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CURRENCY AND EQUIVALENT UNITS

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Currency Unit = euro
US$1 = 0.79 euros

FISCAL YEAR

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ABBREVIATIONS

BiH	Bosnia and Herzegovina	MONSTAT	Montenegro Statistical Office
BOT	Build, Operate and Transfer	MOU	Memorandum of Understanding
CEEC	Central and Eastern European Countries	MTMA	Ministry of Transport and Maritime Affairs
CPAR	Country Procurement Assessment Report	NEX	Montenegro Stock Exchange
DPR	Department of Public Revenue	NHA	National Health Accounts
DPW	Directorate of Public Works	NMS10	New Member States 10
DRRI	Department of Roads and Railway Infrastructure	PAYGO	Pay-as-you-go
EAR	European Agency for Reconstruction	PCG	Pošta Crne Gore
EBRD	European Bank for Reconstruction and Development	PEIR	Public Expenditure and Institutional Review
EF	Employment Fund	PHC	Primary Health Care
EIB	European Investment Bank	PIO	Pension Fund
EPCG	Electric Company of Montenegro	PPA	Public Procurement Agency
EU	European Union	PPAA	Public Procurement Administrative Authority
EUR	Euro	PPC	Public Procurement Commission
FDI	Foreign Direct Investment	PPI	Private participation in infrastructure
FFCD	Frozen Foreign Currency Deposits	PPL	Public Procurement Law
FIAS	Foreign Investment Advisory Service	PPPs	Public Private Partners
HIF	Health Insurance Fund	RER	Request for extraordinary review
HRM	Human Resource Management	RoM	Republic of Montenegro
ICAO	International Civil Aviation Organization	SAA	Stabilization and Association Agreement
IMF	International Monetary Fund	SAI	Supreme Audit Institution
KFW	German Funding Agency	SAM	Serbia and Montenegro
LFS	Labor Force Survey	SOE	State-owned Enterprises
LSMS	Living Standards Measurement Survey	SPAI	Stability Pact Anti-Corruption Initiative
MOES	Ministry of Education and Science	SUs	Spending Units
MOF	Ministry of Finance	WTO	World Trade Organization

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EXECUTIVE SUMMARY

1. **On May 21, 2006, Montenegro held a national referendum to decide its political future**. Official referendum results showed that 55.5 percent of voters chose independence with a turnout of 86.3 percent. With the majority of Montenegrins voting for independence, the referendum has paved the way for Montenegro as a new independent state, ending the loose federation with Serbia that has been in place since the disintegration of the Socialist Federal Republic of Yugoslavia.

2. **Full integration into the European Union remains Montenegro's main strategic goal,** starting with a resumption of talks on the Stabilization and Association Agreement (SAA). With only about 620,000 inhabitants, Montenegro's domestic market is extremely small. EU integration thus remains fundamental to enhancing its growth and prosperity through expanded market access, increased specialization and efficiency in production, increased risk diversification, reduced income volatility, and peace and stability.

3. **With independence, Montenegro may be on a separate path toward the goal of EU integration.** The European Commission has indicated that, in view of the outcome of the referendum, it will issue a separate mandate for Montenegro with respect to both the SAA, and an eventual EU membership. An independent Montenegro will be fully responsible for the speed of its integration. It can negotiate its own transitional period for convergence to EU requirements, fulfill the requirements at its own pace, and even speed up its progress toward integration.

4. **Yet, Montenegro's rediscovered statehood may also test its ability to form a viable economy and push through the strict reforms set by the EU as a condition for eventual membership**. The country must confront several problems which have not been fully addressed in the past. Two such key challenges are the weak governance and the perceived wide prevalence of corruption,[1] and the need for creating better administrative and institutional capacity for EU integration.

5. **This first report in a series of programmatic reviews is concerned with identifying opportunities for policy, administrative and institutional reforms to strengthen good public sector governance and accountability, as well as improve the administrative capacity for EU integration in Montenegro.** It focuses on three key institutional aspects of good governance: public administration reforms, public financial management reforms and transparency (e.g. budget comprehensiveness and transparency, budget credibility, internal audit,

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[1] For sources that indicate corruption has been widespread over the last decade, see: (i) The Stability Pact Anti-Corruption Initiative (SPAI) general assessment report, chapter 6; (ii) Damar Agency public opinion poll of March 2004, where citizens perceived corruption and crime, poverty, and unemployment as the three biggest social problems in Montenegro; (iii) Freedom House Serbia and Montenegro Country Report, 2004; (iv) EU Feasibility Assessment, 2005.

and procurement), and reforms of public oversight and watchdog institutions (e.g. supreme audit institution; ombudsman office) to consolidate accountability for public money and resources.

6. **The report delineates five themes as key priorities for Montenegrin policy makers to address** in order to improve public sector governance, strengthen institutions for accountability and transparency, and enhance Montenegro's administrative and institutional capacity for EU integration:

- Reducing the current costs of public employment to create budgetary space for strengthening EU-related administrative functions and infrastructure spending;
- Creating an effective and accountable public administration, compatible with EU structures and standards;
- Reforming public financial management and procurement to ensure better transparency and accountability for public money;
- Improving the institutional capacity for public investment planning and infrastructure investment; and,
- Monitoring and controlling fiscal risks beyond the National Budget for better governance of the broader public sector.

Reducing the Costs of Public Employment

7. **First, the government must contain the high cost of public employment, manifested in the high wage bill** to assure that the costs of public employment do not squeeze the fiscal space needed to fund infrastructure and new institutions and administrative capacity for European integration. Although the Government has made substantial progress (employment in the public administration fell by almost 14 percent between 2002 and 2005), the public sector wage bill continues to represent a relatively heavy burden on the economy. A comparison with regional states shows that Montenegro's wage bill as a proportion of total government expenditure or GDP still remains far above average. On the other hand, capital expenditure is much below the level for other countries in the region.

8. In order to further reduce the wage bill and the costs of public employment, the Government would be well advised to:

- *Focus efforts to reduce public employment and wage bill on public order, defense, health and education.* Eighty-seven percent of the wage bill is concentrated on just these four functions. All of the other functions and institutions of government operate on the remaining 13 percent. Montenegro's expenditure on public order and safety, at about 4 percent of GDP, is about twice the average for new member countries. Similarly, spending on health care and education services are much higher than the average for new member states by 2-3 percent of GDP each. Any future reductions in employment and wage bill should therefore be targeted toward these four dominant sectors.

- *Expand administrative capacity in EU-related and governance functions.* Savings from staff reduction and wage control in the above areas are needed, partly, to improve staffing and administrative capacity in EU-related functions. With statehood, Montenegro would need to transfer and strengthen some key functions—intellectual property rights protection, standardization and accreditation of products, processes and services, national statistics, visa, asylum, and border management, civil aviation, and meteorology—which have to date been carried out at the State Union level with Serbia. In addition, several institutions will need increased staffing and resources—the Civil Service Agency, internal audit, the Supreme Audit, the Administrative Court, the Ombudsman, the Public Procurement Commission, the Public Procurement Administrative Authority (yet to be established)—for better public sector governance, transparency, and accountability.

- *Control the pace of, and target, annual wage increases.* Granting across-the-board increases in public sector salaries erodes the fiscal space needed to decompress the salary structure to attract and retain the most qualified people. Future increases in real salary rates should be highly targeted rather than implemented across-the-board.

9. **The case of education, the largest contributor to the government wage bill, illustrates the challenges as well as what the government can do.** Out of the total recurrent expenditure on general education in 2004, 82.3 percent was spent on the wage bill, leaving only 17.7 percent of total recurrent expenditure for non-staff items, which includes spending not only on classroom materials and teacher training but also on utilities. A closer look at the fiscal structure in the sector shows, again, that the Government faces a clear choice between a sharp rise in salaries and staff costs on the one hand, and spending on non-salary expenditures to pay for the school reform agenda and improve education quality on the other. Some key steps that the government should take:

- *Control the rapid wage increases.* The average annual salary of a teacher in Montenegro, including all the allowances is €7,103, which amounts to over 160 percent of GDP per capita. This puts the salaries of Montenegrin teachers well above the OECD comparative average. Furthermore, in January 2006 average salaries for both teaching and non-teaching staff in non-university education increased by between 8 and 9 percent against a planned salary budget increase of only 3 percent. The larger-than-planned increase was the outcome of a branch (sectoral) collective agreement and negotiation, which resulted in higher salary coefficients. In light of this, the Government may wish to more strongly engage the teacher unions with a view to re-negotiating the collective agreement so that wage increases fit within the resources available. In the future, collective bargaining should include a careful and transparent analysis of the impact of the salary increases on the education budget.

- *Reduce salary costs through staff reductions.* In addition to controlling wage increases, the Government may want to implement further staff reduction measures –mainly through school consolidation--to contain salary costs, and protect the already low non-staff spending in education.

- *Create budgetary space to implement the schools reform program.* Savings from staff reduction and wage control are needed to implement the government's education reform program, which calls for school renovation and equipment, and a new curriculum and associated textbooks, assessment arrangements and teacher training. A cost analysis based on recently reformed schools shows that the cost of school reforms each year in

2006-2010 is projected to rise to two or three times the annual spending to date (€1.8 million in 2005).

10. While there are potentially significant savings to be made through staff reductions, and rationalizing the school network without reducing educational quality and, in some cases, even improving it, the government needs to actively manage staff reductions, including the use of involuntary separation.

Modernizing Public Administration

11. **Second, while containing the costs of public employment, the government must strongly pursue the tasks of creating a modern and effective public administration, compatible with European principles and standards**. The key challenge is to re-orient and reorganize the role and functions of the State Administration, a process which began with the Government's adoption of its Public Administration Reform (PAR) strategy in 2003.

12. Since 2003, Montenegro has shown commendable progress in putting in place the legal framework necessary for modernizing the public administration and bringing it closer to European standards. All the major pieces of legislation envisioned in the PAR strategy have been adopted and a number of new institutions have been created that will either assure compliance with the laws or be charged with implementing them. In reform of the civil service, major steps have been taken to encourage merit-based recruitment and advancement. Nevertheless, creating an effective and sustainable public administration structure – capable of implementing EU standards – will require continued, high-level political leadership.

13. **Indeed, several medium and long term challenges remain**. As discussed, the cost of the public employment is already quite substantial as a share of GDP. Plans to introduce performance-based pay are commendable, but the current practices still give heavy emphasis to tenure. Development of a performance appraisal system is a critical element in moving toward performance-based pay, but thus far, too few resources have been devoted to developing the system in a credible or sustainable manner.

14. **The key near-term priority measures should be to**:

- *Ensure continued high-level political leadership and support to the PAR implementation*, including development of a sequenced action plan and resource implications. The inter-ministerial committee for PAR has met rarely, and has thus played little role in substituting for a stronger center-of-government coordination. The lack of a tradition within Montenegro of inter-ministerial coordination structures suggests that there is a need for a strong, high-level leadership for PAR.

- *Develop and implement a medium term civil service pay strategy that will further decompress the salary structure* for positions that are most difficult to recruit and retain and that can be implemented within a fiscally sustainable resource envelope. Despite modest progress in 2005, the system is still highly compressed compared to European standards. This will continue to make recruitment and retention difficult. While concerns over fiscal pressures limited the government's scope for decompression in 2005, further decompression is possible if the government focuses such increases toward the skilled and professional positions.

- *Enhance the capacity of the Civil Service Agency--through staffing and technical assistance--to implement a credible performance appraisal system and move toward a performance-based pay system*. While it is common within the public sector to adjust pay based on the years of experience, seniority has too large an impact in the Montenegrin system. Civil servants and public employees can receive up to 35% of base pay as a bonus for length of service. However, those with the longest tenure will not necessarily have the most needed skills, and the continuation of the current system undermines performance-based principles. Since the bonuses are part of the General Collective Agreements that that government signs with unions, it is essential that changes are sought and initiated at this level to progressively reduce the impact of seniority in the calculation of total pay.

15. **Over the medium term, Montenegro faces continued challenges to simplify and streamline the state administrative structure**. Overlapping responsibilities and fragmented organizational structures impede effective policy coordination, weaken governance, and add to the cost of running government. The Government should thus build on the existing Law on State Administration and conduct a horizontal review of government functions that may lead to streamlining ministerial accountability and setting of government-wide priorities. Plans to introduce program budgeting can, in that respect, help to clarify the current priorities and facilitate the evaluation of trade-offs. More specific measures the Government should consider over the medium term:

- *Undertake a horizontal review of government functions and activities,* with the aim to abolish “left-over” structures from the previous system and to strengthen capacities in the functions and activities most needed to support effective EU integration. A relatively under-developed central apparatus of the state administration is increasingly called upon to coordinate and manage a plethora of subordinated institutions. This in turn weakens the overall governance process and adds an unnecessary administrative cost to running government. Such horizontal reviews should be integrated into the ongoing budget reforms led by the Ministry of Finance.

- *Strengthen the management structures and administrative capacity for EU integration.* Montenegro’s ability to successfully conclude negotiations with the EU during the SAA and beyond will require the creation of a much enhanced level of public administration capacity with respect to intellectual property rights protection; standardization and accreditation of products, processes and services, national statistics; visa, asylum, and border management; civil aviation; and meteorology. Further needs and lessons for institutional strengthening and administrative capacity for EU accession should be drawn from a comparative assessment of how the EU process has been managed in countries of similar size as Montenegro.

16. Again, while a number of functional areas that are vital to EU accession are currently under-developed, they can only be enhanced by shifting resources (human and financial) away from current inefficient functions. Measures to reduce the costs of public employment and wage

bill in the key areas--public order, defense, education, and health—are therefore essential as are organizational consolidations to reduce the costs of running government.

Reforming Public Financial Management and Procurement

17. **Third, Montenegro would need to press on with the public financial management and procurement reforms started in the early 2000s.** Significant progress has been achieved in public financial management reforms since 2001. The Ministry of Finance (MOF) has developed clear and comprehensive budget documentation that provides the appropriate context and assumptions for budget policy. Forecasts of revenues and expenditures are within a reasonable margin and the MOF has been able to execute the budgets with modest variation at an aggregate level. Budget execution has been aided by a fully functioning Treasury system, which is linked to all of the major budget users. Although some arrears and modest shifts in composition of spending are noticeable, these could be addressed through better planning in the future.

18. **While many of the basic features of good budget preparation and budget execution are in place, four key challenges would need to be addressed going forward**:

- *Help all major budget users to develop a sensible program budgeting structure that is rooted in the organization's strategic plan and that clearly reflects the three to five major policy priorities of the institution*. Introduced as a pilot program in a couple of ministries in 2004, program budgeting seems to have suffered from a lack of clarity over what qualitative changes it is expected to introduce into the budget making process. Although the number of ministries with "program budgets" has expanded over the past three years, the process is yet to have a substantial impact on policy planning and prioritization across government. While performance indicators may be addressed over a longer time frame, improving program budgeting through identification of the overall policy priorities of line ministries should be an immediate priority.

- *Develop indicative expenditure levels for the medium term budget framework broken down by sector or function, including the extra-budgetary funds*. While the current medium term fiscal framework is a good foundation on which to build, the MOF would need to extend the medium term budgeting framework to all budget users, including the extra-budgetary social funds. Ministries and budget users will need to develop indicative levels of spending by sector or consolidated programs, for at least one year beyond the budget year. Capacity constraints within the MOF and other line ministries are likely to be daunting challenges both to do the program budgeting well and to move towards a medium term expenditure framework.

- *Modestly increase the staffing of internal audit and external audit, and gradually reassign internal audit (IA) staff at the Ministry of Finance to work with key ministries as their own IA staff*. Institutions that are essential for assuring accountability of public expenditure are established and functioning, but their longer term effectiveness will require a willingness to significantly expand resources devoted to them. The creation of the internal audit department within the MOF and the establishment of the supreme audit institution (SAI) are both important milestones. Fundamental issues need to be addressed concerning staffing, training, and institutional mandate in order for each institution to play its proper role and to be effective.

- *Improve efficiency and transparency of public procurement by:* (i) adopting the new procurement law (PPL), which is consistent with the EU directives, and preparing all supplementary regulations, rules and procedures, and standard bidding documents consistent the new PPL; (ii) establishing the Public Procurement Administrative Authority (PPAA), with proper staffing, and institutional infrastructure and enhancing the capacity of the Public Procurement Commission (PPC) through additional staffing; and (iii) training all public procurement officials--in ministries and local governments as well as suppliers, contractors and consultants--with the new public procurement law, and the related supplementary regulatory rules, procedures, and standard bidding documents.

19. Montenegro’s overall challenge in public financial management is to strengthen the process of managing reform and the institutional mechanisms that support reform. Since many of the PFM reforms have implications across sectors and in the way ministries interact with MOF, the Government should consider strengthening the institutional arrangements for reform coordination. Building up the capacity within the MOF to implement reform is critical. Though the MOF bears the primary responsibility for day-to-day implementation, a strong support and accountability from the Office of the (Deputy) Prime Minister may be critical. Integrating PFM reforms as part of the broader EU accession agenda may be another strategy worth considering.

Improving the Institutional Capacity for Public Investment Planning

20. **Fourth, Montenegro would need to urgently introduce public investment planning and prioritization of capital projects in order to overcome years of neglect in infrastructure investment.** At 2 percent of GDP, Montenegro’s domestically financed capital expenditure is much below the level of other countries in the region. Of this, capital investment in infrastructure accounted for only about 0.5 percent of GDP in 2005.

21. **Reflecting years of underinvestment, the current state of infrastructure is quite poor**. In transport, for instance, the mountainous nature of the terrain, coupled with the maintenance backlog during the last decades, has resulted in higher costs for road users. The average driving speed is down to less than 50 kilometers per hour. Similarly, in railways, there has been progressive deterioration of the quality of service with repeated traffic breakdowns particularly during the winter seasons, which has resulted in a speed as low as 30-50 km per hour. Similar poor conditions, and urgent need for rehabilitation, exist in maritime transport, water and sanitation and energy. The low numbers, and the current state of infrastructure, indicate that there is a need for more capital investment.

22. Yet, in addressing the current underinvestment in infrastructure, the Government needs not only to ensure that public investment decisions respect the broader macroeconomic and fiscal constraints, but that projects are strictly prioritized and funded on the basis of their economic and social merits. While Montenegro’s pool of investable funds has been potentially increased by the high volume of privatization proceeds, estimated at about 10 percent of GDP in 2005, the institutional processes for planning and executing infrastructure investments would need to be significantly improved.

23. **Going forward, the Government should take the following measures to strengthen public investment planning and prioritization**:

- *Develop a capital budget as part of the process for preparing the 2007 State budget.* At this stage the capital budget may be no more than a summary of the current and future budgetary impact of each project. Yet, this could be improved over time.
- *Strengthen the staffing and institutional capacity of the Capital Budget Unit within the Ministry of Finance to help coordinate and prioritize investment projects.* At present, no one agency has the overall responsibility of coordinating capital investment planning. While the establishment of the capital budget unit in the Ministry of Finance is a step forward, the unit currently lacks proper staffing (only one staff). An assessment of the staffing and institutional needs of the Unit in order to considerably expand its technical and institutional capacity to coordinate all public investment planning, evaluate investment proposals and coordinate capital and recurrent budget within the same framework is urgently needed.
- *Strengthen the technical and institutional capacity of spending units (SUs) to prepare good capital projects*, based on sound economic, social and environmental analyses. The current technical capacity at line ministries, whether to produce forward estimates of costs or to develop effective indicators to measure program performance, is weak. For better budgetary impact assessment, it is also essential that both capital and recurrent budgets are estimated by the same agency. An assessment of the current technical skills and staff should be made and adequate training programs organized accordingly by the MOF for line ministries as well as the DPW and DPR.
- *Strengthen the technical and institutional capacity of DPR and DPW to manage the consolidation and preliminary screening of all capital projects at the preparation stage*. The DPR and DPW should be well staffed to ensure availability of the necessary technical capacity required to coordinate all SUs capital budgets. Technical skills should cover the financial aspects as well as the technical aspects that are specific to each sector. An assessment of technical skills at those two agencies should be made and adequate staffing and training programs organized accordingly.

24. **In view of the limited fiscal space available, the Government must also create an enabling environment for private sector participation in the transport sector** to cater for the growing demand for infrastructure investments. In that respect, the government should (i) develop an adequate and strong institutional framework for private sector participation, including a well-designed and sectoral policy and strategy, (ii) the primary and secondary legislation on concessions and public procurement, and (iii) appropriate capacity within the MoF and the Ministry of Transport to evaluate proposals and assess the potential implicit and explicit contingent liabilities. These would allow to strengthen partnership with the private sector while protecting fiscal stability and limiting the government's fiscal exposure wherever possible.

Monitoring and Controlling Fiscal Risks beyond the National Budget

25. **Finally, there is a need for Montenegrin authorities monitor a comprehensive picture of fiscal activities in the broader public sector**. The current coverage of the fiscal accounts includes extra-budgetary funds and partial information on local government, but excludes the SOE sector. Furthermore, all local government liabilities are not reported in the public sector debt statistics. As such, they do not provide an adequate basis for formulating fiscal policy and identifying fiscal risks.

26. **Going forward, the Government may want to**:

- *Strengthen oversight over local governments and SOEs.* There are 67 SOEs in Montenegro, 15 of which are owned by the central government. The MoF lacks centralized information on the SOE sector, and gathers only partial information on local governments (i.e., excluding their extra-budgetary activities). It does not sanction delays or inadequate reporting from local governments. Thus, if the financial position of local governments or SOEs were to weaken unexpectedly, the state government could find itself in a situation where it is asked to provide financial support without adequate information.

- *Set up a unit within the MoF to monitor the operations and financial activities of local governments and SOEs.* The unit should collect and compile quarterly statements on consolidated municipal government accounts (including extra-budgetary activities), and liabilities (including arrears and overdrafts). The unit should also create a database on SOEs, collect and compile quarterly information on SOE liabilities including arrears, and receive the income statements from the electricity company, ElektroPrivreda Crne Gore (EPCG).

- *Expand the coverage of fiscal and debt statistics by:* (i) including all local government liabilities in the public sector debt data, with the liabilities of SOEs that are not guaranteed by the government and arrears marked as a memorandum item; (ii) including local government extra-budgetary activities in the operations of general government; and (iii) adding the operating balance of EPCG in the fiscal tables as a memorandum item. A wider coverage of fiscal operations to include that of SOEs is not recommended in the short run, in light of the other priorities.

- *Develop an institutional framework for private sector participation in infrastructure (PPI).* While local governments intend to foster PPI, there is currently an absence of adequate legal or institutional mechanisms to develop these local projects in an orderly fashion. To prevent the emergence of fiscal risks related to these contracts, the government should develop a sound legal and institutional framework for PPI (see above). Furthermore, it should build state and local government capacities to handle PPI projects, including assessing value-for-money and fiscal risks. Over the medium term, when PPI contracts become effective, the government should monitor these activities through its municipal reporting mechanisms.

27. The implementation of the above measures, while politically challenging, will go a long way towards helping Montenegro confront the two key challenges it faces on the road to EU accession: weak governance and the low administrative and institutional capacity for EU accession. Reducing the high costs of public employment and wage bill, currently concentrated in four key areas, would be key to freeing up resources to create administrative capacity in other areas, including for EU accession. Modernizing the civil service will help improve service delivery and accountability in the public sector. Continued reforms in public management and public procurement are essential to reduce wastage and increase transparency and accountability for public money. Strengthening the institutional capacity for public investment in infrastructure is a prerequisite to ensuring that whatever investable funds become available are used wisely. And monitoring the fiscal activities of local governments and state owned enterprises more closely would allow the government to minimize fiscal risks, and improve public sector governance in general.

1. THE ECONOMIC AND INSTITUTIONAL CONTEXT

1.1 **This report constitutes the first phase of Montenegro Programmatic Public Expenditure and Institutional Review (PEIR).** In its March 2006, the World Bank country management decided that, given the wide range of public expenditure and institutional issues to be addressed in Montenegro, a programmatic PEIR would be more suitable. The management provided further guidance that the first phase of the PEIR would focus on governance and institutional development issues, including a broad update and assessment of the structure and composition of public expenditure in Montenegro; how to strengthen public administration and the administrative capacity for EU integration; how to improve public financial management and procurement processes; how to strengthen the institutional capacity for capital investment planning and prioritization; and how to improve coverage of fiscal accounts and monitor fiscal risks in the broader public sector including local governments and state-owned enterprises. Accordingly, this report focuses on these issues and offers analysis and policy recommendation in each area. The later phases of the programmatic PEIR will focus on issues of expenditure policy and efficiency, debt and fiscal sustainability, and possibly decentralization and service delivery.

1.2 **The rest of this chapter is organized as follows.** The next section briefly discusses European integration as a strategic goal for Montenegro. Section B reviews recent macroeconomic developments. Section C provides the governance and institutional context for this report. Section D outlines how the report is organized.

A. EU INTEGRATION AS A STRATEGIC ANCHOR

1.3 **Following the recent referendum on independence, Montenegro is now in the process of separating from the State Union of Serbia and Montenegro, created in 2002.** Official referendum results showed that 55.5 percent of voters chose independence with a turnout of 86.3 percent. With the majority of Montenegrins voting for independence, the referendum has established Montenegro as a new independent state, ending the loose federation with Serbia that has been in place since 2002.[2]

1.4 **EU accession remains a major strategic goal for Montenegro**. With about 620,145 inhabitants according to the 2003 population census, Montenegro's domestic market remains narrow. Given its small domestic market, EU and regional integration remains fundamental to Montenegro's growth and prosperity: it will help Montenegro increase specialization and efficiency in the production; and increase risk diversification and reduce the high income volatility that small states like Montenegro can often experience. From a political standpoint, EU integration serves as a strategic anchor to foster conditions for peace and stability in the region.

[2] As constituted, the State Union had limited responsibilities in the area of foreign affairs, defense, human rights, intellectual property rights, standardization and technical regulations, meteorology and statistics. The two republics, however, run domestic and economic policy separately and have different currencies, laws and customs borders.

1.5 **The Stabilization and Association Process (SAP), which offers a prospect for EU membership to all Western Balkan countries, including Montenegro, was put in place in 1999**. The SAP refers to both a Stabilization and Association Agreement (SAA) and its implementation. An SAA in turn consists of a detailed agreement on asymmetric trade liberalization where EU opens its markets faster than the country it is negotiating with, and a more general part consisting of the Copenhagen conditions supplemented with country-specific conditions. As part of an SAA, an interim agreement is signed on trade liberalization whose implementation starts immediately, while the SAA as a whole becomes operational once it is ratified by the EU Parliament. The European Commission has indicated that, in view of the outcome of the referendum, it will issue a separate mandate for Montenegro with respect to both the SAA, and an eventual EU membership.

1.6 **In October 2005, Serbia and Montenegro officially started negotiations with the EU on the SAA.** The EU adopted its twin-track approach in September 2004, and the decision to negotiate an SAA with Serbia and Montenegro in April 2005. The twin-track approach established that each republic—Serbia and Montenegro—would be assessed separately on tariff and customs policy, and internal markets in general. As part of the SAA, Montenegro is expected to negotiate with the EU on trade and tariff protection, and the transitional periods for convergence to EU requirements.

1.7 **At the republican level, Montenegro's own institutional and administrative efforts towards the SAA began in 2003.** The Ministry for International Economic Relations and European Integration was established in 2003 to lead the institutional coordination of the SAP. Soon after, the Parliament of the Republic of Montenegro established the Council for European Integration, the highest political advisory body giving strategic direction in regards to the EU association process. Following this, the Government established a Commission for Coordination of Accession to the European Union as a technical body which would assist in legislative harmonization, and setting of priorities and action plans for the SAA.

1.8 **The Government adopted the Action Plan for Implementation of the European Partnership Priorities in December 2004**. Within the Government, primarily through the Commission for Coordination of the Process of Accession to the European Union, a regular SAP monitoring mechanism has now been established. To date, two regular reports have been presented to the Parliament of Montenegro and the European Commission on the implementation of the Action Plan.

1.9 **One of the key challenges going forward is to create increased administrative and institutional capacity for EU accession.** Although the Ministry of European Integration appears to be playing a catalytic role in coordinating the government's preparation for EU accession, there is no question Montenegro will need to increase its administrative capacity for EU accession over the medium to long term. This report will discuss, among other things, the institutional and administrative implications of the EU accession process over the medium to long-term.

B. MACROECONOMIC DEVELOPMENTS

1.10 **Since 1997, Montenegro, with the support of the international community,[3] has been engaged in a long series of macroeconomic stabilization, and market-oriented structural reforms**. It has implemented currency and fiscal policy reforms, and in parallel, a number of structural reforms, including price and trade liberalization, privatization, public administration reform, financial sector reform, and labor market and business environment reforms. The Government's recently updated Economic Reform Program for 2005-2007, which lays out what economic reforms remain to be done over the coming years.

1.11 **The macroeconomic and structural reforms have yielded modest economic recovery and transition.** Over the last five years, real GDP grew by an average of about 2 percent per year; inflation dropped from 24.8 percent at the end of 2000 to 1.8 percent at the end of 2005; Montenegro's consolidated budget deficit has been reduced; its current account deficit, although still high, is improving; and, its principal human welfare indicators such as poverty, life expectancy, and adult literacy have remained moderate and stable.

