement and internal controls and create a government-wide manual to guide project managers in organizing, managing, and reporting on project progress to completion. • Require regular reports on project progress (or lack thereof), with data on disbursements, total estimated costs of the project, and explanation of delays. Articulate performance indicators early in project design for the purposes of regular monitoring. • Prepare completion reports on all projects. Establish an ex post review function for all publicly-funded investment projects, perhaps by creating a special unit with responsibility for contracting external peer reviewers to provide unbiased, independent reviews, or by expanding the role of the SAI.

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