Growth and Employment

1.12 **In 2005, real GDP is estimated to have grown by about 4.1 percent (Table 1.1)**.[4] This is higher than the average annual real GDP growth witnessed over 2000-2004 (about 2 percent). On the supply side, growth in industrial production was negative (-1.9 percent) mainly on account of reduced economic activities of the coal mining company, which in turn adversely affected the thermal power plant operation, and steel production. However, tourism has shown significant growth, with tourist arrivals increasing by 16 percent in 2005 (and the number of foreign tourists[5] increasing from 25 percent to 33 percent in total tourist arrivals). On the demand side, FDI increased (mostly through Telecom and KAP privatization) and a significant credit growth fueled household consumption.

1.13 **While employment recovery seems underway since 2004, unemployment still remains high.** After declining by about 7 percent over 1998-2004, employment seems to be recovering. The "official" data from the Employment Bureau show that employment increased and unemployment declined in 2005 (but the more reliable labor force survey data is not yet available). Yet unemployment remains high. Long-term unemployment is widely prevalent, as more than one-fifth of the registered unemployed are on the roster for more than eight years. The persistence of high unemployment even after more than a decade of transition suggests that the new private sector, comprised of small firms, has not yet developed the critical mass to generate enough jobs to offset the job losses in the old public sector.

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[3] Main donors in Montenegro include USAID, EAR, World Bank, UNDP.

[4] This is an agreed estimate of the Development Secretariat, the Ministry of Finance, and the Institute for Strategic Studies and Prognoses. The Republic of Montenegro lacks up to date national accounts statistics. MONSTAT, the republican statistical agency, is still working to produce national accounts statistics for 2003. The lack of national accounts data—in particular the supply and demand side breakdown of GDP--poses a significant challenge in undertaking detailed analysis the composition of growth in Montenegro.

[5] Domestic tourists include those from Serbia.

Table 1.1. Montenegro's Growth, Employment, and Unemployment (in '000), 2000-05

	2000	2001	2002	2003	2004	2005
Real GDP Growth	3.1	-0.2	1.7	2.3	3.7	4.1
Employment (LFS)	181.7	176.6	177.6	168.5	187.3	n.a.
Employment (official)	140.8	141.1	140.1	142.7	143.5	144.4
Unemployment (LFS)	54.9	57.5	57.7	62.1	71.8	n.a
Unemployment (official)	84.1	81.5	80.9	71.7	65	54.5

Sources: MONSTAT for Labor Force Survey (LFS) data; Montenegro Employment Fund for "official" employment and unemployment data; IMF and WB staff estimates.

Inflation

1.14 **Inflation, as measured by the retail price index, dropped from 24.8 percent at the end of 2000 to 1.8 percent at the end of 2005 (Table 1.2).** Montenegro's adoption of the DM and then the euro as the sole legal tender helped rein in inflation. With currency reforms, inflation. By the main components of the CPI, the prices of agricultural products grew (10.1 percent) by much more than the other components, and industrial prices grew the least (1.2 percent).

Table 1.2. Inflation by Major Component, 2000-04 (percent)

	2000	2001	2002	2003	2004	2005
Overall Inflation	24.8	28.0	9.4	6.7	4.3	1.8
Ind. production	25.5	27.0	8.0	5.7	1.5	1.2
Agric. production	24.6	4.9	19.6	-2.9	-5.4	10.1
Services	21.8	39.5	12.7	14.3	18.1	1.8

Sources: MONSTAT and Central Bank of Montenegro.

Current Account Deficit

1.15 **Montenegro's current account deficit stood at 9.7 percent of GDP in 2005 (after grants).**[6] Merchandise exports, at about 26 percent of GDP, are not diversified and remain largely dominated by the export of aluminum, which accounts for almost 50 percent of merchandise exports. Merchandise imports stood at about 57 percent of GDP in 2005, while recorded private remittances stood at about 9.5 percent. Net non-factor service receipts, which include mainly tourism receipts, have grown slightly.[7]

1.16 While it is not unusual for transition countries such as Montenegro to run a high current account deficit in view of the low domestic savings and the huge need for capital replacement, there is a need for Montenegro to adjust to a lower current account deficit over the medium term. With euroization, this will need domestic demand restraint through a tighter fiscal policy and/or

[6] Montenegro's balance of payments data are generally unreliable. For 2002-05, imports are probably overestimated since some of the imports are "re-exported" to Serbia. Also, the quality of the capital account data, such as FDI, is questionable.

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

significant expansion of exports (in particular in tourism). Continued structural reforms are crucial for the latter.

Debt Position

1.17 **Montenegro's total public debt—inclusive both of foreign and domestic debt—stood at about 42.5 percent of GDP as of end-2005.** Foreign debt accounted for 30.9 percent of GDP, down from 32.2 percent of GDP in 2003. (Table 1.3). With an expected debt write-off to Montenegro of some 26 million euros by the Paris Club creditors, the external debt position is expected to further improve in 2006.

Table 1.3. Total Public Debt of Montenegro, 2002-05 (% GDP)

	2002	2003	2004	2005
Foreign debt	68.7	32.2	31.8	30.9
Domestic debt	19.6	17.4	16.6	11.6
FFCDs	9.8	8.9	8.0	7.2
Budget Liabilities/ Arrears	7.7	5.8	4.0	2.1
Credits	1.4	1.4	0.6	0.1
T-bills	0.8	1.4	2.4	0.8
Local Government Debt	0.0	0.0	1.5	1.4
Total public debt	88.3	49.6	48.4	42.5
Memo: GDP (million euros)	1,301.0	1,433.0	1,535.0	1,644.0

Source: Montenegrin Ministry of Finance.

1.18 **Domestic public debt accounted for about 11.6 percent of GDP in 2005** (see Table 1.3). Domestic debt includes debt for the repayment of Frozen Foreign Currency Deposits (FFCDs) whose repayment deadline is 2017 (7.2 percent of GDP); payment arrears (2 percent of GDP); debt toward commercial banks (0.1 percent of GDP); T-bills debt and other debts on behalf of Government institutions or for which guarantees were issued (0.8 percent of GDP); and, local governments' debt (1.4 percent of GDP).

C. THE GOVERNANCE AND INSTITUTIONAL CONTEXT

1.19 **Good governance across a broad spectrum of policy, administrative and institutional dimensions is now widely recognized as a key factor in attracting investment, increasing growth, and reducing poverty**.[8] The literature reveals that significant improvements in governance, property rights, and absence of corruption can increases a country's income per capita and improve development and poverty outcomes.

1.20 **One of the principal causes of "bad governance" is the spread of corruption**--the abuse of public power for personal gain or for the benefit of a group to which one owes allegiance.[9] According to Transparency International (TI), SaM belongs to a group of countries

[8] See, for example, Knack and E. Keefer, 1995, Mauro, 1995; Acemogh, Johnston and Robinson, 2000.

[9] Corruption violates public confidence in the state and endangers social cohesion. It impacts negatively on growth and development through various channels: by reducing public revenue; by reducing investment and the productivity of public investment and infrastructure; by increasing income inequality and allowing those in

that have a serious corruption problem.[10] In 2005, SaM's position, with a corruption perception index of 2.8 in 2005, remained similar to that in 2004, but improved significantly from 2003, when it scored 2.3 and ranked 106th. The index measures the degree to which corruption is perceived to exist among a country's public officials and politicians.

1.21 **The EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS) shows that corruption is a problem for doing business throughout Central and Eastern Europe.** The BEEPS has been carried out in three rounds in 1999, 2002, and 2005 and covers virtually all of the countries of Central and Eastern Europe and the former Soviet Union, as well as Turkey. It measures some key indicators of corruption and unofficial payments, such as bribe tax, bribe frequency, percent of firms saying corruption is a problem for doing business, and state capture. The Survey offers simple averages over all firms of these measures of corruption for a single country as well as regional aggregates, computed using firm-level data. The aggregates show that Southeast Europe as a region generally performs poorly when compared to EU8[11] or Europe and Central Asia in general: in 2005, bribe frequency, corruption as a problem doing business, and state capture were all higher in SEE (Figure 1.1).

Survey-based Governance Indicators for Serbia and Montenegro

1.22 **Serbia and Montenegro compares unfavorably to the average regional performance in most indicators of corruption (Figure 1.1).** SaM's bribe tax compares favorably to the SEE regional average of about 0.9 percent in 2005, but unfavorably to the EU8 average of about 0.66 percent in 2005. With respect to the percent of firms saying corruption is a problem, SaM compared unfavorably to the regional SEE average (24 percent) and the EU8 average(10 percent). The percentage of firms indicating corruption as a problem is larger in SaM than the SEE regional average (48 percent) and the EU8 average (30 percent).

1.23 **According to the BEEPS, administrative corruption seems to have increased in Serbia and Montenegro in recent years**. The percent of firms indicating corruption as a problem for doing business increased from about 30 percent in 2002 to about 50 percent in 2005. Bribe tax as a share of annual sales remained low at about 0.6 percent (and down from 1.5 percent in 2002), but bribe frequency increased. Of the surveyed firms, the percent saying unofficial payments are frequent rose from about 15 percent in 2002 to about 32 percent in 2005. According to the survey, unofficial payments are mainly connected with government contracts, courts decisions, customs and taxes collection, and business licenses and permits.

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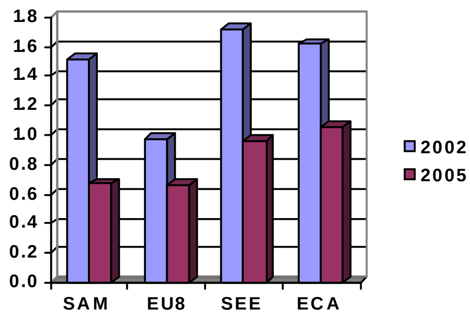
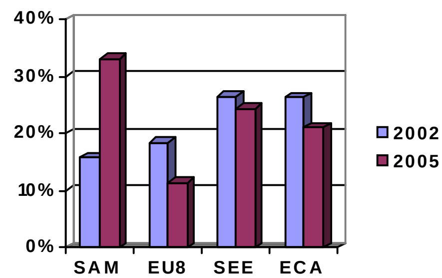
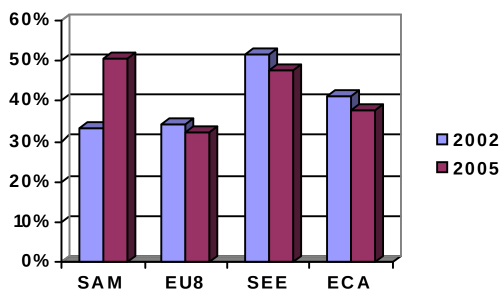
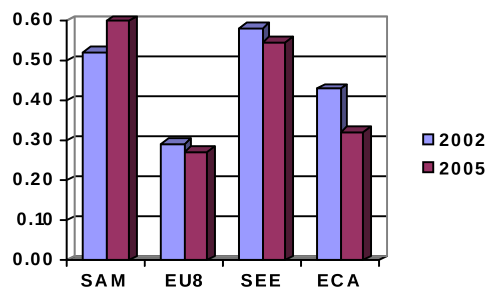
influential positions to take advantage of government activities at the expense of the rest of the population; by interfering with the government's ability to impose necessary regulatory controls and inspections, and enforcement of contracts and property rights; and by acting as a tax to discourage foreign investment.

[10] A score of 5.0 is the number Transparency International considers the borderline distinguishing countries that do and do not have a serious corruption problem. In 2005, Iceland was the world's least corrupt country (with a score of 9.7) while Bangladesh and Chad were the most corrupt (with a score of 1.7). The State Union of Serbia and Montenegro ranked 97th out of 159 countries surveyed.

[11] EU 8 countries are the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia.

Figure 1.1. Unofficial Payments and Corruption in SaM and in the Region

Bribe Tax (bribes as a share of annual sales)	**Bribe Frequency** (percent of firms saying unofficial payments are frequent)
	
Corruption as a Problem Doing Business (percent of firms indicating corruption as a problem doing business)	**State Capture (State Capture Index: 0=no impact, 4=decisive impact)**
	

Source: BEEPS 2005.

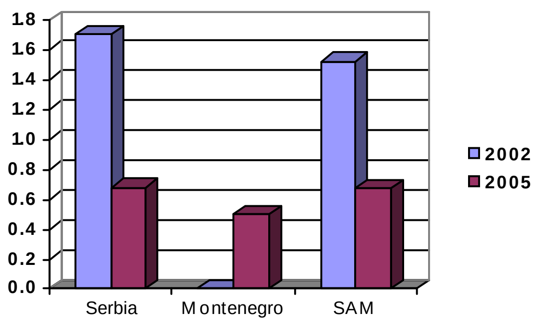
Survey-based Governance Indicators for Montenegro

1.24 **Montenegro-specific data on governance and corruption are scant.** The number of Montenegrin firms included in BEEPS is low. In 2002, a total of 250 SaM firms were interviewed by the Survey. Of this, only 20 firms were in Montenegro. Similarly, only 18 firms out of the total 300 firms surveyed in 2005 were Montenegrin firms. Given the small number of Montenegrin firms covered in the Survey, one needs to be cautious about drawing firm conclusions from the survey about trends in administrative corruption.

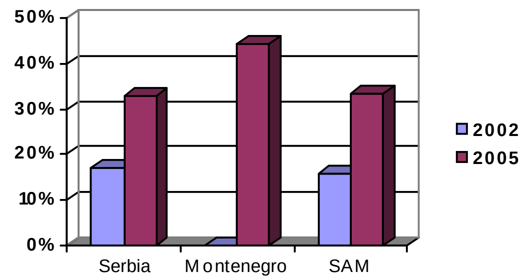
1.25 **Although the number of Montenegrin firms included in the BEEPS is small, the survey shows that the trends in Montenegro have been broadly consistent with that of SaM (Figure 1.2)**. Bribe frequency not only increased between 2002 and 2005 but, at about 42 percent in 2005, was significantly higher than the average for SaM (32 percent).) Similarly, the percent of firms indicating corruption as a problem for doing business and state capture, although smaller than in SaM as a whole, both increased between 2002 and 2005 in Montenegro. According to the Survey, bribes are frequent in government contracts, fire and building inspections, customs and imports, and public services, in particular telephone and electricity services.

Figure 1.2: Unofficial Payments and Corruption in Montenegro

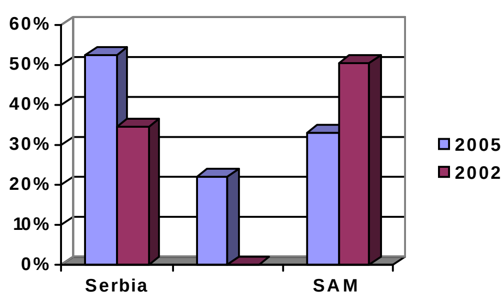
Bribe Tax (Bribes as a share of annual sales)



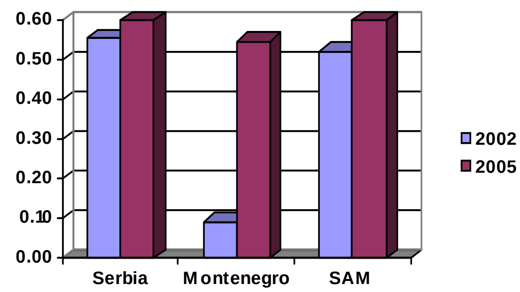
Bribe Frequency (Percent of firms saying unofficial payments are frequent)



Corruption as a Problem Doing Business (percent of firms indicating corruption as a problem doing business



State Capture (State Capture Index: 0=no impact, 4=decisive impact)



Source: BEEPS 2005.

1.26 **Furthermore, public opinion indicates that corruption has been widespread over the last decade in Montenegro**.[12] Regional instability created opportunities to develop contraband activities and collect bribes from materials smuggled across the Serbian and Albanian borders. Similarly, public polls conducted in Montenegro have shown that citizens consider corruption and organized crime as extremely wide-spread. According to the results of the public poll conducted by Damar agency in March 2004, for example, citizens perceived corruption and crime, poverty, and unemployment as the three biggest social problems in Montenegro. Corruption and bribe paying are perceived to be most common in privatization, tax administration and customs collection, and public contracts and procurement.

1.27 **In recent years, Montenegro has undertaken legal and institutional reforms to improve governance and reduce corruption**. In February 2000, Montenegro adopted the Stability Pact Anti-Corruption Initiative (SPAI) Compact and Action Plan. It has also become a member, through the membership of the State Union in the Council of Europe, of the Group of States against Corruption (GRECO). It has established a separate government agency, the Anti-Corruption Initiative Agency, which has responsibility for preparing draft laws and sub-legal regulations; defining an anti-corruption strategy; and promoting transparency and integrity in

[12] See for example the Stability Pact Anti-Corruption Initiative (SPAI) general assessment report (chapter 6) and action plan.

government. In recent years, the Government has strengthened the legal framework to improve governance, and reduce opportunities for corruption:

- In 2001, the Parliament of Montenegro passed two important pieces of legislation containing anti-corruption provisions were passed: the Public Procurement Act and the Organic Budget Law.
- In 2004, a number of laws were passed, including the criminal code, the Law on Money Laundering, and the Law on the Public Prosecutor.
- In May 2005, the Parliament adopted the Law on Conflict of Interest, which requires high-ranking state officials to report their assets before taking office, although provisions for implementing and monitoring these requirements are poorly detailed in the legislation.
- A new Public Procurement Law was adopted in July 2006. Some key laws are currently being drafted, e.g. the Draft laws on Police and National Security Agency.
- The government has also set up several independent bodies in an effort to reduce corruption: the State Revision Institute, the Unit for the Fight against Organized Crime, the Commission for Observing the Privatization Process, the Office of the Ombudsman, and the Commission for Public Procurement. The Commission for Public Procurement has been the most active of all, investigating and ruling on a number of appeals in recent years.

1.28 **While these are important legal steps, vigorous implementation of these laws and sustained institutional reforms are needed to achieve concrete results on the ground**. Successful strategies to improve governance and curb corruption will have to simultaneously seek to reduce an official's monopoly power through market-oriented reforms, reduce discretionary power through administrative reform, and enhance accountability through watchdog agencies and strengthening of institutional processes.[13] While monopoly power has been successively reduced through privatization and market-oriented reforms in Montenegro, building effective administrative and financial systems for accountability and strengthening the institutional capacity of watchdog agencies will be central to improving governance and controlling corruption in the future.

D. WHAT THIS REPORT DOES AND HOW IT IS ORGANIZED

1.29 **While the issue is obviously larger, this report is concerned with the challenges and opportunities for administrative and institutional reforms to strengthen the governance of public monies in Montenegro.** It covers three key institutional aspects of good governance:[14]

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[13] See Klitgaard (1996).

[14] According to Langseth et al. (1997), eight institutions together constitute pillars of 'national integrity' and good governance: political will; administrative reforms; "watchdog" agencies (anti-corruption commissions; supreme audit institutions; ombudsman offices); parliaments; public awareness/involvement; the judiciary; the media; and, the private sector. If any one of these "integrity pillars" weakens, an increased load is thrown on to the others (Langseth et al. 1997). An accountable government has interest in keeping the eight pillars in balance.

public administration reforms and public sector transparency, financial discipline and strengthening of the institutional processes for good budget and financial management (e.g., internal audit and control; public procurement), and strengthening of key oversight and accountability institutions (e.g., supreme audit institutions; ombudsman office). In each of these areas, the report analyzes the current challenges faced by Montenegro, and suggests policy, institutional, and capacity building measures that the government may want to consider for implementation.

1.30 **The report is organized as follows**:

- Chapter 2 provides the general fiscal context for the rest of the report. It reviews the composition of public expenditure both in terms of economic spending and functional spending, and takes a closer look at two key drivers of fiscal pressure: the wage bill, and school reforms in education.
- Chapter 3 discusses Montenegro's public administration and institutional reform challenges, including: (i) the legal institutional framework for public administration reforms; (ii) progress with the implementation of the new salary policies, performance appraisal systems, and the new institutions recently created to promote transparency and accountability in the Civil Service (Administrative Court, and the Office of the Ombudsman); and (iii) new institutions or strengthened administrative capacity that may be needed for EU accession.
- Chapter 4 reviews Montenegro's public financial management and public procurement systems, including budget preparation and execution; financial control and internal audit; and the extent to which the public procurement commission and the supreme audit institution (SAI) are effective in promoting accountability, transparency and good governance.
- Chapter 5 discusses infrastructure investment planning and institutional development challenges, largely from the perspective of the transport sector. A review of the transport sector is used to illustrate the challenges in capital budget planning and institutional coordination.
- Chapter 6 discusses the nature and extent of fiscal risks posed by state-owned enterprises and local governments, and suggests steps that the Government can take to minimize such risks.

2. COMPOSITION OF PUBLIC EXPENDITURE AND KEY SOURCES OF FISCAL PRESSURE

2.1 The objective of this chapter is two-fold: first, it provides the general fiscal context for the rest of the report, including recent fiscal policy developments and an update of the discussion of the economic and functional composition of public expenditure in Montenegro.[15] Second, it takes a closer look at two of the key drivers of fiscal pressure in Montenegro—the wage bill and costs of public employment, and the fiscal pressures in education arising from teachers salaries and wages, and new reformed schools. Detailed analysis of the fiscal allocation and efficiency issues will be carried out in the second phase of the PEIR.[16]

2.2 The chapter is organized as follows. Section A recent fiscal policy developments. Section B reviews the economic and functional composition of public expenditure across key spending categories. Section C discusses the composition of wage bill in depth, and suggests measures that can help contain this source of fiscal pressure. Section D examines the sources of fiscal pressure in the education sector, including teachers salaries and the newly reformed schools which require substantially greater input and for which the Government may need to find cost saving measures elsewhere to complete the reforming of schools.

A. RECENT FISCAL DEVELOPMENTS

2.3 **Fiscal policy has tightened in 2005, with the government deficit declining from about 3 percent of GDP in 2004 to about 2 percent in 2005**. However, general government expenditure (comprising of central government and three extra-budgetary funds) remains high, in part because of the high wage bill and social welfare transfers to households. Chapter 2 contains further analysis of the composition of the wage bill in Montenegro.

2.4 Montenegro's consolidated government expenditure, excluding local governments and transfers to the State Union of Serbia and Montenegro[17], declined from about 38.6 percent of GDP in 2002 to about 37.9 percent in 2005, suggesting that the role of the Government in the economy declined only marginally (Table 2.1). Current expenditures, accounting for over 90 percent of total general government expenditure, declined from over 35.5 percent of GDP in 2002 to about 32 percent in 2005.

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[15] See "Republic of Montenegro Economic Memorandum", World Bank, October 2005, for a recent discussion of the composition of public expenditures in Montenegro.

[16] Given the range and complexity of the public expenditure and institutional issues to address in Montenegro in the coming years, the World Bank management approved a programmatic approach to PEIR, where the first phase covers institutional issues, but the subsequent phases will address expenditure composition and efficiency as well as debt and fiscal sustainability issues.

[17] Montenegro's transfer to SaM increased from nil in 2002 (when State Union was created) to 2.5 percent of GDP in 2005.

Table 2.1. Montenegro: Consolidated Government Fiscal Operations, 2001-05,% GDP

	2001	**2002**	**2003**	**2004**	**2005**
Total revenue	38.0	35.1	35.0	36.4	37.7
Current revenue	38.1	35.2	34.9	36.2	37.6
Tax revenue	33.0	32.9	32.7	34.5	35.8
Personal income tax	5.4	4.4	4.5	4.2	4.0
Social security contributions	10.8	11.5	10.6	11.2	10.5
Corporate income tax	0.6	1.0	0.9	1.1	1.5
Retail sales tax	7.1	8.3	9.7	10.3	11.9
Excises	4.4	4.3	4.1	4.0	3.7
Taxes on international trade	4.3	3.0	2.7	2.4	2.4
Other taxes	0.4	0.4	0.2	1.3	1.8
Non-tax revenue	5.1	2.3	2.2	1.7	2.0
Capital revenue	0	0	0.1	0.2	0.2
Repayment of old fiscal claim					
Statistical discrepancy	-0.1	-0.1	0	0	0
Total expenditure and net lending inc. Union Transfers	42.8	38.9	39.9	39.9	40.4
Total expenditure and net lending	42.4	38.6	37.8	37.6	37.9
Current expenditure	38.7	35.4	34.2	33.9	32.0
Expenditure on goods and services	17.4	14.8	14.7	14.7	14.1
Wages and salaries	11.5	11.1	10.5	11.2	10.6
Other purchases of goods	5.9	3.7	4.2	3.5	3.5
Interest payment	0.1	1.0	1.0	1.6	0.9
Subsidies and other current transfers	20.7	19.0	18.0	16.9	16.7
Subsidies	1.2	1.9	1.0	0.6	0.4
Transfers to households	19.5	17.1	17.0	16.3	16.3
Transfers to local government					0.1
Other current expenditures	0.5	0.6	0.5	0.7	0.2
Capital expenditure	2.0	1.5	1.6	2	3.8
General reserves	0.6	1.0	0.6	0.7	1.1
Domestic Arrears (army)					0.6
Lending minus repayment	1.1	0.7	1.4	1.0	0.5
Transfers to the Union	0	0	2.2	2.3	2.5
Discrepancy	0.4	0.3	-0.1	0	
Overall balance	-4.3	-3.7	-4.9	-3.5	-2.6
Grants	3.1	2.1	0.9	0.5	0.2
Overall balance after grants	-1.2	-1.6	-4.0	-3.0	-2.4
Financed	1.6	1.8	4.0	3.0	2.5
Domestic financing	1.6	-3.7	1.7	0.6	-8.4
Bank financing	0.8	-3.4	1.1	-0.8	-7.8
Non-bank financing	0.8	-0.3	0.6	1.4	-0.5
Foreign financing	0	0.6	1.3	2.0	1.5
Privatization receipts	0	4.9	1.0	0.4	9.4
Memorandum items:					
GDP, in current EURO, mln.	1049	1301.5	1433	1535	1644

Sources: IMF; Montenegrin Ministry of Finance.

2.5 **Government revenue increased from about 35 percent of GDP in 2002 to about 37.7 percent in 2005**. By composition, social security contributions and value-added tax (VAT) account for about 62 percent of the total tax revenue. Personal income tax revenue and the excise tax each account for an additional 12 percent of total tax revenue. International trade taxes account for 7 percent and corporate income tax accounts for only 3 percent of total revenue.

2.6 **The overall government deficit increased from about 1.8 percent of GDP in 2002 to about 2.5 percent in 2005** (as foreign grants declined from 2.1 percent to 0.2 percent of GDP and transfers to the State Union budget increased from zero to 2.5 percent of GDP during the same period). By type of financing, domestic borrowing, including the issuance of short-term securities (Treasury bills), fluctuated, in part depending on the Government's privatization revenues.[18] Net foreign financing increased from 0.6 percent of GDP in 2002 to about 1.5 percent of GDP in 2005. The recent increases in deficits after grants pose a risk to fiscal sustainability and macroeconomic stability.

2.7 **A recent fiscal sustainability analysis shows that Montenegro needs further fiscal consolidation to achieve sustainability**. Under the assumptions that the economy grows at a constant real rate of 4 percent per year, and that the real interest rate is constant at 5 percent,[19] a recent analysis by the World Bank finds that a primary budget balance of 0.4 percent is needed for Montenegro to achieve long-run fiscal sustainability.[20] In the past two years, estimates of the primary fiscal balance were close to a deficit of 2 percent of GDP. Preliminary data for 2005 suggest a primary deficit of just over 1 percent of GDP. This is still short of the surplus of 0.4 percent of GDP needed for fiscal sustainability. If one were to assume that real interest rate is 1 percent (closer to what Montenegro pays now rather than the 5 percent assumed above) in the long-run, a primary deficit no greater than 1.3 percent of GDP would be needed to maintain a stable debt-to-GDP ratio. A considerable fiscal tightening—on the order of 1 percent of GDP—is needed to achieve fiscal sustainability.

B. COMPOSITION OF PUBLIC EXPENDITURE

Economic Composition

2.8 **The Government of Montenegro spends about two-thirds of its expenditure on wages and salaries, and various social benefits to households (Figure 2.2).** Purchase of goods and services, interest payments, subsidies to enterprises, capital expenditure, transfers to the Union and other non-interest current expenditures, account for only about one-third of total expenditure.

[18] The government received a large amount of privatization revenue—about 10 percent of GDP—in 2005. So far, the Government has used the proceeds to clear of government debt and some domestic arrears. Whether the government uses the remaining revenues to reduce deficit spending instead of increasing it will have important implications for fiscal sustainability and macroeconomic stability.

[19] At the time this analysis was conducted, SaM had a lower B+ rating, for which spreads were running at around 300 basis points over US bonds. With medium term US T-bond rates running at around 4 percent, this suggested an interest rate of around 7 percent in dollar terms. With US inflation rates expected to be on the order of 2 percent, a real interest rate of $r = 0.05$ was assumed.

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

Table 2.2. General Government Spending, Economic Classification, 2004 (% GDP)

	Goods and Services		Subsidies and Transfers		Capital	Interest
	Total	**Wages**	**Total**	**Subsidies**		
SEE average	17.1	9.8	16.9	1.5	5.0	1.7
Montenegro	**14.7**	**11.2**	**16.9**	**0.6**	**2.0**	**1.6**
SaM	17.7	10.4	22.1	…	2.5	1.2
Bosnia & Herzegovina	25.7	13.0	19.7	1.5	6.0	0.7
Albania	9.4	6.3	10.6	…	4.9	3.6
Croatia	19.4	10.8	21.0	…	8.2	2.2
Macedonia	13.1	8.5	11.2	…	3.2	0.9
NMS average	…	8.2	19.0	…	3.9	1.9
Estonia	21.1	7.6	12.9	1.4	2.9	0.2
Lithuania	14.9	6.7	12.5	0.5	3.6	1.1
Slovenia	…	11.1	20.4	1.4	4.7	1.5
Slovakia	…	6.5	15.6	2.0	3.9	2.3
Poland	…		20.7	0.6	3.6	2.7
Others						
Chile	…	4.3	6.6	…	3.4	1.0
Ireland	14.8	8.7	12.2	0.7	3.6	1.2

Sources: Montenegrin Ministry of Finance; IMF; World Bank: *Bulgaria Public Finance Policy Review* (November 2005) and *Bosnia and Herzegovina Public Expenditure and Institutional Review* (April 2006).

Wages and Salaries

2.9 **Montenegro's public sector wage bill, at 11.2 percent of GDP in 2004, is higher than the average for even South East Europe (SEE) (Table 2.2).** According to the IMF data, the wage bill accounted for about 10.6 percent of GDP in 2005. However, this figure substantially underestimates the true level of the wage bill, since it does not include the wage bill in the health sector (financed under contractual arrangements through the Health Fund) and other wage bills concealed under transfers to semi-autonomous institutions, such as the University of Montenegro. The total wage bill including all central government institutions and major extra-budgetary funds, in particular the Health Fund, was 13.4 percent of GDP in 2005. This is substantially higher as a share of GDP in comparison to other countries in the region. A closer examination of the composition of wage bill and costs of public employment is provided in the next section.

Transfers to Households

2.10 **Social transfers to households, at about 17 percent of GDP, are comparable to the regional average.** Transfers to households principally include benefits to pensioners through the Pension Fund, medical protection and health insurance through the Health Fund, benefits to the unemployed through the Employment Fund, and other government-funded social protection benefits for children and families, and for war veterans and maternity benefits. The fiscal operations of the social funds are discussed in Box 2.1.

Table 2.3. General Government Spending, Functional Classification, 2004 (% GDP)

	General Public Services	Defense and Public Order		Education	Health	Social Protection		Economic Affairs
		Total	Defense			Total	Pensions	
Montenegro	**8.9**	**6.0**	**2.0**	**5.7**	**6.2**	**14.6**	…	**2.3**
Bosnia & Herzegovina	7.7	7.2	2.4	6.2	7.0	15.1	8.4	4.3
Croatia	2.5	4.9	2.3	4.3	6.6	15.1	…	…
New Member Countries								
Estonia	…	…	2.0	5.7	…	14.3	6.1	3.8
Lithuania	4.6	3.6	1.6	5.9	3.8	15.2	6.2	4.4
Slovenia	8.5	3.4	1.4	5.9	6.8	18.3	11.6	3.5
Slovakia	5.0	3.8	1.8	1.8	4.4	8.4	7.6	4.7
Poland	7.0	2.2	1.8	5.6	4.1	22.1	11.6	3.2
EU-8 Average	6.1	3.5	1.7	5.1	4.7	15.9	8.8	4.5
Others								
Chile	0.3	2.7	…	3.8	3.0	7.5	2.9	2.7
Ireland	2.3	2.2	0.6	4.4	6.4	9.5	3.1	5.1

Sources: Montenegrin Ministry of Finance; IMF; World Bank: *Bulgaria Public Finance Policy Review* (November 2005) and *Bosnia and Herzegovina Public Expenditure and Institutional Review* (April 2006).

Box 2.1. Fiscal Operations of the Extra-Budgetary Social Funds

The consolidated general government in Montenegro covers the Montenegrin Republican budget (central government), and three extra budgetary funds--the Pensions Fund (PIO), the Health Insurance Fund (HIF), and the Employment Fund. Total expenditures by the extra-budgetary social funds accounted for about 17 percent of GDP in 2005. Most of the pensions, health care, and unemployment services are delivered through these social funds.

Pension Fund (PIO). In 2005, the PIO spending amounted to about 10.5 percent of GDP**.** About 84 percent of this (8.8 percent of GDP) was on pensions while health contributions accounted for another 11 percent (1.2 percent of GDP). The remainder was spent on non-pension benefits and on administrative expenditures. On the revenue side, contribution revenue amounted to 72 percent of total revenue (7.2 percent of GDP), and transfers from republican treasury amounted to 27 percent of total (2.7 percent of GDP). The Fund's operational deficit was about 1.5 percent of GDP. The total *stock* of PIO arrears stood at 19.02 million euros at end-2005, of which the stock of pensions benefit arrears amounted to 17.1 million euros.

Health Insurance Fund (HIF). In 2005, the HIF spending amounted to about 6.6 percent of GDP**.** About 49 percent of this (or 3 percent of GDP) was on health care. Gross salaries and contributions charged to the employer amounted to another 44 percent of total spending (2.7 percent of GDP). The remainder was spent on non-health benefits and on administrative expenditures. On the revenue side, contribution revenue amounted to 74 percent of total revenue (4.6 percent of GDP), and transfers from the republican treasury and the PIO amounted to 26 percent of total (1.6 percent of GDP). The Fund's operational deficit was about 0.1 percent of GDP. The total *stock* of HIF arrears stood at 14.5 million euros at end-2005, of which the stock of health benefit arrears amounted to 10.4 million euros.

Employment Fund (EF). The Employment Fund of Montenegro is the main provider of employment services to job seekers. In 2005, its expenditure amounted to about 1.2 percent of GDP. About 50 percent of this (0.6 percent of GDP) was on benefits to unemployed individuals. The remainder was on administrative and operational expenses (30 percent of total), and loans and credits to new unemployed persons (17 percent of total expenditure). On the revenue side, about 50 percent of the total revenue came from contributions, and about 20 percent from republican transfers. The rest (30 percent) came from duties and receipts from repayment of loans given to other institutions. The Fund's operational deficit was about 0.2 percent of GDP. The total *stock* of EF arrears stood at 4.4 million euros at end-2005.

Capital Expenditure

2.11 **Montenegro's capital expenditure is one of the lowest in the region, accounting only for less than one-half of the average regional spending as a share of GDP** (2 percent in Montenegro versus an average of about 4 percent in the region). Furthermore, routine infrastructure maintenance does not appear to be carried out regularly and a large maintenance backlog has been accumulated. Increasing capital spending and reducing the maintenance backlog should be priorities (see Chapter 5 for more discussion).

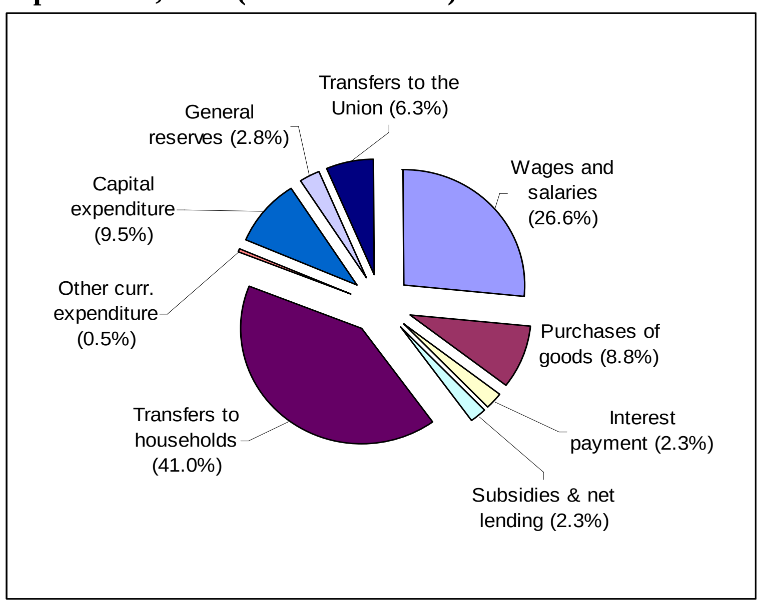
Subsidies and Net Lending

2.12 **Subsidies and net lending to enterprises, at about 0.9 percent of GDP in 2005, remain modest.** Direct subsidies to public enterprises stayed at about **0.6 percent** in 2005. Net lending by the Government, which includes loans to public enterprises, accounted for the rest. There is no adequate transparency surrounding the lending to state-owned enterprises, including the terms and repayment conditions.[21] Finally, interest payments constituted about 0.9 percent of GDP in 2005.

Functional Composition

2.13 A look at the composition of government expenditure by functions shows that the general public services, social welfare and protection, health, and education account for about 80 percent of the total expenditure (Figure 2.1).

Figure 2.1. Economic Composition of General Government Expenditure, 2005 (% share in total)



Sources: Montenegrin Ministry of Finance, IMF.

General Public Services

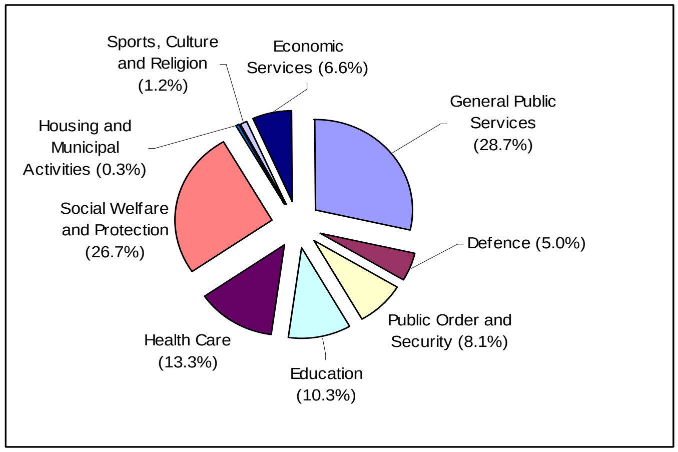
2.14 **Expenditure on general public services, accounting for about 9 percent of GDP in 2004, is out of line with the regional average (Table 2.3).** It is higher by about 2 percent of GDP for the new member countries (NMS). Despite the high spending, the general view is that service delivery in Montenegro is poor, as standards within the public administration are not optimal and staff are often poorly trained and equipped for the functions that they are required to perform. In view of this, it remains essential for the process of public administration reform to help improve standards and accountability in

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

service delivery. Chapter 3 discusses public administration and institutional reforms that can help improve service delivery and accountability within the civil service.

2.15 **Similarly, Montenegro's expenditure on public order and safety, at about 4 percent of GDP, is about twice the average for new member countries.** These expenditures, driven primarily by spending on the police service, are higher than the average levels in CEE countries. Reforms are needed to control spending on this particular component, and progressively bring spending in line with the average norms in the region.

Figure 2.2. Montenegro's Functional Spending by Major Components (% share in total), 2005



Sources: Montenegrin Ministry of Finance, IMF.

Social Welfare and Protection

2.16 **Public spending on social welfare and protection, accounting for about 14 percent of GDP, is high but similar to the levels in other countries in the region**. As elsewhere in the region, within social welfare and protection, pensions and pension related benefits dominate, accounting for about 80 percent of this spending. In Montenegro, recent pension reforms[22] have helped ease the fiscal pressure coming from the Pension Fund (see Box 2.1). Yet, the Pension Fund is still running a deficit. In view of the fiscal pressure, further reforms may be required in the future to bring the system into balance and into compliance with international standards.

Health Care

2.17 **Similarly, Government spending on health care services, accounting for about 6.6 percent of GDP, is much higher than the SEE (5.9 percent) and NMS average (4.7 percent).** Montenegro's health system faces several key challenges, including financial sustainability, equity in access and efficient service delivery, and insufficient governance and information on the financial flow, quality of care and a growing private sector. Most of health care service

[22] The Pension Insurance Act of September 2003 tightened the PAYGO parameters (increased the retirement age by five years over a ten-year period; widened the calculation period from ten best years to full career over a 15 year period; changed the indexation pattern from wage to a combination of wages and prices; introduced a point formula and lowered the accrual rates from more than 2 percent to 1 percent per year of service; and tightened disability conditions and eliminated most social-related benefits from the pension system). In 2004, the Parliament of Montenegro enacted a law on consolidated reporting and control of social security contributions, personal income tax and surtax, which centralizes the collection of taxes and social contributions at the Department of Public Revenue (DPR). The implementation of this law, expected to start in 2006, could further contribute to the effort of tightly linking benefits to contributions.

delivery is financed through the Health Insurance Fund (HIF) (see Box 2.1), whereas an unknown share is paid for out-of-pocket funds through private sources.

2.18 **The current public health financing system may not be financially sustainable for several reasons**. The financing system relies on relatively high payroll contribution rates (13.5 percent of gross salary compared to 6-8 percent in most of EU-15), which will have to be reduced in a planned manner in the medium term to encourage employment. In addition, contribution evasion, a limited contribution base, and inadequate budget transfers from the republic treasury for uninsured erode the revenue base. On the expenditure side, a generous benefits package as well as the insufficient link between access to benefits and contribution payments has underpinned the high and growing health expenditures. Financial sustainability requires revenue and expenditure management, while ensuring equity in access and efficiency in the delivery of care.

2.19 **There is a need to improve equity and efficiency in health care.**[23] Concerns about equity in access to care are caused by insufficient information on out-of-pocket payments and informal payments. An unknown proportion of private spending is used to finance care in a growing and uncontrolled private sector. Inefficiency in the provision of care are related to relatively long average lengths of stay in hospitals that keep occupancy rates high, low patient-loads per staff, sub-optimal distribution of staff across health facilities, and a weak referral system that undervalues the role of Primary Health Care (PHC). The resulting oversupply of beds and staff should be adjusted to increase productivity levels, as is currently being done in Serbia.[24]

2.20 **Governance in health policy needs to be strengthened as well as the monitoring and evaluation function to support evidence-based policy making in health.** Key governance measures to reach overall health goals include: monitoring and control the flow of private and public funds throughout the health system by institutionalizing international accounting standards and National Health Accounts (NHA); validation and resolution of the arrear situation and tightening policies to prevent the accumulation of new arrears; strengthening the purchasing function of the HIF; regulate private practice; improving the quality of service delivery in the public sector; and ensuring efficiency and equity in health care.

[23] The efficiency, equity and governance issues in health will be analyzed in great depth in the second phase of this programmatic PEIR.

[24] See Serbia Ministry of Health Action Plan, September 2005.

Education

2.21 **Montenegro's spending on education, at about 5.4 percent of GDP in 2005,[25] is significantly above that of other countries in the region (Table 2.4) and reaches OECD levels without matching its outcomes by far.** The proportion of government expenditure spent on education is 19.1 percent, and it is the third largest category of spending behind general public services and social care. This figure is high in international terms.

2.22 **Driven by high wages, spending on education is high and needs to be contained.** Indeed, the preliminary budget outturn for the 2005 and projections plans for 2006 indicate that spending on education will fall slightly. This pattern should continue if the government is to meet its objective of an overall reduction in public spending. However, expenditure reductions will need to be done in such a way so that the current performance of the sector, though it has significant weaknesses, does not decline further. Section C below discusses in detail the key sources of fiscal pressure in education as well as opportunities for cost saving in the medium term.

Table 2.4. Education Spending: Overall and on Wages in Selected Countries

	Education Spending		Education Wages
	% of Govt spending	**% GDP**	**% of Education Spending**
Albania	10.4	3.0	…
SaM	7.9	3.5	…
Japan	10.6	3.6	…
Macedonia	10.5	3.7	…
Greece	8.4	4.0	…
Croatia	9.5	4.3	…
BiH [1/]	10.9	4.3	79.9
Ireland	13.0	4.4	…
Germany	9.8	4.8	78.8
Slovenia	n.a.	5.1	…
OECD average[2/]	12.9	5.4	74.4
Hungary	10.3	5.5	71.5
Poland	n.a.	5.6	65.8
United States	15.2	5.6	71.4
BiH [3/]	10.9	5.6	79.9
Montenegro	19.1	5.7	82.3
France	11.0	5.8	72.4
Finland	12.7	6.4	59.5
New Zealand	20.8	6.7	…
Malaysia	28.1	7.6	49.4

Notes: [1/] In percent of adjusted GDP (World Bank estimate). [2/] Figures for OECD countries, 2002; Figures for percent of education spending on wages exclude universities; Germany and Hungary for public institutions only. [3/] In percent of official GDP.
Sources: OECD *Education at a Glance* 2005; LSMS; *BiH Labor Market Update* (Report No. 32650-BA, 2005); Montenegrin Ministry of Science and Education.

C. SOURCES OF FISCAL PRESSURE: WAGE BILL

2.23 **Although the Government has made substantial progress in reducing the size of public employment in the past four years, the public sector wage bill continues to represent a relatively heavy burden on the economy**. Spending on wages and salaries is higher than most European countries when measured as a share of GDP. As European integration brings

[25] This includes spending by social funds as well, but does not include the small amount spent by municipalities.

potentially new pressures to expand functions and increase capacity in selected areas, the government of Montenegro will need to develop strategies to restructure areas of the public administration that are currently over-staffed. The scope for large savings in the level of public employment may be limited, but prioritization of staffing levels across the various functions of government is essential if the government is going to assure that it has capacity in the areas that are most needed.

Progress in Lowering the Cost of Public Employment

2.24 **Encouragingly, total public expenditures in Montenegro for gross wages and salaries have declined as a share of GDP from approximately 14.4 percent in 2003 to 13.4 percent in 2005 (Figure 2.3)**.[26] Most of the reductions have been attributable to the government's success in reducing overall public sector employment and in keeping the "base rate" on which most salaries are determined unchanged through 2005.[27] An increase in the base rate and adjustment of some salary coefficients was planned for the 2006. Even with these changes, however, the nominal cost is expected to rise in aggregate by only Euro 10 million (from 221 to 231 million). With continued growth in GDP forecast for 2006, the wage bill to GDP ratio should drop to about 13.1 percent.

2.25 **Reductions in public employment have been the principal driver of cost savings.** Employment in the public administration (excluding the Health Fund) fell by almost 14

Table 2.5. Changes in Public Employment in Montenegro, 2002-05

	2002	2003	2004	2005
Education	12,272	11,914	11,746	11,872
Police & Prisons	7,846	7,191	7,063	7,116
Defense	7,080	6,860	6,164	3,830
Other Functions	7,111	6,592	6,713	6,739
Subtotal	**34,309**	**32,557**	**31,686**	**29,557**
Health		8,341	8,524	8,656
TOTAL		**40,898**	**40,210**	**38,213**

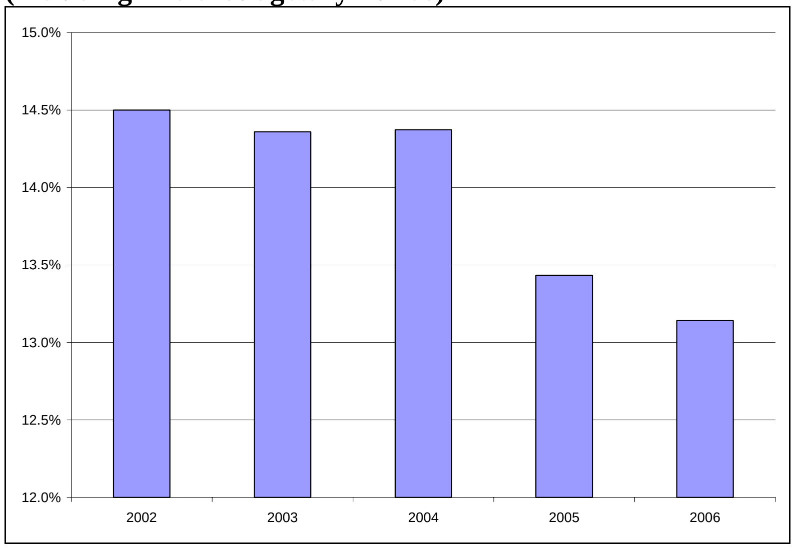
Source: Montenegrin Ministry of Finance.

[26] In this instance the wage bill is defined as including all central government institutions and major extra-budgetary funds (the Health Fund, the Pension Fund and the Employment Fund). It includes an estimate of expenditures for salaries of military personnel, but it excludes the amounts paid for local government employees. The later is estimated to contribute an additional 1.0% of GDP in 2005.

[27] Note that the recent freeze in base rates had been proceeded by a period during which the average wage in the labor market doubled. Given the large contribution that the public sector makes to total employment in Montenegro, it is believed that public employees were among the beneficiaries of the high wage increases. See "Republic of Montenegro: Economic Memorandum," The World Bank, October 27, 2005.

percent (from 34,309 to 29,557 people) between 2002 and 2005 (Table 2.5). Although in principle, all sectors were subject to restructuring and downsizing, in practice almost all the decline came about through reductions in the Ministry of Defense and the Ministry of Interior. Military staffing was reduced by about 3,250 or roughly half, and employment at the Ministry of Interior dropped by about 10 percent or 750 people. Education has been the single biggest employer of public servants with more than 12,700 employed in the sector in 2002. Only about 400 fewer people were employed by 2005.

Figure 2.3. Government Wage Bill as a Share of GDP (including Extra-budgetary Funds)



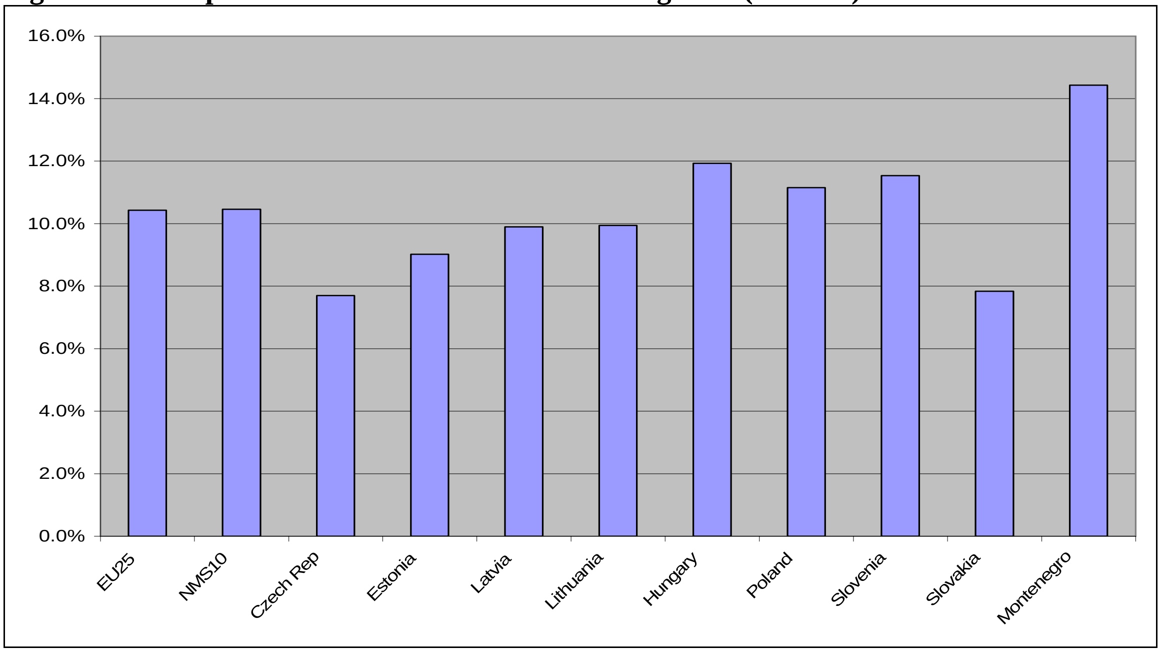
Source: Montenegrin Ministry of Finance.

2.26 **Savings in a few sectors have been partially offset by increases in others.** For example, employment in the health sector rose by 300 people or about 4 percent between 2003 and 2005. Most functions of government outside of the social sectors, police, and defense were grouped in government statistics as "Other Ministries and Agencies." This component of the public administration was reduced initially by almost 600 people (about 10 percent), before being allowed to build up again between 2003 and 2005. Perhaps reflecting the creation of new institutions to support administrative accountability, over 200 new people were added to the payroll among the "Other Ministries and Agencies," representing an increase of about 4 percent.

Deeper Reductions Still Needed

2.27 **Deeper reduction of about 4 percent of GDP is needed to bring wage bill (inclusive of health sector) in line with the average for EU25 and to create room for EU-related functions and infrastructure spending.** There are differences in data reported by different sources, but regardless of the source, at 14.4 percent of GDP for general government, Montenegro's wage bill appears excessive. Figure 2.4 relies on data reported by Eurostat for EU members. It shows the Montenegro wage bill to be almost 4 percent of GDP higher than the EU25 average (10.4 percent) or the average of the 10 new member states (10.5 percent). Among the EU8 all have wage costs that are lower than Montenegro, including the smaller states such as Estonia.

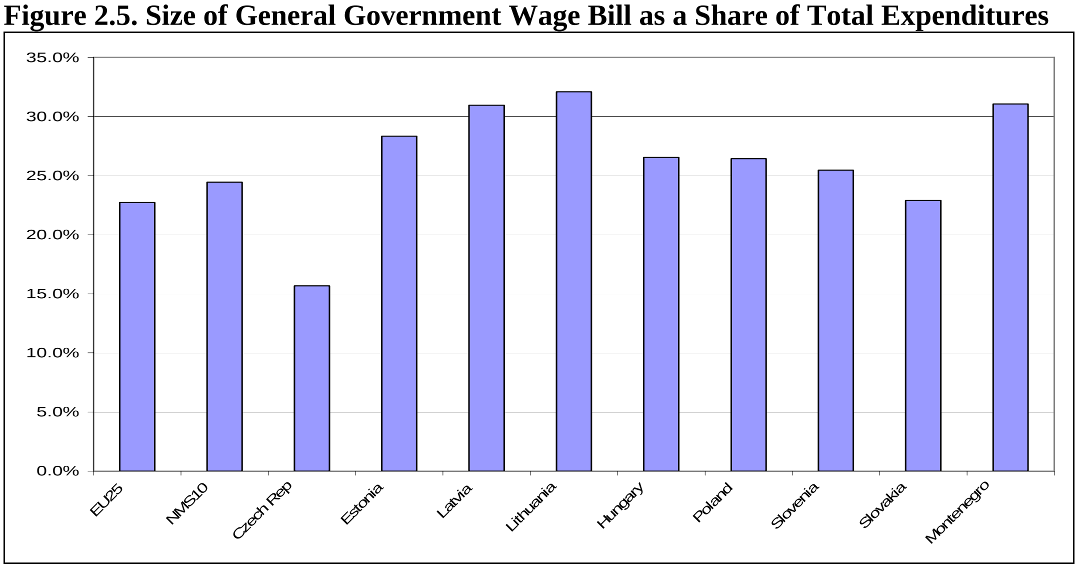
Figure 2.4. Comparison of General Government Wage Bill (% GDP)



Sources: Montenegrin Ministry of Finance; Eurostat.

2.28 **Even when viewed against total expenditures, wage costs in Montenegro consume a greater share than is typical in the EU**. Figure 2.5 shows that wage costs in Montenegro are about 31.1 percent of budget compared with 22.7 percent in the EU25 and 24.5 percent in the NMS10. Among the EU8 represented in the data, only Latvia and Lithuania show a higher share of wages to total spending – yet, both countries have much lower wages to GDP. Moreover, similar data from the IMF show wage bills to total spending for the Baltic States that is lower than that for Montenegro.

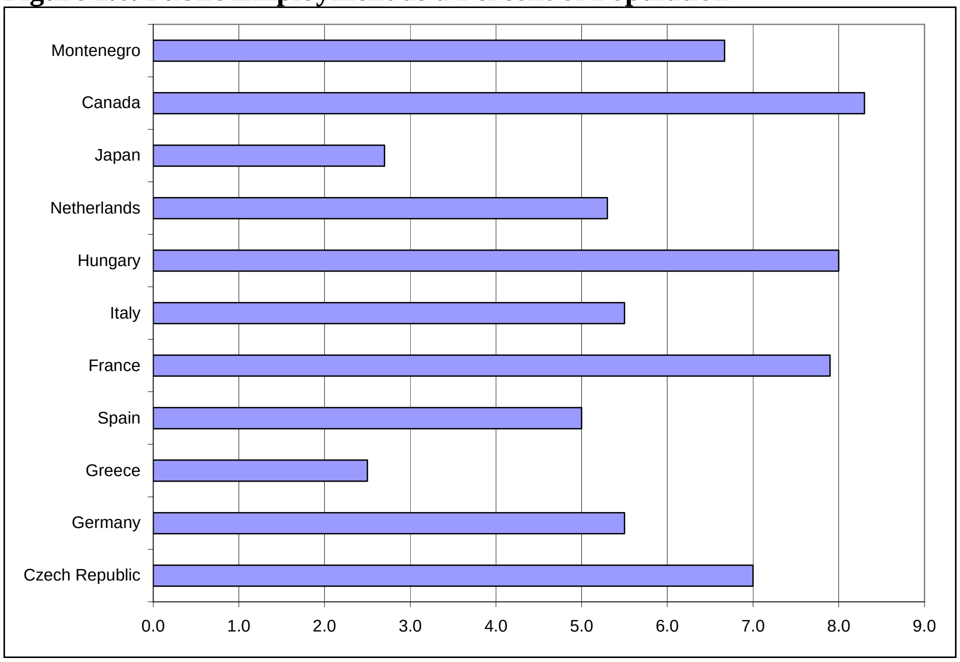
Figure 2.5. Size of General Government Wage Bill as a Share of Total Expenditures



Sources: Montenegrin Ministry of Finance; Eurostat.

2.29 **Insufficient information is available to say with confidence whether it is wage rates or employment levels that contribute most to the overall cost of public employment**. No surveys have been done to compare public sector wages with those in the private sector for similar jobs. Furthermore, international comparisons of public employment as a share of total population show wide differences across countries. For Montenegro, public employment (civilian and military) is roughly 6.7 percent of the population (Figure 2.6). Relative to the countries sampled by OECD/Puma, this appears to be only slightly higher than the median. To the extent that pay rates may be a contributing factor to the aggregate wage bill costs, it would be primarily because of very large increases that occurred between 2000 and 2003.

Figure 2.6. Public Employment as a Percent of Population



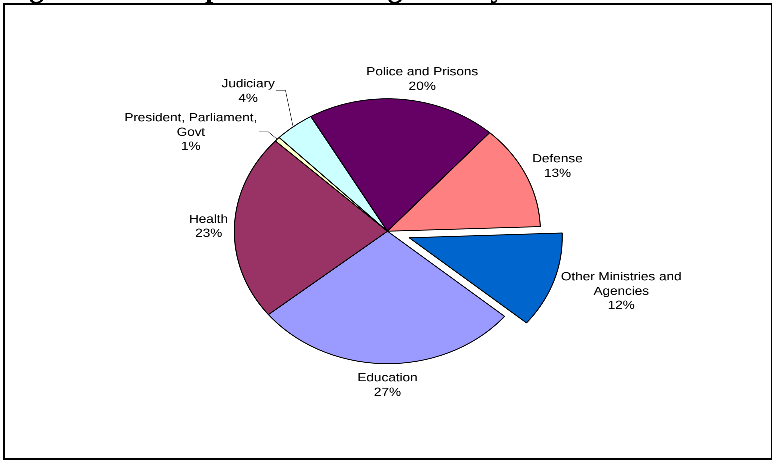
Sources: Montenegrin Ministry of Finance; OECD/Puma.

Public Sector Wage Bill Concentrated in Key Functions

2.30 **Though the cost of the public administration is high, its capacity to carry out many of the core functions for effective service delivery or European integration is rather limited**. Eighty-seven percent of the wage bill (excluding local government) is concentrated on just four functions—public order, defense, education, and health (see Figure 2.7.). All of the other functions and institutions of government operate on the remaining 13 percent. The numbers of staff that work in these "Other Ministries and Agencies" as well as in the representative bodies of government are disproportionately small. Increasing the number of people in these functions may or may not be appropriate; such assessments would normally be part of a broader functional review and are beyond the scope of this report. However, the data strongly suggests that any future reductions in employment should be targeted toward the four dominant sectors.

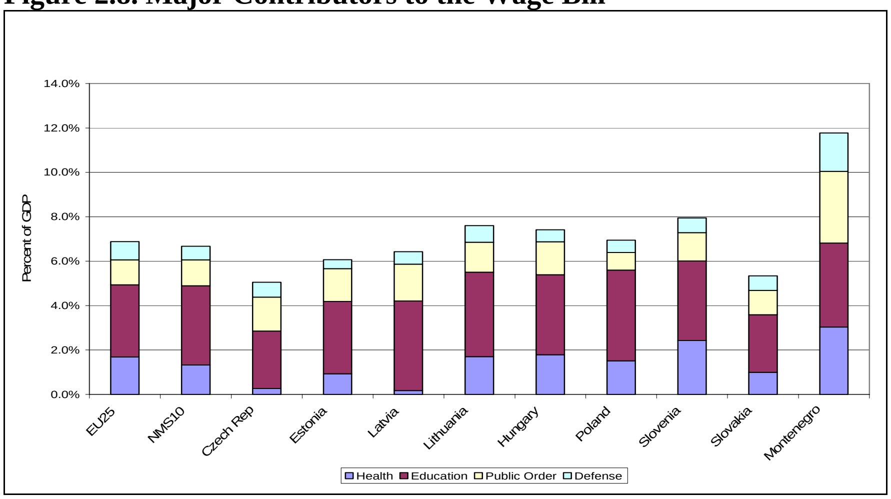
2.31 **Achieving a fiscally sustainable wage bill should start with a reassessment of the cost structure in certain sectors**. As Figure 2.8 shows, there are three sectors—health, defense, and public order—in which the share of GDP devoted to paying wages is much higher than in the case of EU countries. While each of these functions is of national importance, the impact of salaries in some cases is about twice as much as in the EU25 or the NMS10.[28] Defense and Interior ministries have already undergone some downsizing, although the fiscal benefit of the former will only become fully apparent with this year's budget execution. Still the data raises question as to whether reforms have gone far enough. In contrast, the health sector is only beginning to develop its medium term reform strategy. With wages in this sector already at 3.0 percent of GDP, it will be vital to examine how the sector can become much more cost-effective.

Figure 2.7. Composition of Wage Bill by Function



Source: Montenegrin Ministry of Finance.

Figure 2.8. Major Contributors to the Wage Bill



Sources: Montenegrin Ministry of Finance for Montenegro; Eurostat.

2.32 **Even when wage spending is within the ranges of other European countries, it does not necessarily mean that the sector operates cost-efficiently**. For example, spending for salaries within the Education sector is only slightly higher than the EU average. However, as discussed in the following section, some rationalization of resources could be done to improve outputs. Similar questions should be asked within other sectors, including health and public order.

[28] In Defense, the ratio of spending to GDP in 2005 may be artificially inflated due to retrenchment costs that were paid. If costs fall in 2006 from 28 million to 16 million, then wages to GDP will decline to 1.0 percent of GDP. It will still be about one-quarter to one-half higher than in the EU or NMS.

D. SOURCES OF FISCAL PRESSURE: EDUCATION

2.33 As pointed out above, Montenegro's public spending on education is not only high in international terms, but also education accounts for the largest share of government wage bill. This section focuses on two urgent fiscal issues in the education sector: an increase in wages and salaries and the cost of the expansion of the government's school reform program.

2.34 **The reason for this focus is that the Government has recently adopted (May 2006) its education strategy, which could be blown off course if these fiscal issues are not addressed**. The government faces a major challenge to increase spending on non-salary expenditures to pay for its reform agenda and to improve quality of education more generally, while reducing staffing costs in the context of rising average salaries and falling numbers of pupils in primary and secondary education. This section not only estimates, for the first time, the costs of these pressures, but also suggests opportunities for cost-saving which the Government may consider to implement in order to pay for reform.

Pressures on the Education Budget: Staff Salaries and Reform Schools

Rise in Staff Salaries

2.35 **Currently, a very high proportion of spending is on wages, which leaves insufficient room for other spending that will help improve the quality of education.** Out of the total recurrent expenditure on primary and secondary education in 2004, 82.3 percent was spent on the wage bill, leaving only 17.7 percent of total recurrent expenditure for non-staff items, which includes spending not only on classroom materials and teacher training but also utilities. The average for OECD countries for the share of non-staff cost in total recurrent expenditure is 25.6 percent.

2.36 **The very high proportion of spending on salaries appears to be driven by the relatively high salary levels, rather than the ratio of teachers to pupils** (which is in line with international comparators; Table 2.6). Teacher salaries in Montenegro are set under the branch (sectoral) collective agreement. The salary base is a minimum wage and monthly salaries are a multiple of this base and the coefficients set by the branch agreement. Multiples are determined by qualifications, particular roles (e.g., being a mentor or an organizer of practical education), and years of experience. This set up makes the salaries of Montenegrin teachers well above the OECD average and other

Table 2.6. Student/Teacher Ratios, Montenegro and Selected Comparators, 2003

	Primary	Secondary	Higher
Montenegro	15.5	14.3	n.a.
BH			
Federation of BH	18.3	15.8	8.6
Republika Srpska	16.6	18.0	n.a
OECD Average	16.5	13.6	14.9
Hungary	10.6	11.8	14.8
Poland	11.9	13.0	18.3
Spain	14.3	10.9	11.8
United States	15.5	15.5	15.2
Finland	16.6	12.9	12.3
Russia	17.0	8.5	11.8
Czech Republic	18.3	13.4	17.3
Germany	18.7	15.1	12.5
France	19.4	12.2	17.6
Slovak Republic	19.4	14.0	10.8
New Zealand	19.9	14.4	8.5
United Kingdom	20.0	14.8	18.2
Indonesia	23.4	18.0	18.7
Peru	25.1	18.9	14.8
South Korea	30.2	17.8	n.a.

Source: OECD, *Education at a Glance*, 2005.

comparator countries (Table 2.7). The average annual salary of a teacher in Montenegro, including all the allowances is €7,103, which amounts to more than 160 percent of per capita GDP. This is very high in international terms.

2.37 **To make matters worse, average salaries for both teaching and non-teaching staff in non-university education increased by between 8 and 9 percent in 2006**. This was the result of a new branch collective agreement which increased salary coefficients. The projected salary budget for these staff for 2006 as against 2005 showed an increase of only three percent. This means the government faces a simple choice. Either, allow spending on salaries to eat further into the non-salary expenditures, which, as noted above, are already low, or, reduce the number

Table 2.7. Average Teacher Salaries and Benefits, as a Ratio of PPPGDP per Capita, 2003

Montenegro (2004)	1.61
OECD Average	1.31
Indonesia	0.50
Slovak Republic	0.56
Poland	0.82
Hungary	0.98
Czech Republic	1.06
Finland	1.12
France	1.12
Peru	1.13
United States	1.17
Spain	1.42
New Zealand	1.51
Germany	1.71
Korea	2.42

Note: For Montenegro, the figure is based on the average salary for all teachers; for other countries, the base is the average salary for primary education teachers with fifteen years of experience.
PPP: Purchasing power parity
Source: Education at a Glance 2005, Bank staff estimates for Bosnia and Herzegovina and Montenegro.

2.38 of staff in the sector so that the overall wage bill fits within the projected budget. The Bank team has been advised that the government has adopted the second option. This means that the government needs to reduce wage expenditure in non-university education[29] from the approximately €65.9m it would be if all staff remained in the sector[30] to the €60.7m allocated in the Ministry's budget for 2006. The Government has not said how it intends to reduce employment and the time for reductions before the beginning of the 2006-07 school year has passed. Had the reductions been made over the summer, a reduction in the 2006 wage bill of €5.2m would be equivalent to a reduction in education staff of 1,800.[31] In fact, even more savings are needed because making people redundant costs money. In 2005, the Government went through a redundancy program which offered any teacher who wished to leave the profession €2,000. These funds were paid from the budget of the Ministry of Labor and Social Welfare. If this same approach were adopted in 2006, it would mean that the net savings to the government in 2006 from each person

[29] The university is excluded from these calculations because no information is available on spending allocations, as the government gives a lump sum transfer to the university which covers all types of spending.

[30] Assuming an average salary increase of 8.5 percent.

[31] The average gross salary including allowances of staff (including both teaching and non-teaching) is estimated to be €5,780 (for just teachers, €7,103). This implies that for each person made redundant the total savings in 2006 will be €2,890 (€3,557), since staff can now only be released from their duties at the end of the school year (i.e., after six months work in 2006).

leaving the sector would amount to only €890 rather than €2,890, though the salary savings could accrue to the education budget (if that is agreed within the government)[32]).

Cost of Reform Program

2.39 **The other source of pressure on the education budget is from the government's education reform program.** A 'Strategic Plan for Education Reform for the Period 2005-09' has been adopted by the Government.[33] The Plan estimates that it would cost €7.1m to

2.40 implement the reforms in 2006, with total costs over the Plan period of €24.6m.[34] However, this estimate does not include all the costs associated with the policies and programs set out in the Plan. For example, a major element of the Plan is the ongoing reform in primary and secondary schools, which includes school renovation and equipment, and a new curriculum and associated textbooks, assessment arrangements and teacher training. The reform, which started in 2004, is being phased in with the number of grades and schools included in the reform increasing year by year. The first two sets of schools, which started the reform in 2004 and 2005, have had many of the required inputs, allowing, for the first time, a more accurate calculation to be made of the overall costs of the reform. Approximately €19.1m is included in the cost projections of the Plan shared with the Bank team. However, a more detailed analysis reveals that spending on the reform in schools for 2005-2010 is projected to be €24.7m (and a total of €29.4m by 2012, when all reform schools are included) (Table 2.9).[35]

2.41 **While in the first two years the expenses related to the school reform account for a little more than one-third of the allocated budget expenditures, in 2006 the projected costs are slightly greater than the budget allocation** (Table 2.8). It is important to note the pattern of expenditure: spending each year in 2006-2010 is projected to rise to two or three times the annual spending to date. The reform costs are likely to remain this high in the upcoming years because of the large number of schools and classes that will start the reform process in 2007 and 2008. Table 2.8 compares the cost of the reform schools with relevant budget expenditures (capital

Table 2.8. Reform Costs versus Related Budget Expenditures

	2004	2005	2006
Budget expenditures (capital, maintenance and learning materials)	3,899,999	5,892,272	3,531,777
Reform cost	1,431,740	2,188,799	3,612,000
Reform cost as % of budget expenditures	37	37	102

Sources: Montenegrin Ministry of Finance; Bank staff estimates.

[32] Of course, more savings would accrue in future years; but here we are considering what the Government would have to do in order to keep to the 2006 budgeted allocation for salary costs.

[33] The Strategic Plan deals with three key issues: (i) the issues of more efficient management and coordination among the institutions implementing the reform; (ii) the key principles underlying the success of the reform process; and (iii) the reform priorities at different levels of education (pre-school, elementary, secondary, and adult education)

[34] The cost estimates in this section are based on Education Sector Strategic Plan which at the time of preparation of this report was still being finalized. As a result, final cost estimates may change somewhat, but not significantly enough to alter the basic conclusions of this analysis.

[35] The Bank team is working with the Government to calculate more accurate figures for the remainder of the Plan.

expenses, maintenance costs, and expenses for textbooks development, learning materials and teachers training) in the period 2004-2006. This increase comes primarily from the one time reform introduction in gymnasia.

2.42 **For 2006, there seems to be a stark choice between salary increases or more reform schools in order to remain within the allocated budget.** There are additional concerns for future years, especially 2007 and 2008, where the reform costs are the highest; indeed they are three times the level of current spending on reform schools and, therefore, three times the level of resources of these kind of non-salary expenditures in the government's education budget. Given that in 2006 almost all the money in these budget lines is consumed by the reform schools, there is no scope for using some of these resources to pay for the salary increase. The remaining costs in the budget are to pay for utilities and other items which are very difficult to control at the central level.[36] Each additional €1m in reform costs is equivalent to 173 staff salaries.

It seems unlikely that contributions from international agencies can be relied upon to make up the shortfall in spending. Unfortunately, information on the level of contributions and on the expected disbursements is difficult to obtain because of donors' caution in making firm commitments and because that spending does not appear in the Government Budget. In 2005, there were total commitments of approximately €6.1m.[37] However, several of these activities were finished by 2006, several were targeted to activities other than those for reform schools, and, most importantly, at least €3.0m of this amount was targeted to the vocational education (VET) system. In order to meet the projected shortfalls in 2007 and 2008, the Government would have to raise *each year* the equivalent amount of money from international agencies and apply this money to the reform schools. Fortunately, from 2007, Montenegro expects to have access to IPA funding from the EU which, depending on the government's priorities, could be used to address education reform issues.

[36] There is another potential problem: there are likely to be some maintenance and capital expenditures needed for non-reform schools, but there do not appear to be the resources available to meet these needs.

[37] The World Bank Credit which supports the Montenegro Education Reform Project is included in the Budget and so is not counted in this figure.

Table 2.9. Cost of Reform Schools, Government's Plans

Type of expenditure	2004 (20 primary schools)	2005 (27 primary schools)	2006 (27 primary schools and 30 gymnasia)	2007 (48 primary schools)	2008 (40 primary schools)	2009	2010	2011	2012	Total
School reconstruction and upgrading	1,217,960	1,133,841	1,300,000	1,973,723	1,679,764	335,953	251,965	50,000	20,000	**7,963,205**
Training for teachers and directors	213,780	194,000	268,000	298,000	338,000	318,000	298,000	288,000	278,000	**2,493,780**
Teaching aids		107,087	135,000	130,400	107,560	16,134	10,000	10,000	10,000	**526,181**
School furniture		510,000	420,000	887,778	755,556	151,111				**2,724,444**
Computer equipment		195,000	1,325,000	2,956,000	2,655,000	2,585,000	2,675,000	1,250,000	1,240,000	**14,881,000**
Free textbooks provision		7,236	100,000	100,000	100,000	70,000	37,000	41,000	30,000	**485,236**
Library materials		27,120	38,000	47,209	40,178					**152,506**
Civil works supervision		14,515	26,000	39,474	33,595	6,719	5,039	1,000	400	**126,743**
Total	1,431,740	2,188,799	3,612,000	6,432,584	5,709,653	3,482,917	3,277,004	1,640,000	1,578,400	**29,353,096**

Sources: Ministry of Education and Science; authors' calculations.

Opportunities for Cost Savings

2.43 The rise in staff salaries is such that without significant reductions in employment levels, salary expenditures will eat up a substantial portion of spending for school reform. In this section, it is assumed that these staffing reductions are made so that wage spending does not increase beyond the budgeted amount. Given this assumption, what avenues are there for Montenegro to make *additional* savings to pay for the school reform and, more broadly, the priorities identified in the Strategic Plan?

Rationalizing the School Network

2.44 **Montenegro can take advantage of the opportunity offered by the fall in pupil numbers over the next several years.** Keeping the ratio of pupils to teachers and enrollment rates at the same level as currently, teacher numbers would need to be reduced by approximately 370 in primary education and 200 in secondary education by 2012 (Annex 2). This could yield total savings over the period of €4.0m or an annual average of €0.6m (plus, of course, parallel savings from non-teaching staff).[38] The ratio of pupils to teachers in Montenegro is around international averages (Table 2.6). However, even some increases in these ratios would be compatible with good quality education. International evidence does not display a significant correlation between class size and learning achievement. For example, in the 2003 OECD PISA international student assessment, Korea (with an average class size of those taking the test of 37) achieved a far higher mathematics and science scores than Germany (class size of 22) and Greece (17).

Table 2.10. Number of Schools and Classes with 10 or less Pupils, 2004/2005 and 2005/2006

Number of pupils	2004/2005		2005/2006	
	Schools	Classes	Schools	Classes
1	16	16	18	18
2	27	27	21	21
3	11	12	20	20
4	19	19	15	15
5	16	17	22	22
6	19	19	12	13
7	15	18	13	16
8	13	16	12	19
9	11	11	10	18
10	9	9	12	23
Total	156	164	155	185

Sources: Ministry of Education and Science; Bank estimate.

2.45 **There are a large number of small and very small schools in Montenegro** (Table 2.10). There are 167 elementary schools, but 457 active elementary school units. Of these, 74 units have fewer than 5 pupils, and more than one-third of them (155) have 10 or fewer students. The student/teacher ratio is very low in many cases – there are 18 schools with only one pupil! While having satellite schools reduces administrative costs (since the management and administration is done by the central schools), there does seem to be scope for consolidation. It is undoubtedly true that some of these schools could not be combined without making access for some students too onerous. At the same time, it is equally true that some could be consolidated without compromising quality or access. The challenge is to distinguish between schools in the

[38] Even if enrollment rates were to rise to those of the EU, the project fall in the number of pupils would still mean an overall reduction in teacher numbers, perhaps of around 300, in Montenegro.

first category and schools in the second, and to provide the means and the incentive to carry out consolidation where it makes sense to do so.

Table 2.11. Characteristics of the Highest Unit Cost Primary Schools

		Number of schools	Number of pupils	Number of teachers	Number of other staff	Pupil teacher ratio	Mean cost per school	Mean unit cost per pupil
Sparse rural							€	€
	Central school	7	177	71	37	2.5	75711	2778
	Satellite school	18	35	18	9	1.9	7338	4385
	Total	25	212	89	46	2.1	26483	4029
Rural								
	Central school	-						
	Satellite school	4	12	6	2	2.1	11053	3794
	Total	4	12	6	2	2.1	11053	3794
Rural/urban								
	Central school	8	144	40	42	2.3	62817	3932
	Satellite school	29	82	39	19	2.2	10516	4771
	Total	37	226	79	61	2.2	21825	*4589*
Urban								
	Central school	10	247	112	45	2.4	72886	3095
	Satellite school	14	33	16	8	2	8304	4674
	Total	24	280	128	53	2.1	35213	4016
Total								
	Central school	25	568	248	124	2.4	70455	3368
	Satellite school	65	162	79	38	2.1	9193	4583
	Total	90	730	327	162	2.1	26210	4245

Source: Bannock Consulting, *Education Finance Decentralization: Cost-Benefit Report*, manuscript, 2006.

2.46 The MOES has recently produced new Norms and Standards, linked to the number of students rather than the number of classes, but this does not seem to have had a discernible effect, with in fact an increase in the number of very small classes (Table 2.10 above). This may be because the number of children in rural areas has decreased.

2.47 **Consolidating the school network would go some considerable way towards meeting the projected additional costs of reform schools**. If all of the most inefficient central and satellite schools were closed, then savings would be at least €2.4 m each year (Table 2.11). In a few cases it might be possible to sell or rent the school building, resulting in some additional income. Moreover, of course, additional savings could be found if slightly larger schools were closed or slightly larger classes merged. These savings would be slightly offset because there are some costs associated with closing schools, such as for redundancy payments for staff and some additional transportation costs to ensure schools remain accessible.

2.48 **Fortunately, the evidence is that school consolidation is likely to improve rather than reduce student achievement**. There is not much good data on the achievement of students in Montenegro. However, two clear findings emerge from a recent assessment.[39] First, students

[39] In 2005, a national assessment was conducted for third grade students in mathematics and in mother tongue. In that assessment, overall 56.4 percent of questions were answered correctly in mother tongue and 57.5 percent in mathematics. However, it is hard to interpret this overall result, since the assessment was not designed with a minimum standard in mind nor were the expectations of students benchmarked against international standards.

generally do better in *larger* classes.[40] The recent assessment shows that performances in math and mother tongue increase as class size increases. For example, the correlation between math performance and class size increases from 0.40 to 0.58 as the class size grows from under 5 students to above 25 students. This finding, although contrary to the usual expectation of policy makers, is consistent with a large body of international research which shows that, within a wide range of class size, achievement does not significantly differ. Second, students in satellite schools generally do considerably worse than students in associated mother schools. Taken together, these two findings imply that average performance would not decline (and may even rise) if small classes and satellite schools were closed and pupils were taught in larger classes and schools. This outcome would be reinforced if some of the savings from the closed schools were invested in improving the quality of the remaining schools in the network.

Reforming Secondary Vocational Education

2.49 **Reforming vocational education is another potential source of savings.** Vocational education programs in Montenegro have a poor record of providing the skills and knowledge needed for labor market entry. They also provide less opportunity for entry to further education. A study of secondary education students who graduated in 2004 looked at what they were doing one year later[41]. The study found that young people's prospects depend very greatly on the type of secondary program they attended, with those attending four year programs overwhelmingly better off – either because they were able to attend further schooling (usually a public university) or find employment (Table 2.12). Currently, approximately two-thirds of students are enrolled in various vocational programs.

Table 2.12. Outcomes for Students Leaving Secondary Education in 2004 by Type and by Length of Secondary Program

Status	**Type of secondary program**					**Length of secondary program**	
	Gymnasium	**Secondary vocational**	**Secondary technical**	**Crafts program**	**Field of service**	**3 years**	**4 years**
Continued schooling	91	57	53	6	35	7	73
Unemployed	7	24	30	80	50	77	18
Employed	2	18	12	14	14	15	9
Other		1	3				1
Total	100	100	100	100	100	100	100

Source: Strategic Marketing Research, *Survey of Secondary School Completers,* manuscript, May-July 2005.

2.50 **While the three-year programs are specifically intended for those who will enter the labor market immediately after graduation, they fail in this mission**. This represents, therefore, a waste of public resources as these programs are predominately funded by the budget. Those who entered the labor market directly after graduating from secondary school, rather than

[40] It has not been possible to conduct a more detailed analysis to exclude the possibility that this outcome is the result of other factors than simply class size. For example, it may be that larger classes are in urban areas and this is where the better teachers are.

[41] Strategic Marketing Research, 'Survey of Secondary School Completers', May-July 2005, manuscript.

continuing their education, were more likely than not to be unemployed a year later. This is true for every type of program but it is especially true for those who attended three year programs (and 80 percent of those who graduated from craft programs and 51 percent of those from 'field of service', which includes programs for the service sectors like tourism). What is especially worrying about these three-year programs is that those entering these are from poorer families: 93 percent of those students in 3 year programs had parents with no university education, compared with only 63 percent in four year programs (the figure for 'craft programs' is an astonishing 96 percent). So these students are trapped in a cycle of poverty.

2.51 **In general, the prospects for secondary education graduates in the labor market are poor.** This suggests that any skills they learn at school directly relevant for specific jobs are inadequate and likely to become obsolete due to the lack of use during unemployment after graduation (which could last some time—78 percent of the unemployed graduates in the survey were unemployed for the entire year after graduation). This conclusion is reinforced when one considers that 67 percent of graduates who are employed are employed in the service sector, where general skills are more highly valued (and training for the job takes less time).

2.52 **This leads to the conclusion that secondary school graduates are better off with strong general education skills** which will enable them to seek a wider range of employment, learn new skills quickly, and are less likely to ossify during spells of unemployment. This implies that a shift towards more general education studies would have stronger labor market outcomes – even for those who do not go to university. This would represent a dramatic shift in the way that secondary education is provided in Montenegro, where more than 30 percent of all students are in 'field of service' or craft programs, which offer a very narrow curriculum focused around vocational skills. Montenegro has begun a reform of vocational education; usefully it is involving employers in the changes. The impact of this reform clearly needs to be measured. However, the reform focus is on enhancing the practical aspects of vocational education; as such, it is not likely to address the concerns raised here.

Table 2.13. Savings from Adjusting School Reform Compared to Current Projections

	2006	2007	2008	2009	2010	2011	2012
Cost of reform schools	3,612,000	6,432,584	5,709,653	3,482,917	3,277,004	1,640,000	1,578,400
Estimated budget for non-wage costs	3,531,777	4,441,349	4,441,349	4,441,349	4,441,349	4,441,349	4,441,349
Budget gap	80,223	1,991,235	1,268,304	(958,432)	(1,164,345)	(2,801,349)	(2,862,949)
Savings from:							
• reducing computer inputs by 50%	662,500	1,478,000	1,327,500	1,292,500	1,337,500	625,000	620,000
• slowing pace of new reform schools	0	1,847,965	1,324,346	(830,181)	(1,085,653)	(558,658)	(231,658)
Total savings	662,500	3,325,965	2,651,846	462,319	251,847	66,342	388,342

Notes: Budget estimated on average of 2004-2006.
Sources: Ministry of Education and Science, authors' calculations.

2.53 **While data are not available to quantify the costs, such a shift towards general education is likely to be cost-saving for Montenegro**. In all countries for which there is data, vocational education is more expensive than general education because of the additional material costs, more expensive equipment, and lower pupil-teacher ratios. Unfortunately, the data is not available in Montenegro to quantify the additional cost of vocational education; in other countries, the costs are typically more than twice as much per student. Such a shift would also put Montenegro in a better position to use EU funds for reform of vocational education more effectively.

Scaling Back on the School Reform

2.54 **Although not the preferred option, the government could also meet the fiscal costs of reform schools by slowing down the rate at which new schools join the reform process and/ or reducing the level of inputs provided to each school.** Annex 3 shows an alternative scenario, where the *pace* of reform is slowed and whereby the last set of schools is brought in 2011 rather than in 2009. This would reduce spending in 2007 and 2008 to €4.6m and €4.5m respectively (rather than €6.0m and €5.5m). A second choice, though with adverse equity implications, is to reduce the level of inputs for the reform, in particular renovation and computers, which are the big drivers of costs. Given that considerable renovation costs have already been spent, a reduction in the purchase of computers would make the reform significantly more affordable and continue the other interventions which will improve the quality of education. Reducing the money spent on computers by half would save €1.48 m in 2007 and €1.35m in 2008 (€6.1m over the Plan period and €7.3m overall up to 2012), also this would also result in a significant reduction overall in the number of pupils per computer. If both approaches—slowing the pace of reform and reducing computers—were adopted, the total savings in 2007 and 2008 would be €2.9m and €2.3m respectively and these would be more than enough to cover the gap between expected budget allocations and the costs of reform (see Table 2.13 above). Yet, it should be underlined that the costs are only those associated with the reform schools. To meet the larger costs associated with the priorities in the Strategic Plan, it is even more important the Government pursues the school network consolidation and vocational reforms discussed above.

Implementing the Cost Saving Measures

2.55 **Montenegro faces some painful choices in the short and medium term.** Its school reform agenda, which is modeled on good practice in other countries in terms of approaches and sequencing, is threatened by salary increases for staff. As shown above, there are potentially significant savings to be made in the sector, which could be achieved without reducing educational quality and in some cases, such as closing small schools, improve it. While it is theoretically possible to reduce the number of staff and the number of schools without leading to a significant deterioration in access to or the quality of schooling, the *way* that these efficiency gains would be achieved does, however, have an important impact on the success of the changes.

2.56 **Offering voluntary redundancies to teachers and other staff as is currently done may not be sustainable as student numbers fall**. There are several issues. First, the current scheme, with payments of €2,000 per person, significantly reduces the fiscal savings. Second, it is likely that, under a voluntary scheme, those with most skills to offer (and therefore likely to be the best teachers) are those with the strongest incentive to leave since they are most likely to be able to find another job.[42] Third, the distribution of teachers needs to match the distribution of pupils. This is increasingly unlikely to happen as a redundancy program continues. For example, it is more difficult to recruit teachers for rural areas and for certain subjects. The government will need to shift to a more active management of staff reductions for these reasons.

2.57 **The consequences for pupils who previously attended schools to be closed needs to be carefully assessed to ensure that reasonable access to schooling remains possible**. In some cases, some schools or school buildings cannot be closed because they are the only accessible educational opportunity. To be able to make these assessments, locally available knowledge is critical: this implies that any rationalization is done in close cooperation with local governments and communities. This is not to imply that the responsibility for managing the school network (and, as necessary, closing schools and school buildings) should rest with local governments. Given their small size in Montenegro, municipalities are unlikely to have the incentive, analytical capacity, or political will to close small schools. The most effective management of the network is through central direction in the context of local consultations. In this way, school enrollment ratios need not decline: in fact, especially at secondary education there is scope for increasing this ratio so that Montenegro is more in line with other countries (Table 2.14).

Table 2.14. Net Enrollment Rates in Selected Countries, 2004

	Primary	Secondary
Montenegro	99	79
Albania	96	74
Armenia	94	89
Bulgaria	95	88
Croatia	87	85
Georgia	93	81
Hungary	89	91
Macedonia, FYR	92	81
Poland	97	90
Romania	92	81
Slovenia	98	95

Notes: Data for Albania and Croatia, 2003; for FYR Macedonia, net secondary, 2002.
Source: World Development Indicators, 2006, for Montenegro, MONSTAT.

2.58 **Montenegro will also need to consider adjusting the organization of education.** For example, integrating biology, chemistry and science, so that they can be taught by a single teacher. This also has an educational value, if done well, since the research agenda in these subjects is increasingly multi-disciplinary. In addition, the Government should consider a greater use of multi-grade teaching and increasing the workload of teachers.

E. Conclusions and Recommendations

2.59 Montenegro spends about 75 percent of its expenditure on wages and various social benefits to households. By function, general public services account for about 29 percent of total spending; defense and public order for 13 percent; social welfare and protection for about 27 percent; and education and health combined for another 25 percent of the total spending. The rest goes to economic services, and housing, sports and recreation.

[42] Unfortunately, no information is available on the profile of those who left the profession under the 2005 redundancy program.

2.60 Although the Government has made substantial efforts to reduce the size of public employment in the past four years, the public sector wage bill continues to represent a relatively heavy burden on the economy. Between 2002 and 2005, employment in the public administration fell by almost 14 percent (from 34,309 to 29,557 people). Yet, a comparison with regional states shows that Montenegro's wage bill as a proportion of total government expenditure or GDP still remains far above average. On the other hand, capital expenditure is much below the level for other countries in the region.

2.61 The prospect of European integration presents dual challenges to Montenegro and both require politically-challenging prioritization of resources. On the one hand, there is a need to build capacity in areas that are important for a fully functioning state within the EU. On the other hand, there is a need to assure that the cost of public employment does not squeeze the fiscal space needed to maintain existing infrastructure and to fund new programs. In order to achieve a fiscally sustainable wage bill, the Government should:

- **Develop a realistic strategy to reduce staffing in some areas, while expanding capacity in others**. Eighty-seven percent of the wage bill is concentrated on just four functions—public order, defense, education, and health. All of the other functions and institutions of government operate on the remaining 13 percent. Any future reductions in employment should therefore be targeted toward the four dominant sectors. On the other hand, there may be a need to increase staffing and administrative capacity in ministries that are central to the EU integration process (discussed in Chapter 3).

- **Control the pace of, and target, annual wage increases.** The strong leverage of trade unions in salary and wage negotiations has meant a rapid increase in wages in recent years, in particular prior to 2004. Future increases in real salary rates should be highly targeted rather than implemented across-the-board. Without such fiscal discipline, there is a risk that the wage bill will crowd out essential spending on public goods and remains a drag on future economic growth.

2.62 The case of education, the largest contributor to the government wage bill, illustrates the challenges as well as what the government can do. Out of the total recurrent expenditure on general education in 2004, 82.3 percent was spent on the wage bill, leaving only 17.7 percent of total recurrent expenditure for non-staff items, which includes spending not only on classroom materials and teacher training but also utilities. A closer look at the fiscal structure in the sector shows, again, that the Government faces a clear choice between uncontrolled rises in salaries and staff costs on the one hand, and spending on non-salary expenditures to pay for the reform agenda and to improve quality more generally on the other. This choice is particularly stark in the years 2006-2008. Some key steps that the government can take include:

- **Ensure strategic planning takes place within a clear budget framework.** The costs of the education strategy under preparation need to be properly assessed, within a rigorous priority-setting process. It is unfortunate that the Government approved the Strategy before this was done and therefore before it was possible to make an informed judgment that the costs can be met. In addition, funds (grants, credits and in-kind contributions) from other countries and international organizations should be solicited and used only on the basis of the priorities of the approved strategy.

- **Control the rapid wage increases.** The Government may wish to consider, in the light of the evidence from this chapter, whether to approach the teacher unions with a view to re-negotiating the collective agreement so that wage increases fit within the resources available. In the future, collective bargaining should include a careful and transparent analysis of the impact of the salary increases on the education budget.

- **Reduce salary costs through staff reductions.** In 2006, to keep the wage bill within the originally projected increase of 3 percent (as opposed to the projected increase in the collective agreement of 8-9 percent), the government could reduce wage expenditure in non-university education through significant reductions in staffing levels. By way of illustration, about 1800 staff would need to be made redundant to keep salary spending in 2006 to the projected budget amount.

- **Create budgetary space to implement the schools reform program and other priorities to raise education quality**. Apart from salary costs, a significant fiscal pressure is likely to come from the government's education reform program, which includes school renovation and equipment, and a new curriculum and associated textbooks, assessment arrangements and teacher training. A cost analysis based on recently reformed schools shows that the cost of school reforms each year in 2006-2010 is projected to rise to two or three times the annual spending to date (€1.8m in 2005). These costs could be met if reductions are made in the computers bought for schools and by slightly slowing the pace of new schools included in the reform. However, to make further savings and increase non-salary spending on other priorities, the Government will need to: (i) reduce the wage and salary costs staff reductions; (ii) rationalize the school network; and (iii) reform the vocational training programs.

2.63 While there are potentially significant savings to be made through these measures without reducing educational quality and, in some cases even improving it, the current approach of offering voluntary redundancies to teachers and other staff is unlikely to be optimal, and the government needs to actively manage staff reductions. In rationalizing the school network, it is important that the needs of students whose schools are to be closed should be carefully assessed to ensure that reasonable access to schooling remains possible.

3. PUBLIC ADMINISTRATION REFORM

3.1 **While containing the costs of public employment, the government must also strongly pursue the task of creating a modern and effective public administration if EU integration is to become reality**. The key challenge in Montenegro is to re-orient and reorganize the role and functions of the State Administration from one with heavy state involvement in economic management and direct delivery of services, to one supporting a market economy and EU integration. This process began with the Government's adoption of its Public Administration Reform (PAR) strategy in 2003.

3.2 **Since 2003, Montenegro has adopted several pieces of key legislation that provide a good foundation for long-term public administration reform**. It has, among others, adopted the Law on State Administration, the Law on Civil Servants and Employees, the Law on Salaries of Civil Servants and Employees, the Law on Administrative Procedure, and the Law on Ombudsman. Implementation of these laws is well underway. Two of the key institutions that assure accountability of the State Administration have been established and are well-functioning. Government has also made progress in promoting a professional and merit-based civil service, including the creation of a specialized agency for managing the civil service.

3.3 **Notwithstanding these legislative milestones, however, Montenegro is only at a half-way point of its seven-year long PAR strategy, and several implementation challenges remain ahead**. First, the current institutional mechanisms for central policy coordination within government are poorly functioning, and there is a need to ensure a more effective center-of-government coordination across sectors. Second, even with new laws in place, the civil service pay structures and incentives are still inadequate to attract and motivate highly skilled personnel. Implementation of performance-based pay is planned, but it is undermined by other policies and practices that emphasize longevity. Third, the Law on State Administration has redefined some existing structures and accountability relationships, but without adequately addressing whether all the functions within those structures are still needed, or whether such functions could be done with fewer resources. The process of EU integration is already highlighting some areas of public administration that are woefully under-capacity and the government will need to make key policy choices to reduce staffing in some functions in order to build up capacity in others.

3.4 **This chapter discusses the progress in public administration reform (PAR) since 2003 and highlights some of the outstanding policy issues that need to be addressed in the future**. Section A provides a background to the legal and institutional arrangements for PAR. Section B reviews the progress to date in implementing civil service and wage reform, and the performance appraisal systems. Section C examines the new accountability institutions. Section D deals with the challenges of addressing structural and organizational fragmentation and creating European integration structures. Section E offers conclusions and a summary of major policy recommendations.

A. THE LEGAL AND INSTITUTIONAL FRAMEWORK FOR REFORM

Components of the PAR Strategy

3.5 **In June 2003 the Government announced a comprehensive PAR strategy aimed at re-orienting and reorganizing the role and functions of the State Administration** so that they would be more compatible with European standards and principles (see Box 3.1). The PAR strategy covered several inter-related disciplines: state administration, local self-government, public services, and protection of citizen rights. The strategy gave special importance to the harmonization of Montenegrin public administration legislation with that of the *aquis communautaire*. It emphasized the need to build capacity within an otherwise weak public service corps. It also recognized the need to address the administrative structure of Montenegro and to better align State functions with those likely to be required by EU accession.

Box 3.1. Principal Objectives and Measures Envisaged by the Public Administration Reform Strategy

Key objectives of the public administration reform:

- delegation of competencies from higher to lower administrative levels
- strengthening of external and internal administrative accountability
- introduction of client-orientation, with emphasis on competition mechanisms in provision of public services
- strengthening of human resource management system
- introduction of modern information technology
- enhancing the quality of PAR legislation

Key state administration reform measures:

- adoption of state administration legislation in accordance with best international standards and in conformity with administrative systems of the EU countries
- review of the existing administrative functions in order to create effective administrative structures which reflect to the needs of a modern society and would be able to meet the needs of the EU accession process

Source: The Government of Montenegro Public Administration Reform Strategy 2002-09.

3.6 **The first stage of reform, which focused on development of the major laws, has been largely completed** (2003-2004). The second stage (2005-09) has now begun to focus on implementation issues. Consistent with the timelines outlined in the PAR Strategy a set of key public administration laws have been enacted. In particular, the Law on the State Administration, the Law on Ombudsman, the Law on Inspection Control, the Law on Administrative Procedure, and the Law on Administrative Dispute were all enacted in late 2003. The Law on Civil Servants and Employees and the Law on Salaries of Civil Servants and Employees were adopted in April 2004 (see Box 3.2). Adoption of other PAR laws and secondary legislation by year-end 2004 marked the end of the first phase of public administration reform. Since then, the government has focused on adoption of new rules and procedures and on institutional development.

Box 3.2. The Basic Content of the Key PAR Laws

The Law on State Administration clarifies the core functions of ministries and other state administration bodies and establishes clear accountability lines between them.

The Law on Inspection control facilitates introduction of a simple and efficient conduct of inspection of physical and legal person (institutions, state bodies or local government bodies, commercial enterprises etc.) with respect to legality of their actions and with the objective of effective discovering and remedying found irregularities.

The Law on Administrative Procedure regulates the procedure between citizens and administrative bodies when they decide on citizens' individual rights and responsibilities in administrative matters (determine taxes, issue building license, etc.).

The Law on Administrative Dispute regulates the judicial procedure of protection of citizens' rights and responsibilities in administrative matters before the administrative court.

The Law on Ombudsman introduces for the first time in Montenegrin legal system the institution of ombudsman, in order to strengthen the parliamentary accountability of state administration and improve the protection of citizens' rights in their relations with administration

The Law on Civil Servants and Employees regulates rights and responsibilities of civil servants and employees of state bodies providing a basis for creation of depoliticized and professional civil service.

The Law on Salaries of Civil Servants and Employees governs pay levels of civil servants and employees aims at achieving greater transparency and decompression of the salary system.

The Institutional Arrangements for Reform Implementation

3.7 **The Government established in 2003 a high level coordination group,[43] the Forum for Political Coordination of Public Administration, and an inter-ministerial technical committee[44] to support the implementation of PAR.** These new coordination bodies were intended to help overcome the communist-era legacy in which individual ministries are strong, but the center-of-government is weak.[45] The day-to-day oversight of the reform process has been the responsibility of the Ministry of Justice. Throughout the first phase of reform and into the second, it is this Ministry that has been in charge of drafting legislation and preparing other PAR measures. It has had the overall responsibility for implementation of the reforms throughout the public administration. Although it employs officials with long-term and substantive experience in public administration, the Ministry has had few staff dealing with strategic and policy

[43] The group was led by the Prime Minister and consisted of several Deputy Prime Ministers and key Government Ministers (including Justice, Finance, International Economic Relations and European Integration, and Interior, as well as the Secretary of the Legislative Secretariat and Secretary General of the Government). The group was to meet every three to four months to discuss emerging issues concerning PAR.

[44] This Committee was led by Assistant Minister of the Ministry of Justice and comprising senior officials from Ministries of Finance, Interior, International Economic Relations and European Integration, Education, Employment and Social Policy, Agriculture, Forestry and Water Management and representatives of the Legislative Secretariat and General Secretariat of the Government.

[45] Inherent weaknesses of the center of Government stem from traditionally technical role the Secretariats have performed in the communist regime, in which the key coordination body was the communist party itself. Although the situation has significantly changed in the meantime, the center Government structures in Montenegro have still not obtained the role of key Government policy coordinator, which needs to be built up.

planning in public administration reform, and as such, it has not been well-equipped to carry out and oversee extensive reform implementation throughout government.[46]

3.8 **The Government created a Civil Service Administration (CSA) in September 2004 to strengthen the reform management and create specialized expertise.** The CSA, reporting to the Ministry of Justice, is responsible for human resource management and development. After initial difficulties getting started, the CSA is now effectively performing its duties of managing recruitment into the civil service and coordinating training of civil servants – activities which was done in a decentralized manner previously. The continuing performance of the Agency, however, is affected by shortage of staffing and a shortage of technical assistance. The Agency has a systemized level of 22, but only 15 positions are filled. Furthermore, the fact that the CSA has a lower administrative status than a Ministry (i.e., it is subordinate to the Ministry of Justice), has at times undermined the ability of the CSA to push the reform process throughout the government.

3.9 **Though a number of reforms have taken root, on the whole, the institutional arrangements for managing reform implementation are not functioning satisfactorily**. This is in part due to limited capacities of the two key institutions in charge of PAR, the Ministry of Justice and CSA, but even more so due to the poorly functioning inter-ministerial coordination committee. The lack of a tradition within Montenegro of inter-ministerial coordination structures suggests that they require strong leadership to be operational. The Committee functioning has also been exacerbated by the fact that some senior civil servants who were appointed as members of the Committee were moved to different positions within the public administration, creating vacancies that were unfilled as of February 2006. In March 2006, new members of the Committee were appointed, including the representative of the CSA. The Committee has held several monthly sessions since then and created a number of inter-ministerial expert groups for coordination of PAR activities. In spite of these improvements, the role of the Committee in the par implementation has remained limited due to resistance from individual ministries. Therefore, there is an obvious need for a strong political support in the implementation process.

3.10 **To reinvigorate the coordination and leadership of PAR, the following are important steps for the government to consider**:

- For the chairman to provide strong leadership in coordinating activities and assuring support and timely response of the Forum for Political Coordination.
- Provide strong political support for the committee's work, including establishment of performance milestones.

[46] See: Dujic S., "Administrative Reform in Montenegro – State of Affairs and Prospects", *Collection of Papers for the II Conference on Public Administration Reform in Montenegro*, Ministry of Justice of the Republic of Montenegro, 2003.

- Provide technical support and staffing to the Chairman of the Committee, as needed to coordinate activities.

B. Creating the Structures and Incentives for Performance

3.11 **The 2003 PAR strategy recognized that to create a more effective public administration, Montenegro would need structures and policies to attract, retain, and motivate high skilled personnel.** The government has taken some initial steps in this direction but substantial work remains to be done. Macro fiscal pressures, as well as limited capacity within key bodies, are two factors that have had some impact on the pace of reform. However, they do not explain the full story. There have also been policy decisions not to pursue reform as aggressively as may have been possible. Some pay practices and tendencies from the former communist era still persist. Going forward the government will have opportunities to re-orient the pay and promotions systems further towards skills, responsibility, and performance. In particular, restructuring is needed in how base salaries and allowances are awarded for different categories of employees.

Creation of a Professional Civil Service

3.12 **The main achievement in civil service reform has been the establishment of a distinct civil service cadre, with a defined career path and whose recruitment is based on merit.** With adoption of the Law on Civil Servants and Employees, the government brought Montenegro a step closer to European standards of public administration. First, the distinction was made in employment regime between civil servants, who carry out state administration activities, and employees, who discharge only auxiliary functions.[47] Second, the Law requires open competition to be the default method for recruitment, including for top level positions – an important condition for reducing politicization and enhancing professionalism. This prompts the need for strengthening the CSA as a central agency to oversee the competition process which still may be susceptible to inappropriate subjectivity, but it is important that the principle has been established. Third, the law introduces a new classification structure civil servants and employees, including a clear career advancement system based on work experience and performance assessment. Introduction of the new civil service classification structure, required all ministries/agencies to adopt new staffing plans (systematization Acts) based on a new ranking system. Only the Ministries of Interior and Economy had failed to complete their new systemization as of February 2006.

3.13 **The longer term strategic management of the civil service has to be supported by adequate information systems, which are not yet in place**. One of the primary tasks of the civil service administration has been to create a human resource data base to track all public employees and civil servants. That activity has been delayed due to funding shortfalls and the lack of technical assistance. Only in recent months has the tender been issued for the development of such a system. Ultimately, the system is to be used to keep track of performance evaluations, training, and other career related information. However, currently, it is difficult to

[47] The intention was that the civil servants would enjoy more secure employment conditions, whereas employees would be subject to general labor code conditions, enabling greater flexibility in staffing. In practice this distinction in employment security has not been realized. Through the collective bargaining process, public employees were granted many of the same guarantees as civil servants.

obtain more basic information – such as a reliable headcount of the number of public servants, where they work, and their compensation. Information is dispersed in different systems that are not easily reconcilable or that provide a basis for cross-sectoral analysis. To develop effective medium term planning and compensation policies that support it, more comprehensive and accessible systems of information are needed.

3.14 **The key recommendations are**:

- *Complete the "systemization"*[48] *for the Ministries of Interior and Economy immediately so that they are put on the new wage structure*. In addition, government should review across sectors to assure that current job holders have the qualifications that match their pay level.
- *Create greater distinction between the core civil service and other public employees (including teachers).* Differences in responsibility and job protection have not been emphasized in the law, thereby nullifying many of the primary factors for creating a separate civil service. As those distinctions are brought out, so will the justification for civil servants to have higher pay. Moreover, the public administration would benefit from having greater flexibility to change the composition of its work force.
- *Reassess whether the requirements for each grade are appropriate to facilitate recruitment of highly skilled entrants into the civil service.* Experience thresholds for the higher grades could be a barrier to external recruitment. A more flexible or alternative track may be needed to attract highly skilled university graduates (especially those with graduate degrees) into the civil service.
- *Develop a human resource information system that can be used in strategic management of the public service.* Such a system should enable linking of personnel information (e.g., educational background, performance information) with payroll data, including allowances. The database should be used in planning future staffing requirements, training, and costing of medium term pay strategies.
- *Monitor and assess progress in building a more skilled civil service*. Though the policies are intended to help improve capacity within the public administration, indicators should be agreed for how government will measure progress.

Making Pay More Competitive and Motivational

3.15 **Reform of the pay system has not progressed as far as will be needed to support long-term capacity building**. Recruitment of skilled staff is often cited by government officials as one of the major challenges they face in implementing reforms of the state administration. Despite this, there have been only modest changes in the overall pay structure and pay strategy. No data is available to indicate the overall competitiveness of salaries vis-à-vis the private sector, or how the level of competitiveness might change depending on skill level.[49] In fact, the critical

[48] This is a process of determining organizational posts and positions with treasury authority.

[49] In many countries pay for lower skilled positions is much closer to the private sector average than is the pay for more high-skilled, professional positions. There is little reason to believe that this pattern does not hold in Montenegro as well.

needs for the public administration rest with the more technical, professional, and managerial posts. Flat rate increases in the public administration salaries—such as that implemented in 2006—have only modest impact on competitiveness of these skilled positions.

3.16 **Transparency of pay practices has increased moderately, although the biggest source of supplemental income is largely unreformed**. An especially important change that was implemented was the centralization of the pay system, giving the Ministry of Finance the authority to issue payment decisions for the fixed part of the salary for each civil servant and employee. Previously, these were issued by each Ministry/other administrative body separately, which led to a highly opaque system and permitted a level of subjectivity into pay decisions. According to the Law on Salaries the only other incomes are from severance pay, holiday pay, and death or family illness benefits. However, outside of the Law on Salaries the government continues to operate a policy of distributing apartments or housing to civil servants. Although official notices are posted on the distribution of some apartments, the criteria on which the decisions are made do not appear to be transparent to most civil servants. Nor is their any assurance that some apartments are not given away without public disclosure.

3.17 **Salary levels have improved slightly for skilled positions, but resources could be better targeted in order to accelerate reforms**. To increase incentives for staff to pursue a civil service career, the new law increased the base salary compression ratio within the civil service from 4.1 to 5.1. The main reason for limiting the rate of decompression was because of macro-fiscal pressures to contain aggregate wage bill spending as a share of GDP. The Law requires the Government to annually review this ratio with the intention of further decompression of the system, but it is not clear what significance this provision will have in practice. In 2006 the government introduced increases in the "base rate" of labor, which results in a flat rate percentage increase for all salary positions. Though it is understandable why this is important to public sector unions, it represents a missed opportunity for government to engage in further decompression. In addition, the salary structure does not make any significant distinction in pay between public employees and civil servants with the same qualifications—even though the later are assumed to bear higher levels of responsibility.

3.18 **Salaries for Members of Parliament and high office holders were increased under separate legislation, but the process has raised concerns about internal equity**. In December 2005, the Law on Salaries and Other Earnings of MPs and Other Officials was adopted. Though the draft legislation covering pay for civil servants had been developed by the Ministry of Justice, the proposals under this law were not prepared by the same technical group. The levels of pay that were proposed in the law tend to be substantially higher than those for even the most senior civil servants.[50] There was concern expressed that this could have a de-motivating effect on the civil service, especially those working most closely with office holders. Furthermore, there has been sentiment expressed that the relative differences in pay between the judiciary and the MPs and office holders may not accurately reflect the levels of expertise and responsibility

[50] As a point of reference, in the US the highest level civil servants have salaries that are comparable to those of Members of Congress.

required for each.[51] As with the senior civil service, there is some concern that this could have a negative effect on motivation and performance within the judiciary.

3.19 **The concept of performance based pay has been established in law, but it has not yet been tested in practice.** Once implemented, the law will link pay and performance in two ways: (a) promotion to a higher salary grade (if an employee over three consecutive years gets the appraisal mark “good”, or achieves the appraisal mark “excellent“ at least twice during the period) and (b) a bonus which is awarded for excellent performance at the end of the year. This variable pay component will be determined by the head of the administrative body, instead of the Ministry of Finance. The total amount of resources for the bonuses will not be permitted to exceed 10 percent of the resources planned in the budget for the civil service wage bill in the previous fiscal year. Implementation of the performance pay initiative is dependent upon having a functioning performance appraisal system, a task which has not yet been implemented.

3.20 **Resources that could be used to recruit or motivate highly skilled civil servants are instead used to sustain an overly generous allowance for employees with long tenures.** Although it is common within the public sector to give salary adjustments based on the length of employment, in Montenegro the magnitude of the allowance makes it costly and highly distortionary to internal equity. Data obtained from the MOF does not allow one to see exactly what proportion of aggregate base salary goes to support the allowance. However, the benefit structure is very generous compared to other countries—even those from the former Yugoslavia.[52] At 30 years of service, the allowance is equivalent to about 22 percent of base salary. In contrast, a promotion within the civil service results in a base salary increase of only about 5 percent. Consequently, it is possible for two people with very different levels of responsibility to make the same amount of money—thus distorting internal equity. All employees receive the allowance regardless of performance, thereby undermining the concept of performance-base pay. Moreover, keeping the allowance as it is means there are fewer resources to make base salaries competitive for potential new recruits, and fewer resources with which to make promotions meaningful.

3.21 **Although the Law on Salaries of Civil Servants and Employees established a good foundation for the management of the civil service pay, several actions are needed going forward**:

- *Decompress the salary structure further without significant increases in the overall wage bill.* Despite modest progress in 2005, the system is still highly compressed, which will continue to make recruitment and retention difficult. It is likely that further decompression will entail fiscal pressures, but it is important for the government to achieve decompression with little overall impact on wage bill. This could be achieved by focusing increases toward the skilled and professional civil service positions. Reliable data on public-private pay comparisons are needed before additional increases for low-skilled positions can be justified.

[51] In contrast, in Canada and the US the salaries for members of the legislative body are significantly lower than those of judges on the Supreme Court.

[52] Beginning at 10 years of service one receives an extra 0.75 percent of base pay (up from 0.5 percent), and after 20 years the increment jumps to 1.0 percent. In Serbia and Bosnia the increment never exceeds 0.5 percent.

- *Revise the approach to collective bargaining with public sector unions to take the emphasis off changes to the base rate*. Negotiated increases in the base rate of labor lead to across-the-board increases in the wage bill and erode the fiscal margin that the government otherwise might have to decompress the salary structure.
- *Progressively reduce the impact of seniority in the calculation of total pay*. While it is common within the public sector to adjust pay based on the years of experience, seniority has too large an impact in the Montenegrin system, especially given the compressed base salary structure. Those with the longest tenure will not necessarily have the most needed skills, and the continuation of the current system undermines performance-based principles. Since the bonuses are part of the General Collective Agreements that government signs with unions, it is essential that changes are sought and initiated at this level. One initial step would be to cap the amount one can receive within a given grade level. The next step would be for government to reduce the amount of the allowance and offset it with an increase in the base salary structure.
- *Review consistency between pay practices for senior civil servants, judges, and those of office holders*. Pay levels should reflect the relative levels of responsibility and expertise required. Future salary laws should take into account pay practices across different categories of positions to assure that the entire system is internally consistent. Otherwise, one may have a de-motivating effect on the most skilled.

Introduction of the Performance Appraisal System

3.22 **In 2005 the CSA undertook extensive preparation of a performance appraisal system, although implementation will require more time and more buy-in from line ministries.** The Law on Salaries required that civil servants and public employees be evaluated on their individual performance no later than January 31, 2006. Compliance with this provision of the law has not yet been achieved, in part due to resistance of Ministries and other organs to comply with the law. Equally significant was the difficulty of designing and implementing the system for the very first time. With the help of limited technical assistance, the CSA developed the performance assessment questionnaire and conducted training for focal points in each ministry/organization. Procedures were also developed for the review of the assessments and an appeal mechanism was developed. However, as of February 2006, there were still civil servants who were unaware of the process or how it was to function. In early June 2006, only 30 percent of Ministries and other organs have completed performance assessment of their staff.

3.23 **Lessons from the initial phase of implementation will need to be studied carefully and incorporated into future design**. The CSA organized several workshops with its focal points in the line ministries to discuss their experience. The meetings were supported by international and local EAR experts who are providing technical assistance to the CSA. One of the key challenges going forward will be to assure credibility of the system and the fairness of the ratings. It is not unusual in most organizations to find some managers that are very critical in their evaluations and others that will give high ratings to all employees instead of making distinctions in performance. Training of managers on how to use the forms and how to give feedback is essential, as is thorough communications to staff about the new appraisal system. Implementation of the performance appraisal system may have been rushed in order to meet the deadline in the law, even though some important preparatory elements were missing. In contrast, performance evaluations for senior civil servants—which were to involve a separate form—were not initiated at all.

3.24 **Even with a performance appraisal system, payment of bonuses should not be treated as a substitute for improving the base salary structure**. While there is good rationale for incorporating bonuses as part of the overall compensation package for civil servants, there is substantial need to enhance base salary as well. The bonus should play a relatively limited part in the total compensation for a civil servant (generally not more than 10-15%). This is all the more important because performance appraisal systems are challenging to implement in many organizations. If base salaries were more closely linked to actual job responsibilities, it would also help provide an incentive for performance. As noted previously, the link between pay and responsibility is weakened by the inclusion an allowance for length of service. Decompression will also give promotion more significance because the jump in pay would be more substantial.

3.25 **Notwithstanding the urgency to implement the system, thorough and systematic preparation of line ministries will be needed to assure implementation**. In anticipation of the 2007 performance appraisals, the CSA should enhance the resources devoted to implementation, refine the overall approach to setting and reviewing expectations, and deepen training. Specifically, the CSA should:

- Help managers to establish expectations for civil service performance prior to the rating period.
- Invest in training managers on how to give feedback effectively and constructively.
- Develop internal communication tools to assure that staff understand the performance appraisal system and the appeal mechanisms that are available.
- Establish guidelines to prevent bias in ratings across departments or ministries.
- For senior civil service positions assure that organizational or departmental goals are well-defined and that the expectations for individual performance are linked to them.
- Conduct a thorough review of the 2006 evaluation process (with help from external technical assistance) and incorporate the lessons into the timetable and sequencing for 2007.

C. ASSURING ACCOUNTABILITY OF THE PUBLIC ADMINISTRATION

3.26 **An Administrative Court was established over one year ago, with the mission of reviewing the legality of administrative acts of the ministries and other public bodies**. Judicial control of administrative action is not new to the Montenegrin accountability system, as the control of administrative action has traditionally been provided through the judicial review procedure before the Supreme Court. However, upon its establishment, the Administrative Court took over a number of administrative cases from the Supreme Court, which resulted in a significant number of backlog cases.

3.27 **The Court has achieved noteworthy results in a relatively short time of operation**. However, its long-term effectiveness depends on a better match between its resources and its case load. The Court began operated much of its first year with only 3 judges, but it now has a complement of six judges that can form two panels. (An additional judge was to be added sometime in 2006). The court has published a manual for judges and has produced an annual report on its activities. It has settled about 850 cases in the past year, although it still maintains a substantial backlog due to the cases transferred from the Supreme Court. It also continues to get a steady inflow of new cases, not only in 'classical' administrative matters, but also on electoral disputes, disputes arising from violations of the right to free access to information, and so on. (See Table 3.1) Due to its small numbers of judges, the Court has not had specialists in particular fields of law; instead it has relied on the judges to inform themselves on a wide range of different legal codes. To enable smooth functioning of the Court in the future and timely dispute resolution, a moderate increase in the number of judges and judge assistants should be considered.

Table 3.1. The Number of Solved Cases before the Administrative Court in 2005

Type of case	State of affairs at the beginning of 2005	The number of cases received until 31.12.2005.	The number of cases dealt with until 31.12.2005	The number of solved cases by 31.12.2005	The number of unsolved cases on 31.12.2005
Administrative Dispute	834	1345	2179	746	1433
Request for extraordinary review of final misdemeanor decision	6	17	23	13	10
Request for protection of legality in misdemeanor procedure	-	81	81	76	5
Various administrative matters	2	-	2	-	2
Entry into voting register	-	444	444	444	-
Total	842	1887	2729	1279	1450

Source: First report of the Administrative Court of Montenegro, January 2006.

3.28 **The Office of the Ombudsman, in operations for two years now, has also been building an increasing level of awareness among the public about the purpose and function of the office**. In its most recent year, the Ombudsman received about 660 complaints, most of which fell within its area of competency. This is an improvement over the first year of operation when there were common misunderstandings about the purpose of the court (e.g., that it could overrule court decisions). The Ombudsman's public relations and outreach include an annual report, informational brochures, and visits to municipalities (referred to as "Days of the Ombudsman"). Up to now, the Ombudsman has produced two annual reports, informing the Parliament of its activities in the previous period. The first report was reportedly well received by the Parliament, while the second one is waiting to be discussed.

3.29 **Most citizen complaints to Ombudsman relate to delays in the administration of justice**. However, the Office of the Ombudsman has not limited itself to only responding to citizen complaints; it also proactively gives opinions on the public administrations compliance with the law. Its opinions have covered topics such as land laws, citizenship for refugees, prisoner rights, and child protection. Opinions on the public administrations conformity with the EU laws is also an area of future interest to the Ombudsman. The Office of the Ombudsman has had good cooperation from State agencies and courts in resolving complaints and has enjoyed strong support from Parliament (both the governing coalition and opposition).

3.30 **Looking forward, Government could strengthen its new institutions of accountability in the following ways**:

- *Strengthen the capacity of the Administrative Court to render decisions on a timely basis to preserve the integrity of the system*. To that end, the staffing resources (either in judges or judicial support) should be expanded to help clear the back log of cases and to keep up with the flow of new cases that come in.

- *Enhance the budgetary independence of the Ombudsman*, possibly giving a Parliamentary committee responsibility for determining its budget allocation.

D. Organizational Challenges to Sustaining Reform

3.31 The 2003 PAR strategy provided a vision for restructuring the State Administration in order to foster harmonization with external bodies such as the EU and to enhance the effectiveness of internal relationships within the Republic. In the three years hence, substantial progress has been made to put institutional and legal structures in place. But adoption of laws must be followed up by consistent and high quality implementation. Critical decisions need to be taken now in order to strengthen the process of implementation in the years ahead.

3.32 The EU agenda and the need for internal restructuring of the public administration will become increasingly complementary. With spending on the public administration already quite high by EU standards, future capacity building efforts will become contingent on finding savings within the current budget levels. While the first phase of the PAR resulted in the adoption of European principles of administrative structure, the next phase must focus rationalizing the activities of the public sector and streamlining inefficient administrative functions. Achieving this transformation will likely require a stronger center-of-government policy coordination mechanism than is currently in place.

Addressing Structural and Organizational Fragmentation

3.33 **During the first phase of structural reform, the government focused on clarifying the relative roles and accountability between government ministries and other State administrative bodies**. The Law on State Administration introduced a general separation between policy-making bodies (ministries) and policy-implementation bodies of the state administration (e.g., secretariats, directorates, administrations, services, and agencies).[53] Consistent with the organizational principles established by the new Law, Government adopted its current organizational structure in 2004 through issuance of the Decree on Organization and Activities of State Administration. The Decree identifies a list of functions for individual Ministries and other state administration bodies. Pursuant to the Decree, Montenegro now has 15

[53] Whereas secretariats, directorates, administrations and services represent "classical" public administration implementation bodies, the agencies operate at arms length from the Government, with the right to have their own sources of finance. One of the implications of this, is that agencies are able to compensate staff at higher rates than possible within the civil service.

ministries, 12 administrations, 2 secretariats, 7 services and 4 directorates. More importantly, the Decree clarifies the accountability relations between different bodies (e.g., the Civil Service Administration and the Penitentiary Service report to the Ministry of Justice, as presented in Table 3.2), which in turn should enhance the effectiveness of the overall system.

Table 3.2. Accountability Lines between Different State Administration Bodies

Ministries which oversee work of different bodies	**Bodies which report to the designated Ministries**
Ministry of Justice	Civil Service Administration Penitentiary Service
Ministry of Finance	Tax Administration Real Estate Administration Customs Administration Anti-Corruption Initiative Administration Anti-Money Laundry Administration
Ministry of Education and Science	Bureau for Education Service (Institute) Vocational Education and Training Center Examination Center
Ministry of Culture and Media	State Archive
Ministry of Economy	Directorate for small and medium size enterprise development
Ministry of Maritime and Traffic Affairs	Naval Safety Administration Directorate for State Roads Directorate for highway Construction
Ministry of Agriculture, Forestry and Water Management	Veterinary Administration Forestry Administration Water-management Administration
Ministry of Environmental Protection	Hydro-Meteorology Service Seismology Service Directorate of Public Works
Ministry of Labor and Social Protection	Administration for Sport and Youth Statistical Service (Office)
Ministry of Interior	Police Administration Agency for National Security

Source: Government Decree on Organization and Activities of State Administration, Official Gazette of Montenegro, No. 53/2004, 61/2005, 06/2006, 32/2006.

3.34 **Some substantial functional areas are not adequately addressed through the existing legislative framework and should be reviewed to assure that proper accountability exists**. For example, Government's employment, health, and pension insurance funds are not governed by the Law on State Administration, but have a distinct legal status defined by separate laws on health and pension insurance.[54] As mentioned in chapter 4, these funds represent a substantial share of public outlays and contribute to fiscal risk for the Republic budget. Furthermore, Montenegro has a number of independent regulatory bodies which are not governed by the Law on State Administration, but operate in accordance with the laws that establish them.[55] These

[54] The World Bank Policy Note, Serbia and Montenegro, Public Administration Development: Creating the conditions for effective economic and social reform, 2004.

[55] These are: Telecommunication Agency, Agency for Restructuring of Economy and Foreign Investment, Broadcasting Agency, Agency for Foreign Investment Promotion, Regulatory Agency for Energy.

agencies operate at arms length from the Government and are able to have their own sources of finance, often used to reward their staff beyond what is feasible within the civil service. There is still no overall legal framework for establishment, management and dissolution of regulatory agencies, which creates legal uncertainties in their functioning. Since the criteria for establishment of different state administration bodies and regulatory agencies are not very clear, his creates an incentive for establishing additional agencies (instead of ministries or policy-implementation bodies), due to better pay and benefit opportunities.

3.35 **A high level of fragmentation still persists within the State Administration because the horizontal functional review envisaged by the PAR strategy has not been carried out**. Such a review would lead to abolishing unnecessary functions of existing bodies and merging a number of small bodies which cannot justify their separate existence. Up to now the impact of the Law on State Administration and the Decree on State Organization and Activities has been limited because modern principles of public administration were superimposed on outdated institutional structures. There was no effort to review whether the state administration should be carrying out certain functions or whether the functions could be organized more effectively.[56] As a result, a relatively under-developed central apparatus of the state administration is increasingly incapable of coordinating and managing a plethora of subordinated institutions. This in turn weakens the overall governance process and adds an unnecessary administrative cost to running government

3.36 **Building new or additional capacity in areas required by the EU will necessitate making trade-offs across functions of the public administration**. As noted in chapter 2, the government spends a very high share of GDP already on wages and salaries of civil servants and other public employees. Despite the high cost, a number of core functions suffer from low very capacity according to the EU's progress reports and from the slow pace of reform implementation. Highly skilled people are present within the public administration but not in the numbers needed to sustain reform implementation. Several new bodies are below their authorized staffing levels, while some long-established institutions/ministries have people with the wrong mix of skills. Anecdotal evidence suggests that there are still overlapping and inefficient functions because of the high degree of fragmentation in the administrative structure, and that has yet to be addressed.

3.37 **A few major sectors should undergo a vertical functional review in order to make them more cost-effective**. The PAR strategy had an over-arching goal to make the public administration more efficient and effective. Moreover, to create fiscal space to expand capacity in high priority areas, will require freeing up resources from activities that over-consume budget resources. The vertical functional reviews could be carried out immediately after or in parallel to the horizontal functional review. The choice of the institutions to undertake the review should depend on the importance of the sector to the overall budget and on the EU accession. Data in chapter 2 indicated that there are 3 or 4 sectors where the level spending is relatively high compared to EU levels (as a share of GDP). The management of such a review would need to be given to an expert team, comprised of both international and local experts, as well as government representatives. If overall oversight of the review is assigned to the Ministry of Justice (because

[56] The existing fragmentation may be a result of the relatively long period of coalition politics, during which different parties have tried to secure their share in power by establishing new administrative bodies.

of its current role responsibility for PAR implementation), then it would need additional technical capacities, but more importantly it would require strong political and technical support from the Forum for Political Coordination of PAR.

3.38 **Reforms in the budget process, including the implementation of a medium term budget framework, are needed to support the functional reviews**. For the functional reviews to be effective they need to be linked to the budget process in several ways. First, to establish a genuine prioritization of activities and goals, the process must be guided by a resource constraint or target level of savings. Secondly, government decision-making would benefit from tools to assess the relative costs and goals of various functions and sub-functions. The efforts within MOF to develop program budgets could help facilitate the trade-offs by providing information that links specific policy goals with their resource costs. Third, to implement cost-savings measures in the ministries and other administrative bodies, the Government should adopt a medium term budgeting horizon. (See chapter 4.) This would be necessary to signal the structural or policy changes that are to occur, and to give institutions sufficient time to plan their implementation, including changes in the size of their human resources.

Meeting the Demands of EU Integration

3.39 **The institutional mechanism for coordinating EU negotiations has been adequate for supporting the initial phases of the stabilization and association process (SAP).** In 2003 the Government established the Ministry of International Economic Relations and European Integration. Montenegro is one of the few states to adopt a 'specialized ministry' system to lead the accession process.[57] This model offers some advantages, such as specialized management capacity, but it also presents challenges with respect to dissemination and spread of EU knowledge and practice across government institutions. Although the Ministry of European Integration is very small in terms of staffing, it appears to be playing an effective catalytic role in coordinating government's preparation for EU accession. A new unit in the Ministry has been authorized to check the legal compliance of national legal acts with the *acquis communautaire*. This function had previously been assigned to the Legislative Secretariat.

3.40 **In order to facilitate the coordination of the EU accession process, several additional institutions were created in 2004**. The Government first established the Council for European Integration,[58] as a high level political advisory body providing strategic guidelines to the Government and administrative bodies on EU integration. The Government further set up a Commission for Coordination of the SAP, which comprises senior officials from all Ministries, who hold regular monthly meetings to follow-up on the EU accession progress and resolve inter-ministerial issues. In addition to this, contact persons for EU integration have been designated in all Ministries and other administrative bodies. EU contact persons are in charge of coordination and promotion of activities related to EU accession process and for setting the basic internal institutional structure. Furthermore, permanent working groups on EU integration issues have

[57] The two usual European models are that the management and coordination of EU affairs is given either to the Prime Ministers Office or to the Ministry of Foreign Affairs. Other examples include Croatia and Serbia, where a specialized ministry is in charge of the EU accession process.

[58] This body consists of President of the Parliament, President of the Republic, Prime Minister, the President of the Supreme Court and other highly positioned personnel in Montenegrin state.

been formed in all key Ministries to facilitate internal coordination on EU affairs within those Ministries which currently have most complex tasks in the accession process.[59]

3.41 **Montenegro's independence will simplify some aspects of the SAP, but it will add new costs as well**. Under the EU's twin-track approach for the two republics, Montenegro had responsibility for roughly 80 percent of the negotiation package (related to internal market, trade and customs policy), while the remainder was in the hands of Union level institutions (related mainly to political requirements, human rights issues and cross-border coordination). Montenegro therefore carried out negotiations both at the Republic level and the Union level. With independence, the Montenegrin state will have to transfer and/or strengthen certain functions from the Union level which currently do not exist in Montenegro. These functions include intellectual property rights protection; standardization of products, processes and services and accreditation systems; visa, asylum and border management; national statistics; civil aviation; and meteorology. At the moment, these functions are performed by several bodies under the Union Ministry of Internal Economic Relations and do not have an equivalent in the Montenegrin administrative system. During the last year, the Ministry of Economy established a department for Intellectual property which has only just started to build capacity for carrying out comprehensive intellectual property rights activities. Continuous attention will also be needed to establish the complex functions of standardization and accreditation; strengthening of the national accounts data and statistics; and border control and immigration.

3.42 **EU accession will require Montenegro to reexamine the structure and composition of the public administration in ways that have not been fully estimated to date**. The *acquis* will most certainly require building institutional capacities that are not fully developed currently. The fiscal implications of compliance with the *acquis*, however, need to be studied so that Government can adopt an appropriate strategy. With limited fiscal space, Government should eliminate left over structures from the previous system of governance, in which the role of the state was heavily involved in economic management and direct delivery of services. In this regard, it will be important to assess whether the employment levels of various ministries adequately reflect the longer-term priorities of the government. The government could benefit from also examining the experiences of other small EU accessions states (e.g., Malta, Lithuania, Estonia) to gauge the administrative capacity that will be needed.

3.43 **The current institutional structures for managing EU accession are probably inadequate to champion the administrative transformation that is needed**. One of the aims of the PAR strategy has been to develop an "understanding of the functioning of the administrative systems of the EU." This initial phase has involved a process of information gathering and dissemination of EU standards and practices among the various Montenegrin institutions. The more challenging task ahead is in adapting the structures public administrative system to those required by EU integration – building capacity where it does not exist and in managing the process of reform. It is not apparent the Ministry of International Economic Relations and European Integration is best suited for this role. In the short term, the Forum for Political Coordination of Public Administration needs to play a more active role in driving

[59] Ministries in which the working groups have been established are: Ministry of Justice, Ministry of Economy, Ministry of Agriculture, Forestry and Water Management and the Ministry for Environmental Protection and Physical Planning.

administrative restructuring. This is especially the case when EU accession may require making difficult resource trade-offs across institutions and functions. Over the medium-term, however, Government should consider strengthening the center-of-government institutions so that they assure a more effective policy planning and coordination function.

3.44 **Civil service reforms will need to be elevated to a more strategic role in order to support EU integration processes.** As noted in the previous section of this chapter, the reform of the civil service has progressed very slowly. Although a separate cadre was established with merit-based principles of recruitment, the impact has yet to be realized. Critical functional areas still suffer from low capacity. Despite some progress, the current pay systems are not adequately designed to recruit or retain the skills that are needed to support EU accession processes. Changing the current incentive structure—which strongly favors long-tenured employees over new ones—is likely to require a higher level of political support than has been realized to date.

E. Conclusions and Recommendations

3.45 **Public administration reform has been progressing in Montenegro with mixed success – the main achievements being centered around the establishment of new laws and new institutions**. Since 2003 all the major pieces of legislation envisioned in the PAR strategy have been adopted, including the Law on State Administration which helped clarify the responsibilities of various state bodies. The Administrative Court and the Office of the Ombudsman are now functioning and represent significant steps to assuring accountability of the public administration. The newly created Civil Service Administration is working to create a merit-based civil service, while the Ministry of International Economic Relations and European Integration has assumed responsibility for the EU accession process.

3.46 **Despite the legal foundations for reform being set in place, the real impact on public sector effectiveness remains to be seen in practice**. A number of important functional areas still suffer from weak capacity. Implementation of the Law on Salaries is intended to help, but the changes thus far have been too small to have a major impact on government's ability to recruit and motivate highly skilled staff. While efforts have been underway to develop a performance-based pay system, the current practices still give heavy emphasis to tenure and no steps have been taken to reduce this. Across-the-board wage increases negotiated with public sector unions have eroded some important fiscal space needed to decompress the salary structure.

3.47 **Over the long-term, Montenegro faces continued challenges to simplify and streamline the state administrative structure**. Overlapping responsibilities and fragmented organizational structures are an impediment to effective policy coordination and increase the cost of government. The inter-ministerial committees have not been an adequate substitute for a stronger center-of-government coordination. Going forward, the Government should build on the existing Law on State Administration and conduct a horizontal review of government functions that leads to streamlining ministerial accountability and setting of government-wide priorities. This should be supported by efficiency reviews within a few major sectors, especially where costs appear to exceed the levels common in EU countries. Introduction of program budgeting (see Chapter 4) should help to clarify the current priorities and facilitate trade-offs. Given the macro-fiscal constraints faced by Montenegro, areas that are vital to EU accession can only be enhanced by shifting resources (human and financial) away from the lower priority functions and inefficient functions.

3.48 **In summary, key areas of priorities over the next two to three years should be to**:

- Develop a medium term civil service pay strategy that will lead to decompression of the salary structure for positions that are most difficult to recruit and retain and that can be implemented within a fiscally sustainable resource envelope.

- Reduce the impact of seniority-based allowances on total civil servant pay and restructure the collective bargaining process to facilitate future policy reforms.

- Enhance the capacity of the CSA (e.g., through staffing, technical assistance, etc.) to implement a credible performance appraisal system and to follow-through on other outstanding civil service reforms within a realistic timetable.

- Strengthen the institutional arrangements for overseeing and managing PAR implementation, including development of a sequenced action plan and resource implications.

- Develop a consolidated human resource data base for planning and managing the composition of the public service

- Plan and undertake a horizontal review of government functions and activities with the aim to abolish "left-over" structures from the previous system and to strengthen capacities in the functions and activities most needed to support effective EU integration. Integrate the horizontal reviews into the ongoing budget reforms lead by Ministry of Finance.

- Plan vertical functional reviews of three to four major sectors or functions in order to reduce inefficiencies and identify potential savings

- Carry out a comparative assessment of how the EU integration process has been managed in countries of similar size (e.g. Lithuania or Estonia).

4. PUBLIC FINANCIAL MANAGEMENT AND PROCUREMENT

A. INTRODUCTION

4.1 While reforming public administration, Montenegro would also need to strengthen its budgetary processes and institutions to ensure transparency, accountability and better public sector governance. Effective budget management, including medium-term sectoral plans tied to the budget, is central to maximizing the impact of current public expenditure on service delivery.

4.2 **Montenegro has made a significant progress in public financial management reforms in recent years**. The MOF has developed clear and comprehensive budget documentation that provides the appropriate context and assumptions for budget policy. Budget execution has been aided by a fully functioning Treasury system, which is linked to all of the major budget users. Forecasts of revenues and expenditures seem within a reasonable margin and the MOF has been able to execute the budgets with modest variation at an aggregate level. Although some modest shifts in composition of spending as well as arrears are noticeable, these could be addressed through better planning in the future.

4.3 **While some of the basic features of good budget preparation and budget execution are in place, several challenges remain**. One challenge relates to the implementation of program budgeting. Introduced as a pilot program in a couple of ministries in 2004, program budgeting seems to have suffered from a lack of clarity over what fundamentally is expected to change about the budget process or in the relationship between MOF and the line ministries. Although the number of ministries with "program budgets" has expanded over the past three years, and a comprehensive extension of program budgets to all ministries is planned in 2007, the depth of change induced by such budgets remains shallow. As a result, the process is yet to have a substantial impact on policy planning and prioritization across government.

4.4 **A second important challenge relates to the development of a medium term budget framework to strengthen the linkages between policy, planning, and budgeting**. Effective planning of capital investments would especially benefit from having such a budget framework. While the current medium term fiscal framework is a good foundation on which to build, the MOF would need to extend the medium term budgeting framework to all budget users, including the extra-budgetary social funds. Ministries and budget users will need to develop indicative levels of spending by sector or consolidated programs. Capacity constraints within the MOF and other line ministries are likely to be daunting challenges both to do the program budgeting well and to move towards a medium term expenditure framework.

4.5 **A third challenge is to ensure that resources devoted to oversight and accountability institutions are significantly expanded**. Although internal audit, external audit, and public procurement commission have been established and are functioning, their longer term effectiveness will require better staffing, training, and infrastructure. With regard to internal audit, there is a need to expand the IA functions beyond the Ministry of Finance and build capacity for internal audit within line ministries.

4.6 This chapter is organized as follows. Section B discusses budget preparation issues, in particular the transparency and comprehensiveness of the budget, the reliability of the budget, program budgeting and medium term budget planning. Section C discussed budget execution and cash management. Section D discusses public procurement. Section E focuses on internal and external audits, and the last section offers conclusions and recommendations.

B. BUDGET FORMULATION

4.7 **Montenegro's Organic Budget Law, adopted in 2001, provides a framework for budget formulation and execution.** The Law assigns responsibilities to the Ministry of Finance (MoF) to issue detailed subordinate regulations to guide the processes. The MoF is responsible for managing the budget preparation process for the central government. The budgets of municipalities and social funds are prepared by their respective bodies.

4.8 **The budget preparation process begins in June with the preparation of the macroeconomic and fiscal policy framework for the next fiscal year, which in turn defines the overall budget resource envelope**. The MoF then issues circular instructions, for each spending agency and the formats for budget submission. The spending agencies then prepare their budgets according to the format provided by the MoF and submit their budgets to the MoF in September. Budget planning at the spending agencies is based mainly on historical costs and future projected needs. The final budget allocation outcome would involve negotiations. After negotiations, budget analysts from the MoF work with the budget officer of the respective spending unit to fit demands within the approved level of spending. The consolidated draft budget is then approved by the Government and forwarded to the Parliament in November for voting. The voted budget is published in the official Gazette to inform budget users and citizens of budget allocations.

Transparency and Comprehensiveness

4.9 Montenegro's budget for 2005 contains tables with the consolidated budgets of the central government and social funds, and a new harmonized chart of accounts is being implemented that would allow for the consolidation of municipal budgets into the general government budget as well. The budget, however, is still not fully comprehensive as it does not include municipalities.

4.10 **In general, the Montenegrin budget presents a clear and detailed description of planned spending for the budgeted year**, as well as the macroeconomic and fiscal assumptions that underpin the spending proposal. The structure and clarity of budget documentation submitted to Parliament is essential to assure that budget decisions are transparent to the public. The budget is accompanied by very good narrative that explains some of the major changes from the previous year both on the revenue and the expenditure sides. A comprehensive summary table is included that shows the economic classification of revenues and expenditures for four years – the budget year, the current and prior years, and one year into the future. The same table shows the planned deficit and the levels of financing that will be required. There is detailed reporting on special funds (namely the pension and health funds), as well as the financial activity of local government. Summaries are presented on types of revenue and sources of financing.

4.11 **On the whole the budget documentation is very thorough and well done**, however, some analysis could be added that would aid in the review and scrutiny that Parliament should be carrying out. Four refinements stand out that government may wish to consider to enhance the current budget documentation:

- Include columns in the budget that enable comparison with the current budget estimates and the prior years executed budget. Currently, one would be required to compare them manually by holding it with the current year's budget document and the prior year's audited financial report. If there are any mid-year revisions to the budget those should be included as well.
- Include summary tables in the document that provide an overview of aggregate spending categorized first by budget user and secondly by economic classification. This should also be done with the current year and prior year's figures shown in comparison. The intent is to help users of the budget see how the proportion of spending may have changed, and to see where the larger increases have been.
- Provide a narrative commentary on how the budget allocations have changed compared to the current year and the major policy changes that they reflect. The link between the policies and the allocations is somewhat weak because government's policy priorities are expressed only in a very broad terms.
- Have additional information on the progress of capital investment projects. Where there is spending on capital investment, it would be useful to include an annex that describes the projects, whether they are new or existing, and the proposed expenditures for the budget year and the future years until completion.

4.12 **In terms of coverage, however, the current coverage of the fiscal accounts does not yet provide an adequate basis for formulating fiscal policy and identifying fiscal risks**. The fiscal coverage in reports published by the government includes extra-budgetary funds and partial information on local government, but excludes the SOE sector. Furthermore, all local government liabilities are not reported in the public sector debt statistics. Thus, the government is not in a position to identify key fiscal risks that may be arising from local government and SOE operations. The fiscal risks posed by local government and SOEs are further discussed in detail in Chapter 6.

Budget Credibility

4.13 **The out-turn data show the budget is credible**. The capacity to implement the budget as planned is key performance criteria for well-functioning budget system, and it is generally one that Montenegro does well on, especially at an aggregate level. Audited reports for 2004 and preliminary data for the 2005 budget year show that the Montenegrin budgets are generally executed as planned. In 2004 actual budget execution was about 98 percent[60] of the planned

[60] This is a simple average of the ratio of outturn to planned budget across all economic classification items.

amount (EUR 439 versus 449), and a similarly high level is expected for 2005. Despite variations that occur across economic classifications and across ministries, the annual budget appears to be a credible representation of government's spending priorities for the year. Apart from the decision in 2004 to repay credits to financial institutions, there was no major over-spending either by economic classification or by ministry.

4.14 **Notwithstanding the aggregate stability, some significant shifts in the composition of expenditures sometimes occur that could undermine the quality of public expenditure in the future**. Two categories of expenditure that suffered in 2004 were "cost of recurrent maintenance" and "investment maintenance of infrastructure." While it is not uncommon among governments to reduce maintenance spending when there is a cash shortfall, a pattern of consistent under-spending on maintenance of assets could generate large future liabilities. Problems may also arise due to unanticipated reductions in allocations to specific ministries. The Ministry of Health and the Ministry of Maritime and Transport stood out in 2004 as those with the lowest rates of budget execution (36 percent and 46 percent respectively). Apart from the negative effect on operations, such large shifts may increase skepticism about the credibility of budget allocations and may encourage exaggerated estimates from line ministries and may contribute to accumulation of arrears.

Program Budgeting

4.15 **Program budgeting is still in its infancy**. Though program budgeting has been the most prominent of reforms introduced by MoF in the last few years, it has yet to result in any profound changes in the budget planning process within government. Since 2004, when the first two ministries piloted program budgets, more have been added each year. By 2006 most of the major ministries had been included in the piloting of program budgets, and many of the others will be added in 2007. The gradual roll-out has in part reflected capacity concerns within MOF. But even as the number of ministries has increased, neither the quality of the output nor the impact on the process has changed much.

4.16 **In reviewing the program budgets for 2006, several weaknesses stand out in how pilot ministries have undertaken the process**, starting with the structure of programs. For example, ministries have defined their programs in a way that appears to reflect their past administrative or organizational structure rather than any strategic regrouping of missions and primary objectives. The programs are defined inconsistently even within the same ministry. They are sometimes highly fragmented and do not reflect a prioritization of key missions. For example, in the Ministry of Education and Science there are a few large programs that consume most of the resources, but there are also several very narrow activities that are each defined as programs and use very little budget. At the very least, it presents the ministry as fragmented activities without a coherent or unifying theme.

4.17 **The lack of understanding about how to define programs also stands out in the case of the Ministry of Interior**. Though they are supposed to have a program budget, in fact, the budget reflects little more than a single program. Policing involves a few different functions, but it is defined by the Ministry as a single program that consumes about 85 percent of the budget. There are only two other programs defined by the Ministry, one of which uses only about 1 percent of the budget. The structure of the Ministry's budget is not conducive to making any type of policy trade-offs because all activities are essentially lumped into one item.

4.18 **Strategic linkages that should exist between ministry goals and those of the supporting programs are generally missing from the budget documentation**. In fact, there is little information available to define why the programs exist or what they are to achieve. Instead, the programs are accompanied by a list of "tasks" which are not necessarily helpful in defining the main content or priorities of the program. Some tasks appear tangential to the program, or reflect one of the goals.

4.19 **The selection of useful performance indicators is a challenge in many countries, but it is especially a weak link in the Montenegro program budgets**. The indicators typically reflect measures of workload or outputs, rather than the expected results. For example, there are indicators that focus of numbers of students, and numbers of permits. Key parameters are also missing. In education, for example, indicators that might reflect on quality are completely missing. In the case of the Ministry of Interior the indicators selected for Police (e.g., number of violations of public order or the number of registered border crossings) are thoroughly impractical and suggest little effort was made to come derive meaningful measures that one could act on. In several other cases, there is no attempt to include data.

4.20 **Ultimately, programmatic information should affect the strategic allocation of national resources and create incentives for better management; however, critical linkages are still missing in Montenegro**. Currently, the process of preparing the budget by MOF appears to be somewhat separated from the critical policy planning processes of government. MOF alone proposes ceilings to ministries, and the budget requests that are received are still apt to exceed them. Even after the budget conferences, ministries will still appeal the decision of MOF to the government. As the Bank noted in the Montenegro Economic Memorandum, despite the government having some clearly defined national development priorities (such as promoting the tourism industry), the process of allocating budget resources has been slow to reflect this.

4.21 **Continued implementation of program budgeting will require changes in the role of budget examiners**, and it would be appropriate for ministry officials to begin planning for this impact on staffing even now. In the future budget examiners will need to be able to engage in discussions with line ministries about program objectives and the cost-effectiveness of specific programs, rather than on the increase in cost for specific line items, like purchase of goods and services (i.e., inputs needed). In more advanced countries, budget examiners will tend to specialize in certain policy areas (e.g., health and education), so that they may understand how the sector is working as well as the staff from the ministry. In addition, staff in the line ministries who prepare the budget need to change their skill sets—instead of viewing budget preparation as an administrative tasks prepared by administrative staff of the ministry, it should be intertwined with ministries strategic planning processes.

4.22 **If program budgeting is to expand not just in coverage, but in the quality of budget preparation, then a substantial increase and refocus of technical assistance may be required**. It is unclear to what extent MOF had the capacity to advise ministries in developing program budgets. The results in the 2006 budget suggest a lack of effective engagement and knowledge transfer to line ministries about how to do program budgeting. Going forward the government should make a priority to do the following:

- Develop an overall action plan that captures the specific outcomes expected of the reform, the sequencing and timeframes attached to the activities that will support reform, and the resources required (whether technical or financial).
- (Provide extensive guidance to line ministries on how to define programs and to assure their consistency with ministry strategic plans and priorities. (Generally the programs should reflect 3 to 5 major policy areas, with at least 10 percent of the budget).
- Have ministries detail the main objectives and goals of each programs and link these to the overall goals and objectives of the ministry.
- Identify sub-programs where appropriate for major programs.
- Assist ministries in selecting a range of indicators, including those that reflect quality of services delivered not just quantity of people served or the number of procedures executed.
- Develop capacity within the MOF and other institutions (e.g., auditors) for verifying and using performance information provided by line ministries. Even though budget decisions may not be affected by the information initially, the information should be used to improve the management of the programs.
- Develop skills among budget examiners to discuss policy-based issues with line ministries and assure that budget examiners views are rooted in the policy priorities of the Cabinet.

Integrating Medium Term Planning into the Budget Process

4.23 **Development of a medium term budget framework would be a useful tool for Montenegro to strengthen the linkages between policy, planning, and budgeting**. As individual ministries prepare their detailed spending proposals, these should be guided by some top-down instruction that provides medium term policy priorities by functions or sectors. Even with national strategy documents, the ability to translate the broad priorities into specific budget allocations will be weak as long as budgets are only focused on a one year horizon. The current medium term *fiscal* framework is a good foundation on which to build; the MOF would need to add indicative levels of spending grouped by sector or consolidated programs. Initially, the MOF could start by projecting out only one year beyond the budget year (eventually expanding to two years). Then for purposes of accountability, the MOF would begin the next year's budget preparation at that level, with any differences between the final budget allocations and the projected level explained.

4.24 **As with implementation of program budgeting, it would be important for MOF to develop a sequenced action plan for implementing a medium term budget framework** (MTBF). Such a plan would include specific reform outcomes, times for achieving them, and the resources required. A key priority should be to start taking medium term policy priorities and to begin translating them into budgetary implications. Some actions the government may consider as part of the process of developing the MTBF over the next few years:

- Include the extra-budgetary funds in the current medium term framework.
- Establish indicative sectoral allocations for the out-year (i.e., the year beyond the budget year) based on agreement with Cabinet, including the policy justification for any significant changes.
- Require input from line ministries on their policy and funding priorities for the out-year, within the overall ceiling given.
- Use the out-year ceilings as the starting point for the next year's budget preparation.
- Track the policy decisions on which the out-year allocations were based and report the justification for any changes.
- Using the inputs from line ministries on their policy and spending priorities to assist Cabinet in setting the next year's indicative ceilings.

4.25 **Effective planning of capital investments would especially benefit from having a medium term budget framework**. Moreover, the MOF is taking the right steps to centralize information on proposed capital projects and to assure that all are subject to appropriate economic analysis before they are included in the budget. Previously, it was possible for the Roads Directorate and the Transport & Maritime Ministry to plan projects without MoF having full information on the budgetary impact in future years. Steps now being taken to establish a capital budgeting process managed by the MOF appear to be positive, however, staffing the department with skilled technician must be a priority if it is to succeed.

C. CASH MANAGEMENT AND BUDGET EXECUTION

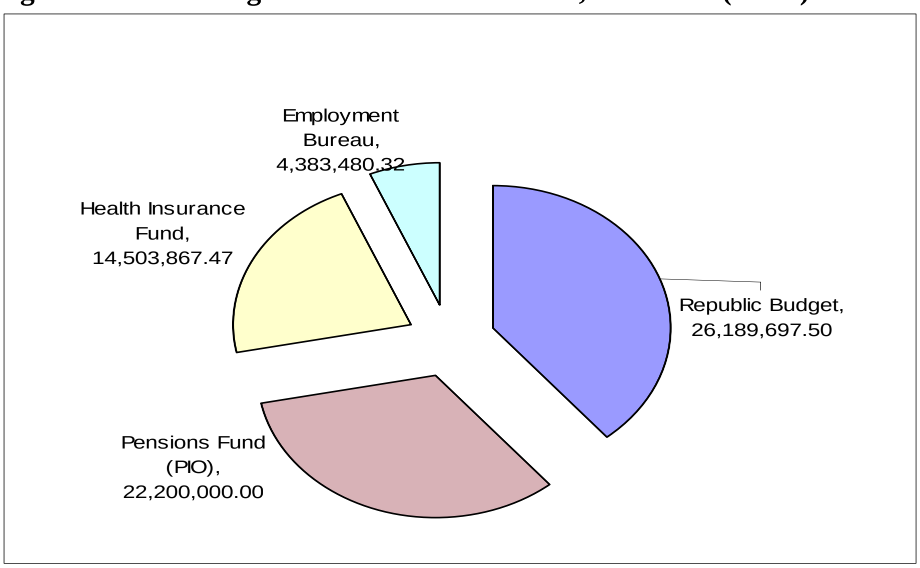
4.26 **The Treasury system has been operating for about four years and has helped lead to a smoothly function payment and reporting system**. The Treasury utilizes an SAP system that is linked to most of the major budget users and allows real-time monitoring of expenditures by both the MOF and the line ministries. Ministries we met expressed general satisfaction with the SAP system. Payment requests are made on-line by the ministries, but then must be approved by the Treasury for payment. Some delays are known to occur in honoring payments because of cash shortfalls, and ministries realize that some payments at year-end might get deferred until the following year. The ministries are obligated to clear existing arrears before incurring new expenditures, but it is not clear how consistently this is applied. Arrears have been moderate in the past, and the stock of central government arrears declined in 2005. Arrears of local governments were estimated at 1½ percent of GDP in 2004 (Chapter 6).

4.27 **Although a formal process exists for cash planning, it was unclear how well it is working and whether it reflects genuine planning or merely month-to-month cash control**. In principle, ministries prepare spending plans for the year which are submitted to the MOF, which in turn develops its 12 month cash ceilings. Treasury officials were unable to provide information as to how closely the cash requests match the MOF's plan, or to what extent the actual cash allocations match the planned levels established by the MOF. Some rebalancing is reported to occur during the year on cash ceilings, but for many ministries total spending for the year comes close to the budgeted amounts. Temporary cash shortfalls are managed by a Treasury committee that has a prioritization that it follows that includes debt, social obligations, and wage payments among the first items to be honored; operating expenditures and capital are paid with remaining funds.

4.28 **Commitment control is still non-existent and this creates a potential risk for accumulating payment arrears.** The absence of commitment recording could be a result of limitations in SAP or a conscious policy decision. Official statistics indicate that the stock of arrears of the Republic government has declined since end-2004 (from Euro 62 million in 2004 to about 26 million at end-2005). However, because commitments are not being monitored it is impossible to know whether a build-up of new arrears is likely or not. Since line ministries are able to monitor their cash allocations each month, it is probable that some would hold back payment requests until additional funding is available even though the commitment already exists. For ministries where the planned expenditures deviate significantly from the actual cash allocations, the risk of arrears will be greater. On aggregate budget execution tracks closely to the budgeted amount; however, as noted earlier there are exceptions with individual ministries. Moreover, the Audit Report for 2004 indicated that some budget users failed to accurately record their payment liabilities.

4.29 **The impact of extra-budgetary funds on the consolidated fiscal position of the government suggests that stronger oversight may be needed.** As Figure 4.1 shows, in 2005 the stock of arrears of the three main extra-budgetary funds exceeded those of the Republican budget (Euro 41.1 million versus 26.2 million). No data was available on changes in the stock of arrears for any of the funds; however, the financial statements suggest that imbalances in the pension fund could generate significant arrears in the future. In fact, were it not for substantial subsidies to the pension fund from privatization receipts, there would have been a need for budget financing or accumulation of arrears. This imbalance between revenues and expenditures must be addressed in the near future, but the efficiency of spending within the other two funds should be improved as well.

Figure 4.1. Montenegro Total Stock of Arrears, End-2005 (euros)



Source: Ministry of Finance.

4.30 **End-of-year reporting on expenditures appears to be very timely and of good quality**. The annual financial statements are ready by the end of the first quarter and submitted at that time to the State Audit Institution. Moreover, the 2004 Final Budget Account was given a favorable opinion by the State auditors. The report contains an adequate level of detail and comprehensive review of revenue and expenditure activity. The summary tables are clear and provide in some cases, comparison with the prior year as well. The availability of such information provides an excellent foundation for Parliament to able to exercise its oversight role and to make informed decisions about future budget proposals.

4.31 **Although the SAP software has generated effective reporting on expenditures, current reforms taking place in the area of budget preparation will place new demands on the system's functionality.** If not already undertaken, the government should assess the types of information that will need to be captured and reported in the future, and to assess whether the current system can be adapted to meet those demands. The cost of maintaining the system has obviously been an issue in the past. Even though the capacity may exist within the modules purchased by the government, a decision is still required on whether that can be utilized in a cost-effective manner. If not, then alternatives for managing information should be explored in order to support the implementation of program budgeting and medium term budget frameworks.

4.32 **Going forward the MoF should strive to**:

- Establish a commitment control process within the SAP system in order to monitor commitments.
- Strengthen cash management and predictability by providing at least quarterly expenditure limits to line ministries to plan procurement.
- Assess the current oversight arrangements for EBFs to assure that the fiscal risks are adequately controlled in the future, especially to prevent new arrears.
- Assess the scope of information required to support reforms in budget preparation and develop a plan for how the current IT systems will be adapted to meet them cost-effectively.

D. PUBLIC PROCUREMENT

4.33 Since June 2002, Montenegro has made significant progress in improving the public procurement legislation, procedures and practices, organization and resources, control environment, and training and capacity building. However, significant challenges also remain.

Public Procurement Legislation

4.34 **A new public procurement law (PPL), replacing the public procurement law of 2001, was adopted by the Parliament in July 2006**. The new law harmonizes Montenegro's law with the EU directives on public procurement, and envisions the creation of two separate public procurement entities: (i) a public procurement administrative authority (PPAA) which will develop and issue bylaws and regulations, sets standards, and issues tenders; and, (ii) the current PPC which will continue to handle complaints.

4.35 **The law has several strengths**, including:(i) a clear definition of the responsibilities and activities of the administrative body for public procurement (Articles 16 and 17); (ii) a clear definition of the types of procedures, with open procedure as the main method of procurement (Article 19); (iii) specifying the conditions for restricted procedures with prequalification (Article 20); (iv) for publication on the website of the contract award notice (Article 34); (v) for joint and several liability in case of joint tender (Article 52); (vi) for public opening of tender immediately after the deadline for receipt—latest within one hour (Article 65); and (vii) for legal protection of tenderers through a complaints review mechanism (Article 79-95). Anti-corruption and conflict of interest rules are also introduced in the new draft PPL.

4.36 **Two areas where further improvements to the law may be needed**: (i) evaluation criteria—This is currently based on a point system rather than on a monetarily quantifiable criteria (Article 63 and 64); (ii) selection of consultants-- No definition is available in Article 4, but the issue seems to be dealt with in Article 74 without fully describing how the final selection shall be made. Further, Annex I on Services does not distinguish between maintenance and repair services and services of intellectual nature. The law does not have features of dynamic purchasing system or electronic auction (only electronic means are defined in Article 4). In addition, once the new PPL is adopted, all supplementary regulations, rules and procedures, and standard bidding documents and forms should also be revised and adopted.

Procurement Procedures and Practices

4.37 **The Public Procurement Commission was established in September 2001, and comprises of the President, the Secretary General, and two members**. The main functions of the PPC include: review and resolution of bidders' complaints, tender announcement, coordination of preparation of the new PPL, regulations and standard bidding documents, public procurement networking and contacts with other public procurement agencies, and organization of trainings for public procurement officers (currently about 603 offices are subject to the PPL).

4.38 **According to the new law, the PPC will be transformed into a Commission dealing with bidders' complaints**. The PPC currently has three staff, and carries various activities including tender publishing, providing oversight to procurement officers at line ministries, and receiving bidder complaints. For those cases which were accepted, tender/ evaluations were re-done. Both the establishment of the PPAA and strengthening of the PPC would require proper staffing, capacity building, and the strengthening of their institutional infrastructure.

4.39 **The new procurement law envisions the creation of a separate Public Procurement Administrative Authority (PPAA), which will be in charge of the administrative functions of public procurement**. The PPAA will have several administrative functions, including preparation of regulations and standard bidding documents, prior reviews and approvals, publishing advertisements, collecting data and maintaining database, e-procurement, liaison with the Supreme Auditing Institution, and liaison with other public procurement agencies.

Strengthening the Control Environment

4.40 **A strengthened control environment for public procurement requires that there be effective internal and external audits** (see below). To that end, strengthening the internal audit is essential to tighten the control environment for public procurement. In order to equip internal auditors to carry out their duties in respect of public procurement, it would be important to train internal audit staff on public procurement issues, and to avail them of procurement and appropriate technical expertise on an as-needed basis. Furthermore, with the recent establishment of the Supreme Audit Institution (SAI), it would be important for the SAI to carry out annual, sample-based audits of the procurement operations of major spending ministries and public enterprises to tighten the control environment.

4.41 **In addition, a well-functioning bid protest system is essential to tighten the control environment**. The bid protest system is a key element for ensuring that public officials are held accountable for their decisions on public procurement matters. In Montenegro, the bid protest system seems to be working reasonably well, though it is still early and the efficacy of the mechanism will no doubt be improved by the strengthening of the PPC. In 2005, 109 complaints were submitted to the PPC, of which 67 were rejected (because of lack of evidence) but 48 were accepted.

4.42 **Going forward, the following are key steps for further actions**:

- Legal framework: All supplementary regulations, rules and procedures, and standard bidding documents referred to the new PPL should be prepared and adopted.
- Proper staffing and training for PPAA and PPC: Establish the PPAA, with proper staffing, and institutional infrastructure. Enhance the capacity of the PPC through additional staffing and strengthen its institutional infrastructure.
- Training of all public procurement officials. Train all public procurement officials--in ministries and local governments as well as suppliers, contractors and consultants--with respect to the new public procurement law, and the related supplementary regulatory rules, procedures, and standard bidding documents.

E. INTERNAL AND EXTERNAL AUDIT

Internal Audit

4.43 **The internal audit function has only been existence for two years now, but within the capacity constraints that it has, it appears to be carrying out its functions effectively**. The IA, currently located only in the MoF, is staffed with only six people, only four of which have previous public finance experience. Nevertheless, IA has carried out 24 audits of budgetary users already, and it is broadly on track to meet its three year audit plan goals (which call for audits of large budgetary users annually, and small budgetary users once during the three-year period). The operations manual defines that international internal auditing standards are to be used in conducting the work, and the department benefits from a direct reporting relationship to the Minister of Finance. According to the IA Head, the unit's recommendations have been considered by the audited bodies to significant extent.

4.44 **Future priorities for IA must center on building greater capacity, and on establishing IA functions within the line ministries**. Three systematized posts have remained unfilled due to difficulty finding qualified people in the labor market. But even filling these positions would not be enough to expand much beyond the MOF. Intensive training for younger, less experienced recruits may be the only short to medium term alternative for building capacity. Pushing IA out into the line ministries will also enable it to be a more complementary to the role of the external auditor, the State Audit Institution (SAI). Contrary to the traditional role conceived of IA, the department in Montenegro currently functions more as an external control by the MOF rather than a resource to Ministers in line ministries for assuring affective internal controls.

External Audit

4.45 **The State Audit Institution, like the IA, has only a two year history, but it has been effective already in fulfilling its primary duties**. The SAI issued its audit of the 2004 Final Budget Account and its first Annual Report in 2005. Although the 2004 audit focused on financial audit, the SAI also carried out a review of operations, procedures, and controls. The audit also included information on management of the budget, assets, and business operations. The legal framework gives the SAI substantial independence even though it still must follow civil service rules and submits its budget request to MOF. The SAI head indicated that the institution has benefited from strong support from Parliament, and excellent working relationships with IA. The scope of its mandate is sufficient to cover issues such as public procurement and value for money audits, although capacity is likely to be a limitation for some time. Box 4.1 gives an overview of some of the institution's observations in its 2005 report.

Box 4.1. Sample Findings from Audit of 2004 Financial Accounts

The SAI issued clear opinion on the accounts. However, the audit resulted in certain findings that point out areas for improvement. Some of those are the following:

1. There is a lack of accurate and updated deposit signatures.
2. Some payment requests are not authorized by appropriate persons.
3. Procedures relating to revenue collections are not always applied.
4. Some spending units did not perform inventory of assets and liabilities as of December 31 2004.
5. Financial statements do not always include Notes to financial statements. In addition, financial statements are not always timely submitted to the Treasury.
6. Appropriate documentation and records regarding court disputes is not held. In addition, it is not always budgeted for court disputes.
7. It was not possible to verify whether all arrears were captured in the records.

4.46 **A more active role for SAI will depend on a build up in capacity over the coming years**. Staffing has been limited to six people. Since their employment at SAI, all staff has been trained at the Law school and Accounting and Auditing Institute, in addition to obtaining practical experience through a six months training in audit firms Montrev and Deloitte. Continuous training of staff is expected to be one of the policies of the institution, and they are applying for membership in both the international and European associations of supreme audit institutions (INTOSAI and EUROSAI).

F. Conclusions and Recommendations

4.47 The challenge for Montenegro going forward is to strengthen the process of ***managing*** reform and the institutional mechanisms that support reform. Reforms such as program budgeting, medium term budget frameworks, capital budgeting, and strengthening of internal audit are all important over the long term, but they risk being unfocused efforts with little impact. Sustainability of the reforms could be enhanced by having a comprehensive action plan that describes the concrete results expected from each reform and the interim milestones toward each goal. Given the capacity constraints inherent in a small MOF such as Montenegro's, it is even more important to have a coherent and realistic framework through which to sequence activities and to evaluate progress over time.

4.48 Some of the near term milestones that the government should consider as part of its comprehensive plan are:

- Helping all major budget users to develop a sensible ***program budgeting*** structure that is rooted in the organization's strategic plan and that clearly reflects the three to five major policy priorities of the institution. Performance indicators can be addressed later and over a longer time frame, but the process should begin with effective identification of the overall policy priorities.
- Developing indicative expenditure levels for the ***medium term budget framework*** broken down by sector or function, including the extra-budgetary funds. These would be for only one year beyond the budget year, but they should capture future policy priorities and should be the starting point for the next year's budget preparation process.
- Developing a ***capital budget*** as part of the process for preparing the 2007 State budget. At this stage the capital budget may be no more than a summary of the current and future budgetary impact of each project.
- Developing strategies for internal financial control in all major spending units, and gradually moving towards decentralized management of internal audit functions, which in turn will require modest increase in the staffing of ***internal audit*** and the gradual reassignment of IA staff to work with key ministries as their own IA staff.

4.49 Since many of the PFM reforms have implications across sectors and in the way ministries interact with MOF, the Government should consider strengthening the institutional arrangements for reform coordination. Building up the capacity within the MOF to implement reform is critical, and should be reflected within implementation of the PAR. Though the MOF bears the primary responsibility for day-to-day implementation, a strong support and accountability from the Office of the (Deputy) Prime Minister may be critical. Integrating PFM reforms as part of the broader EU accession agenda may be another strategy worth considering.

5. PUBLIC INVESTMENT PLANNING AND INSTITUTIONAL ISSUES: THE CASE OF TRANSPORT INFRASTRUCTURE

A. INTRODUCTION

5.1 Strengthening the institutional and budgetary processes for capital projects is essential if Montenegro is to overcome the infrastructure gap created due to underinvestment and lack of proper maintenance over the last decade. Capital investment in infrastructure remains low, accounting for only for about 0.5 percent of GDP.

5.2 **Reflecting years of underinvestment, the current state of infrastructure in Montenegro is poor**. With respect to public roads, the mountainous nature of the terrain, coupled with the maintenance backlog during the last decades, has resulted in higher costs for road users, and reduced Montenegro's comparative advantages against other transit corridors. The average driving speed is less than 50 kilometers per hour. In railways, due to inadequate routine maintenance during the last 15 years, there has been progressive deterioration of the quality of service with repeated traffic breakdowns particularly during the winter seasons. The average traveling speed is between 30-50 km per hour and the infrastructure is in urgent need of rehabilitation. Similar poor conditions exist in maritime transport, water and sanitation and energy. The low numbers, and the current state of infrastructure, indicate there is clearly a need for more capital investment.[61]

5.3 This chapter reviews the challenges of capital investment planning in Montenegro, largely from the perspective of the transport sector since transport represents a major component of infrastructure investments. Other key infrastructure sectors such as water and energy, while important, are not covered in this chapter. It is organized as follows. Section B reviews public spending on transport infrastructure over the last three years. Section C discusses whether Montenegro has the fiscal space to invest in infrastructure. Section D highlights the institutional challenges with capital investment planning, including in infrastructure. Section E offers conclusions and policy recommendations.

B. PUBLIC SPENDING ON TRANSPORT INFRASTRUCTURE

5.4 **Montenegro's domestically financed capital expenditure in 2005 accounted for only about 2 percent of GDP (Figure 5.1**). Externally financed capital expenditures are not included in the Government data on capital expenditures, but are estimated to constitute slightly over 50 percent of total capital expenditures in Montenegro (Ministry of Finance).[62] Similarly, although local governments/municipalities are involved in the provision of basic utilities, their capital

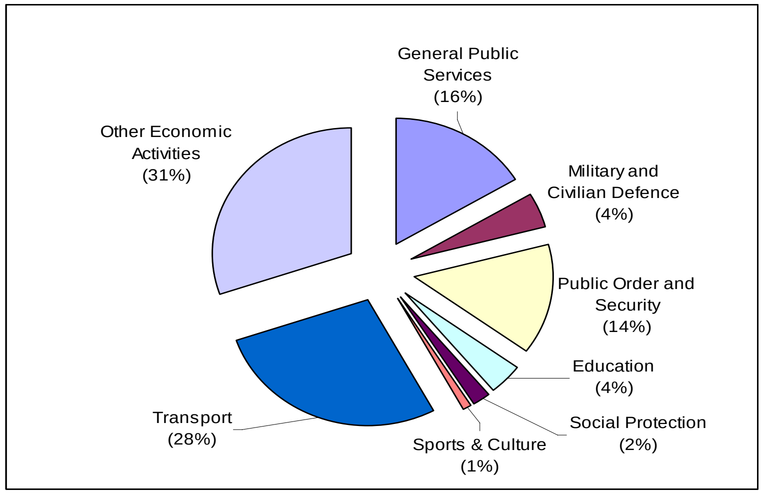
[61] Further details on Montenegro's transport infrastructure network as well as the regulatory framework are provided in Annex 4.

[62] An effort is underway to include capital investments financed through external project loans into the government budget beginning in 2007.

investment is not tracked by the Ministry of Finance, in part because local governments are not yet integrated into general government reporting.

5.5 **In 2005, about 90 percent of domestically financed capital expenditures went to** economic affairs, general public services, transportation, health services, and public order and safety, in that order. Within economic affairs, nearly 90 percent of the capital investment went to development projects. Capital investment in education on the other hand accounted for only about 4 percent of total capital investment. There was virtually no investment in research and development.

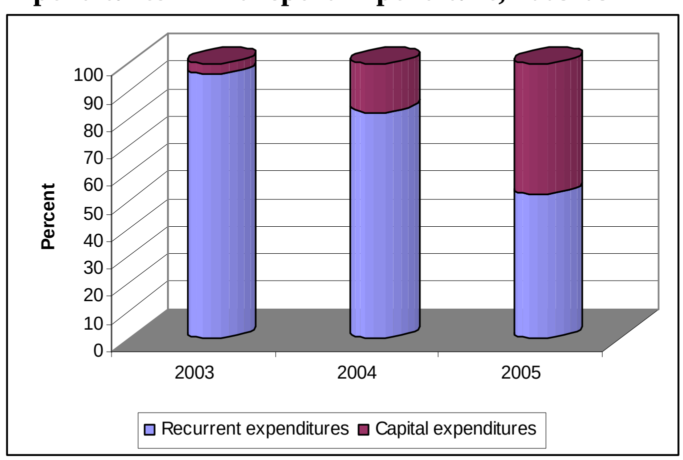
Figure 5.1. Montenegro's Capital Expenditure by Function, 2005 (% share in total capital expenditure)



Source: Montenegrin Ministry of Finance.

5.6 **The total domestically financed transport expenditures in 2003, 2004 and 2005 represented 0.4 percent, 0.79 percent, and 1.29 percent of GDP, respectively**. Roads, railways and administration expenditures remained the most important components of the sector expenditures during 2003-2005, representing more than 90 percent. Although from a low base, total expenditures of the Ministry of Transport increased by 75 percent between 2004 and 2005, which suggests that the sector is gaining greater prominence in resource allocation.

Figure 5.2. Percent share of Capital and Recurrent Expenditures in Transport Expenditure, 2003-05



Source: Montenegrin Ministry of Finance.

5.7 **The domestically financed transport capital expenditures in 2003, 2004 and 2005 represented 0.02 percent, 0.14 percent, and 0.61 percent of GDP respectively**. The share of capital expenditures in transport sector expenditures increased from 4.32 percent in 2003 to 17.68 percent in 2004 to 47.36 percent in 2005, primarily reflecting significant investments in the road sector. In addition, Montenegro has had considerable external support in transport sector over the years. Over the last six years, the total external funding for transport was 114.2 million euros, out of which 85 million euros were loans and 29.2 million euros were grants.[63]

5.8 **Although increasing in recent years, both the ratio of transport capital expenditure to GDP (0.61 percent) and the share of capital expenditures within total sector expenditures (48 percent in 2005) remain very low**. Although the Government is allocating more capital expenditures for the transport sector than in previous years, these remain low. In 2005 at their highest level, transport capital expenditures were 0.61 percent of GDP and transport budget was 1.29 percent of GDP. The latter rate is almost similar to Bosnia and Herzegovina's where transport expenditures represent 1.6 percent of GDP. Montenegro and Bosnia and Herzegovina have capital expenditures below levels among other countries of South East Europe, where the expenditures for other countries vary between 1.9 (for Albania) and 4.3 (for Hungary). Similarly, the experience of other developing countries suggests that recurrent expenditures should not represent more than 20 percent of total sector expenditure.

5.9 **The low capital expenditure on transport reflects, in part, the virtual absence of private sector participation, particularly in road construction**. If the authorities in Montenegro wish to increase investment in the transport sector, they will need to be partner more effectively with the private sector. There is little opportunity, within the available resource envelope, to increase outlays to the sector solely from the budget. Yet, the authorities should also develop a clear legal framework for Public Private Partnerships (PPPs) in infrastructure, so that these PPPs can be effectively monitored to minimize potential contingent liabilities arising from such arrangements.

5.10 **There is a large gap between the maintenance and improvement needs of the transport sector and the actual budget allocation to the sector**. For example, in 2004, the financial resources allocated to road routine maintenance and improvements were only 44 percent of the estimated needs for maintenance, and 18 percent of the road improvements needs. Between 2001 and 2005, only 5 million euros were allocated annually to road routine maintenance. Montenegro raises revenues from road user charges, estimated at about 60 million euros in 2004, but these revenues go to the Ministry of Finance and are not formally earmarked for the transport sector. A more detailed assessment of the gap between needs and resource allocation will be made in the second phase of the PEIR.

C. IS THERE FISCAL SPACE FOR INFRASTRUCTURE FUNDING?

5.11 **While the clear infrastructure gaps suggest the need for more investment in infrastructure, a key question is whether Montenegro has the fiscal space to invest in infrastructure**. On the one hand, as discussed in chapter 2, a recent fiscal sustainability analysis shows that Montenegro needs further fiscal consolidation to achieve sustainability. According to this analysis, a fiscal surplus of 0.4 percent of GDP needed for fiscal sustainability. Yet,

[63] The grants were from the European Agency for Reconstruction, mainly for technical assistance. 80 percent of the loans (67 million euros) were from the European Investment Bank, 12 percent (11 million euros) from the European Bank for Reconstruction, and 8 percent (7 million euros) from the German funding agency, KFW. Annex 4 summarizes the actual contracted amounts by project between 2000 and 2006.

preliminary data for 2005 suggest that the primary deficit was just over 1 percent of GDP. A fiscal tightening—on the order of 1 percent of GDP—is needed to achieve fiscal sustainability.

5.12 **On the other hand, Montenegro's fiscal space for infrastructure investment has been potentially increased by the high volume of privatization proceeds received in 2005, estimated at about 10 percent of GDP**. A recent IMF report[64] recommended that the privatization proceeds be used primarily to reduce the stock of domestic debt. While some of the proceeds have already been used by the Government to pay off domestic debt and, to a lesser degree, arrears, considerable balances still remain. It would seem then that the Government has some fiscal space for investment in infrastructure.[65] However, since capital expenditures are deficit-increasing, the extent to which infrastructure investment is financed from privatization proceeds will need to be carefully managed within the constraints of the overall macroeconomic position to avoid over stimulating aggregate demand in the economy, and adversely affecting the current account and fiscal sustainability.

5.13 **Furthermore, in order for the government to meet its macro-fiscal objectives, and consider funding of investment in infrastructure from the privatization proceeds, it would need to consolidate proceeds of privatization into a single fund**. Under current legislation a significant proportion of the privatization proceeds are owned by the Development Fund and the extra-budgetary funds. For the Development Funds, these proceeds would be primarily aimed at financing its initiatives to boost the SME sector of the economy. If centralized, the Development Fund should then be allocated budget funds for its SME development policy as part of the general government budgetary process.

D. CHALLENGES WITH PUBLIC INVESTMENT PLANNING AND CAPITAL BUDGETING

5.14 **Public investment planning is almost non-existent in Montenegro**. At present, there are a number of agencies and spending units presenting their annual capital expenditure needs to the Ministry of Finance, with little evident coordination or prioritization of proposed investment projects. No one agency has an overall responsibility of coordination. This institutionally fragmented approach to investment planning leads to a situation where there is no holistic strategic vision for the Government to set priorities.

5.15 **Capital expenditures in Montenegro currently have a one year horizon, with little attention paid to the medium-term budgetary needs for completing capital projects**. The MTMA is one of the pilot ministries in which program budget was introduced in 2004. The MTMA and the Budget Department of the MOF worked together to produce a budget for 2005 that is linked to policy objectives based on a transport strategy. While these efforts are to be commended, the transport sector strategy is not yet finalized and work is still needed to strengthen the strategic vision of the MTMA and to produce a 3 year horizon plan. The lack of a medium-term perspective to capital budgets have undermined predictability of funding and proper planning for capital projects.

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[64] See IMF, "Managing the Proceeds of Privatization, Improving Debt Management Capacity and Assessing Future PFM Reform Requirements," September, 2005.

[65] The exact amount is not known, but estimated to be at least 4-5 percent of GDP.

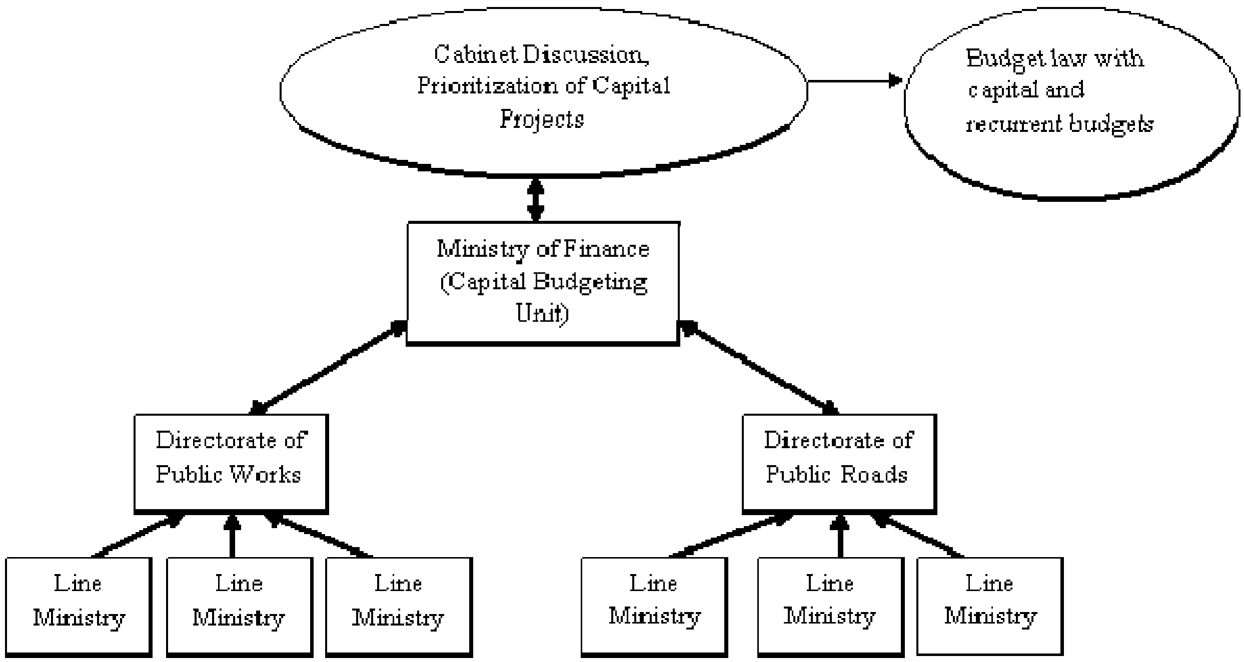
5.16 **There is weak prioritization of capital projects across government**. Each spending unit (SU) typically develops its capital budget and presents it to the MOF without any discussion at the Cabinet level as to where the strategic priorities of government lie. This leads to a situation where budget bids by the spending units take on the shape of wish lists that are subsequently scaled back to fit the constraint of the overall budget envelope. The fragmented nature of operational (current) and investment (capital) budget requests makes it difficult to prioritize and assess the impacts of such investment projects on the economy.

5.17 **For the first time, Montenegro is now planning to introduce capital budgeting in the 2007 budget**. Recent amendments to the Law on Budget (Official Gazette of ROM, #71/05) have provided the legal framework for the introduction of capital budget, alongside with the usual operational budget. A project is considered of capital character if it meets one of the following criteria: (i) long term financing of one or more structure creates additional space of 200 or more square meters; (ii) the construction of a building, procurement or purchase of equipment exceeds one million euros; and (iii) renovation, maintenance or reconstruction of existing structure exceeds 800,000 euros.

5.18 **A Capital Budgeting Unit has also been created at the Ministry of Finance to manage the capital budgeting process in coordination with Directorate of Public Roads and Directorate of Public Works**. According to a guideline developed by the Ministry of Finance, a project is considered of capital character if it meets one of the following criteria: (i) long term financing of one or more structure creates additional space of 200 or more square meters; (ii) the construction of a building, procurement or purchase of equipment exceeds one million euros; and (iii) renovation, maintenance or reconstruction of existing structure exceeds 800,000 euros. Furthermore, all capital investment projects of spending units will be coordinated and consolidated by the Directorate of Public Works (DPW) and the Directorate of Public Roads (DPR). Along with the newly established Directorate of Public Roads (DPR) in 2005 and the existing Directorate of Public Works (DPW), a new preparation is underway to begin capital budgeting starting with the 2007 budget.

5.19 **Spending units are to submit a multi-year capital budget plan to the DPW, DPR and the MOF for all capital projects (Figure 5.3)**. The DPR will be responsible to coordinate all transport infrastructure projects, whereas DPR will be in charge of coordinating the capital investment plan in non-infrastructure spending units (e.g., education, health, general government services). The two, in cooperation with the Ministry of Finance (MOF), will consolidate capital projects from all spending units by how well they are prepared, by development and construction stages, and submit them to the Government for a cabinet-level discussion and prioritization. Out of a priority list that was determined during the preparation stage, the cabinet will make a final selection of projects to be approved and financed through the annual budget plan. Implementation of the capital budget projects and report on budget realization will be monitored by the MOF, DPR, and DPW. Quarterly reports on implementation stages and amount of expended funds by financing sources and expense types will be submitted by the SUs to the Government.

Figure 5.3. A Schematic of the Planned Capital Budgeting Process in Montenegro



Source: Bank staff discussion with the staff of Montenegrin Ministry of Finance.

5.20 **There are several institutional and administrative capacity concerns going forward.** The bottom up planning of capital projects, based on sound analysis of the economic and social returns of projects, will be crucial for a successful prioritization and selection of capital projects across government. The preparation of such good project plans in turn depends on the institutional and human resource capacity of each ministry.

5.21 **First, line ministries do not have the requisite human and institutional capacity to prepare and submit good capital projects at the moment.** The limited use of formal techniques of economic appraisal in project identification and prioritization is one of the main weaknesses in the budgetary process. In transport, for example, setting up a road and structures database is a prerequisite to a professional approach to asset management. There is no road and structure inventory database, nor a regular monitoring of the condition of the assets. Whatever little information that is gathered on traffic volumes and axle loads is done in a less than systematic and robust manner. To prepare good capital projects, there is a need first to introduce of robust data collection systems on the condition and use of the assets, which is stored in a database. The identification of priorities for maintenance expenditures in the sector can then be made on a sound assessment of economic viability given the available budgetary envelope, using the Highway Development and Management Model. A similar, but simpler, data collection exercise could be undertaken for the local roads, which would allow a simpler system to also be employed to manage that network. A considerable institutional capacity building and training at line ministries is thus required to introduce capital budgeting and to enhance the quality of capital projects to be submitted by these ministries. Considerable efforts and skills are also needed to integrate capital and recurrent budgets for such projects.

5.22 **Second, it is not clear whether the DPR and DPW will have the technical capacity to provide support to spending units** in preparing good capital projects, and how well the latter can effectively serve as the first point of "screening" good and bad capital project proposals. In view of the past experience that SUs investment proposals tend to consist of little more than wish lists of investment projects that have to be considered by cabinet without any supporting analysis of the expected outcomes, costs or benefits associated with such programs, it is not clear whether and how the DPR and the DPW will help introduce strong supporting economic and social analysis of capital projects.

5.23 **Last but not least, although a Capital Budgeting unit has been established within the Ministry of Finance in 2005, the unit is currently understaffed and under-resourced**. Beyond playing a supervisory and coordinating role, this unit is expected to ensure the integration of the planning of investment and operational budgets, an integration that is essential for a successful introduction of an MTEF over the long term. In order to discharge this role effectively, the Ministry of Finance should undertake an assessment of the current technical staff within the Ministry and the technical skills needs of the Unit to explore opportunities for increased staffing of the Unit through horizontal moves. Further, adequate training programs will need to be organized for the staff, which will cover both technical and financial aspects of capital budget planning and prioritization, as well as on ways to integrate the recurrent and capital costs of capital projects.

E. CONCLUSIONS AND RECOMMENDATIONS

5.24 At 2 percent of GDP, Montenegro's domestically financed capital expenditure is much below the level of other countries in the region. Capital investment in infrastructure accounted for only about 0.5 percent of GDP in 2005.

5.25 **Reflecting years of underinvestment, the current state of infrastructure is quite poor**. With respect to public roads, the mountainous nature of the terrain, coupled with the maintenance backlog during the last decades, has resulted in higher costs for road users, and reduced Montenegro's comparative advantages against other transit corridors. The average driving speed is down to less than 50 kilometers per hour. In railways, due to inadequate routine maintenance over the last 15 years, there has been progressive deterioration of the quality of service with repeated traffic breakdowns particularly during the winter seasons. The average traveling speed has been as low as 30-50 km per hour, and the infrastructure is in urgent need of rehabilitation. Similar poor conditions exist in maritime transport, water and sanitation and energy. The low numbers, and the current state of infrastructure, indicate there is a need for more capital investment.

5.26 **Indeed, addressing the current underinvestment in infrastructure, in particular in road network, should be a top priority for the Government**. This will require not only an increased allocation to the transport sector to ensure that necessary expenditures to develop, maintain and address backlog maintenance can be provided, but also a review of the current structure and scale of roads user charges to ascertain the need and scope for amendments to ensure that revenues are maximized and incentives to users are optimized (e.g., charges to heavy trucks), commensurate with ability to pay.

5.27 **Yet, the Government needs not only to ensure that public investment decisions respect the broader macroeconomic and fiscal constraints, but that projects are strictly prioritized and funded on the basis of their economic and social merits**. There is clearly a trade-off between public infrastructure investment program and macro stability/fiscal sustainability, and the Government should first make sure that there is an adequate fiscal space to undertake additional infrastructure investment. Once the fiscal space for capital projects is determined, it is critical that a rigorous public investment project appraisal and screening system is put in place to rank public investment projects, and fund only those whose economic and social returns warrant funding. While Montenegro's fiscal space for infrastructure investment has been potentially increased by the high volume of privatization proceeds, estimated at about 10 percent of GDP in 2005, the institutional processes for planning and executing infrastructure investments would need to be improved.

5.28 A review of the capital budget planning and institutional arrangements in Montenegro, shows that there is a need to create both the administrative and institutional capacity for public investment planning and coordination as well as prioritization. More specific steps that the Government should pursue to strengthen public investment planning and prioritization:

- *Develop a capital budget as part of the process for preparing the 2007 State budget.* At this stage the capital budget may be no more than a summary of the current and future budgetary impact of each project. Yet, this could be improved over time.
- *Strengthen the staffing and institutional capacity of the Capital Budget Unit within the Ministry of Finance to help coordinate and prioritize investment projects.* At present, no one agency has the overall responsibility of coordinating capital investment planning. While the establishment of the capital budget unit in the Ministry of Finance is a step forward, the unit currently lacks proper staffing (only one staff). An assessment of the staffing and institutional needs of the Unit in order to considerably expand its technical and institutional capacity to coordinate all public investment planning, evaluate investment proposals and coordinate capital and recurrent budget within the same framework is urgently needed
- *Strengthen the technical and institutional capacity of spending units (SUs) to prepare good capital projects*, based on sound economic, social and environmental analyses. The current technical capacity at line ministries, whether to produce forward estimates of costs or to develop effective indicators to measure program performance, is weak. For better budgetary impact assessment, it is also essential that both capital and recurrent budgets are estimated by the same agency. An assessment of the current technical skills and staff should be made and adequate training programs organized on technical and financial aspects of capital budget planning by the MOF for line ministries as well as the DPW and DPR.
- *Strengthen the technical and institutional capacity of DPR and DPW to manage the consolidation and preliminary screening of all capital projects at the preparation stage*. The DPR and DPW should be well staffed to ensure availability of the necessary technical capacity required to coordinate all SUs capital budgets. Technical skills should cover the financial aspects as well as the technical aspects that are specific to each sector.

An assessment of technical skills at those two agencies should be made and adequate staffing and training programs organized accordingly.

5.29 **In view of the limited fiscal space, the Government must also create an enabling environment for private sector participation in the transport sector to cater for the growing demand for infrastructure investments**. In that respect, the government should strengthen partnership with the private sector for financing future investment requirements in two ways. First, by developing the key pre-requisites for successful Public-Private Partnerships (PPPs), namely: a) an adequate and strong institutional framework including a well-designed sectoral policy and strategy, b) primary and secondary legislation on concessions and public procurement and c) appropriate capacity within the MoF and the MPWTT to evaluate proposals and assess the potential implicit and explicit contingent liabilities. And second, by protecting fiscal stability and limiting the government’s fiscal exposure wherever possible.

6. BEYOND THE NATIONAL BUDGET: FISCAL RISKS OF LOCAL GOVERNMENTS AND STATE-OWNED ENTERPRISES

A. INTRODUCTION

6.1 **While progress has been achieved at the central government levels, the accountability framework deteriorates as one moves to the broader public sector.** Effective fiscal management and public sector governance requires that the Montenegrin authorities monitor a comprehensive picture of fiscal activities undertaken by all parts of the government. A narrow coverage of government activities creates incentives for circumventing fiscal accounts, potentially results in hidden vulnerabilities, and contributes to an overall lack of transparency. In contrast, a broad coverage that includes local governments and state-owned enterprises (SOEs) lowers fiscal risks and improves transparency, which is a key factor for market confidence and good governance.

6.2 **The current coverage of the fiscal accounts does not provide an adequate basis for formulating fiscal policy and identifying fiscal risks and needs to be broadened.** The fiscal coverage in reports published by the government includes extra-budgetary funds and *partial* information on local government, but excludes the SOE sector all together. While local governments have been included as part of the consolidated government budget since 2004, and a set of reporting rules have been developed, all local self-government units do not adhere to this requirement and the Ministry of Finance does not have instruments to sanction compliance. As a result, not all local government liabilities are reported in the public sector debt statistics. Thus, the government is not in a position to identify key fiscal risks that may be arising from local government and SOE operations.

6.3 **Against this background, this section assesses potential risks posed by local governments and SOEs and provides suggestions for capturing these in the government's fiscal accounts**. It finds that both local governments and SOEs bear significant fiscal risks. Local governments have sizeable extrabudgetary activities and arrears, their combined budget deficit amounted to 0.3 percent of GDP in 2004, and the financing of the deficit is unsustainable. Two of the three SOEs examined are loss-making and their total operating losses amounted to about one percent of GDP in 2004, while the third barely covers its costs and has a large currency mismatch in its operations. To address these issues, the section suggests strengthening government oversight; expanding the coverage of fiscal accounts; and implementing an institutional framework for private participation in infrastructure (PPI).

B. LOCAL GOVERNMENTS

6.4 **There are 21 local governments, all of which execute their budgets individually**. Two main laws organize their activities, define their executive structures and supervisory bodies, and give them revenue and expenditure assignments (law on local government finance and law on local government). Their budgets are prepared in collaboration with the civil society, approved by the municipal assembly, sent to the Ministry of Finance (MoF) for information, and published. Local government budgets, which represent about 5 percent of GDP, include own revenues, shared revenues, and transfers from an equalization fund, a special account at the Treasury that receives 10 percent of the personal income tax and finances the municipal accounts in the form of equalization and incentive grants.[66] The centrally administered revenues account for almost 50 percent of total local government revenues (more than 70 percent of the municipality of Podgorica revenues).

State Government Oversight

6.5 **Legally, local government fiscal operations are overseen by the MoF**. Although local governments enjoy autonomy over their budgets and are allowed to sell their assets, their borrowing is subject to state government approval.[67] They are also required to provide the MoF with quarterly data on their fiscal operations and borrowings, within 30 days from the day the quarter period expires.[68]

6.6 **In practice, however, MoF oversight on local government activities is weak.** Not all local governments respect reporting requirements: some report with lags, others do not carry external audits, and some others provide partial information.[69] However, the MoF does not sanction noncompliance, in light of the weak administrative capacity of certain local governments. Furthermore, the MoF does not check the accuracy of the reported information, which requires collecting data on local government commercial bank accounts from the central bank.[70] Also, local governments do not report on their extra-budgetary activities (i.e., agencies, funds, sub-entities) and carry sizeable arrears.[71] Thus, if the financial position of local governments were to weaken unexpectedly, the state government could find itself in a situation where it is asked to provide financial support without adequate information.

6.7 **Reflecting weak oversight, data on consolidated general government prepared by the MoF are not comprehensive**. Data on general government operations excludes local government extra-budgetary operations and relies fully on local government reporting. Data on general government debt includes the authorized local government debt, but excludes local government debtor accounts at commercial banks and arrears.

[66] Taxes and fees administered by the central government are: (i) personal income tax; (ii) real estate sales tax; (ii) beverage tax; and (iv) concession fees. Equalization and incentive grants are distributed to municipalities as follows: Municipalities whose revenues per capita from physical person income tax, value added tax, and corporate income tax are lower than that of other municipalities receive an equalization grant from the Treasury. Municipalities that achieve the highest annual increase in self-collected revenues receive incentive grants from the equalization fund.

[67] However, the law does not forbid local governments from using bank overdraft facilities.

[68] The MoF issued an ordinance in January 2006 that obliges municipalities to provide MoF with accounts based on a unified charter of account.

[69] Most audits are undertaken by either public audit companies or not reputable auditors.

[70] Local governments hold their accounts at commercial banks.

[71] The mission was not able to receive information on the outstanding amount of arrears. However, at end-2004, these arrears were about 1.5 percent of GDP.

Assessment of Fiscal Risks

6.8 **Local government operations pose fiscal risks because of their sizeable extra-budgetary activities, the unsustainable nature of deficit financing, and the accumulation of arrears**. The combined deficit of local governments – as reported by local governments (i.e., excluding municipal extra-budgetary activities) – was about 0.3 percent of GDP in 2004.[72] The municipality of Podgorica poses the largest risk as 80 percent of the deficit was concentrated in this municipality, and mainly financed through municipal property sales (Tables 6.1).[73] Furthermore, accumulated arrears were equivalent to 1½ percent of GDP in 2004. Even excluding potential hidden liabilities (i.e., extrabudgetary operations and arrears), local government deficit, and, more importantly, the nonsustainable nature of its financing create important fiscal risks.

Table 6.1. Montenegro: Fiscal Operations of Local Governments, 2002-04[1/]

	2002	2003	2004	2002	2003	2004
	(in millions of euros)			(in percent of GDP)		
Total Revenues	53.8	70.7	72.0	4.1	4.9	4.7
Taxes	33.7	39.4	31.4	2.6	2.7	2.0
Personal IncomeTax	16.9	18.7	9.0	1.3	1.3	0.6
Real Estate Transfer Tax	3.0	3.0	1.9	0.2	0.2	0.1
Local taxes	13.8	17.7	20.5	1.1	1.2	1.3
Non-tax revenues	18.3	25.1	31.2	1.4	1.7	2.0
Interests and penalties from unpaid local taxes	0.1	0.1	0.2	0.0	0.0	0.0
Interests on unpaid local taxes	0.0	0.0	0.1	0.0	0.0	0.0
Fines sentences through administrative procedure	0.1	0.1	0.1	0.0	0.0	0.0
Fees	14.3	21.4	25.5	1.1	1.5	1.7
Other revenues	3.9	3.5	5.5	0.3	0.2	0.4
Transfers received	1.8	6.2	9.4	0.1	0.4	0.6
Transfers from State budget - Equalization Fund	1.1	3.4	9.4	0.1	0.2	0.6
Other Subsidies	0.7	2.8	0.0	0.1	0.2	0.0
Total Expenditures	58.7	77.2	75.8	4.5	5.4	5.0
Operational Expenditures	35.3	42.6	50.9	2.7	3.0	3.3
Personnel overall expenditures	16.6	20.7	21.0	1.3	1.4	1.4
Materials and services	8.7	12.1	18.9	0.7	0.8	1.2
Interest and other financial related costs	0.0	0.5	1.8	0.0	0.0	0.1
Subsidies to public financial corporations	9.2	8.6	5.2	0.7	0.6	0.3
Social assistance and other transfers to individuals	0.7	0.7	4.0	0.1	0.0	0.3
Capital Expenditures	15.6	26.0	17.1	1.2	1.8	1.1
Other Expenditures	7.8	8.6	7.9	0.6	0.6	0.5
Balance	-4.9	-6.5	-3.9	-0.4	-0.5	-0.3
Identified financing	5.1	7.6	5.6	0.4	0.5	0.4
Proceeds from property sale	4.7	6.9	3.7	0.4	0.5	0.2
Revenues from loans	0.4	0.7	1.3	0.0	0.0	0.1
Change in deposits (+ = reduction)	0.0	0.0	0.6	0.0	0.0	0.0
Unidentified financing/discrepancy	0.2	1.1	1.7	0.0	0.1	0.1

1/ Data for 21 municipalities.
Source: Montenegrin authorities, and IMF staff estimates.

[72] Data are not available on the liabilities arising from extra-budgetary activities, though these are thought to be large.

[73] Property sales are politicized. Given legal ambiguity in the ownership of municipal land, opposition municipalities have difficulties selling municipal land.

6.9 **Local government plans to carry out investment in the form of public-private partnerships (PPP) constitute further sources of fiscal risk**. The municipality of Podgorica is planning on two PPP projects (see Box 6.1).[74] However, PPPs are complex and involve a range of different risks. Absent a sound legal framework for PPPs, effective investment planning, and strong government and municipal capacities to price and monitor these risks, PPPs can pose important fiscal risks to the government.

Box 6.1. The Municipality of Podgorica

The municipality of Podgorica accounts for a third of Montenegro's population. It has 879 employees in agencies and institutions managed by the municipality (e.g., cultural centers, information centers, museums, libraries). The municipality of Podgorica holds a single account in a commercial bank and reports regularly to the MoF. Its annual reports are audited by a state-owned audit company.

The budget of the municipality of Podgorica has registered deficits of 0.2-0.4 percent of GDP during 2002-05. Expenditures represent about 25 percent of total local government spending, but the deficit accounts for 80 percent of combined local government deficit. Centrally administered taxes and government transfers constitute more than 70 percent of the municipality's revenues, leaving less than 30 percent to self-collected revenues. All revenues are earmarked to certain categories of spending. The deficit is fully financed through property sales. Recently, the municipality has also contracted a commercial bank debt of €5.5 million.

The municipality of Podgorica undertakes extra-budgetary activities, which are not reported to the MoF. It finances the activity of "Podgorica Agency for Investment" partly outside its budget. This agency undertakes investment projects other than the municipality's own investment projects, and has a budget of about 0.8 percent of Montenegro's GDP. Together with grants and transfers from the municipality of Podgorica, two municipal fees (construction fee, vehicle registration fee), not included in the municipal budget, finance the budget of the Agency.

The municipality of Podgorica is planning two PPI projects (e.g., a hotel; and creation of a green market) mainly by providing land that would later be converted into private ownership. The value of the municipality's contribution to these planned projects amount to about one percent of Montenegro's 2005 GDP. According to the municipality, all contracts are guaranteed through performance bonds provided by the private investor that amount to a certain percentage of the project value.

C. THE STATE-OWNED ENTERPRISE SECTOR

6.10 **The SOE sector poses additional fiscal risks of its own**. There are 67 SOEs in Montenegro, 15 of which are owned by the central government (see Appendix I).[75] Information on their size, turnover, and financial condition of SOEs is not available. Although each SOE is under the tutelage of a line ministry, which supervises the activity of the SOE, consolidated accounts of the SOE sector are not produced, and with the information currently available to the authorities, it is not possible to construct fiscal operations and debt indicators for the sector.

Government Oversight

6.11 **Comprehensive monitoring of SOEs to assess fiscal risks is not carried out.** There is no centralized unit or single government institution that performs the government oversight

[74] Since the mission did not meet with other municipalities, it is not aware of other PPPs.

[75] The government is a shareholder in more than 160 enterprises.

responsibility over SOEs. Line ministries receive annual financial reports from these enterprises, a copy of which is occasionally sent to the MoF for information. The MoF does not collect data on all SOE liabilities or monitor SOEs' accounts, and is not in a position to judge which SOEs pose a potential risk to the budget in the short term.[76] Thus, fiscal risks that currently exist in some SOEs or could emerge in the future when the financial position of a SOE is unexpectedly weakened are not captured by the government.

Assessment of Fiscal Risks

6.12 **The assessment of fiscal risks posed by SOEs is based on a case study of three enterprises** (Table 6.2): ElektroPrivreda Crne Gore A.D. (EPCG), Montenegro Airlines (MA), Pošta Crne Gore (PCG). The data requested to carry out the assessment were only provided in part, and no details on financing the operations of these SOEs were provided.

6.13 **A first concern is that managerial independence is generally lacking.** Only MA operates on a commercial basis. In the other two SOEs, prices are regulated and do not necessarily cover operational costs. The boards of directors include ministerial representatives, and are, in most cases, fully appointed by the government. Still, employment policies are generally independent from government interference, with some exceptions in the appointment of executive directors.

6.14 **Quasi-fiscal activities are common and some activities are exempt from the VAT.** Budget transfers to SOEs are negligible and none of the SOEs under examination received transfers from the budget over the past three years. However, PCG receives annual transfers from the telecommunications company, while EPCG's debt and arrears to the government amount to 1.2 percent of GDP. EPCG and PCG are both subsidized by the government, and offer their services at subsidized prices. Although the SOEs examined are subject to the same taxes as private firms, the sales of two enterprises (MA and PCG) are exempt from the VAT. According to the companies, airline ticket sales are considered as exports and postal services are considered essential. Finally, the debt of EPCG guaranteed by the government is about 7½ percent of the 2005 GDP and its arrears to the government account for 0.8 percent of GDP.[77]

6.15 **Annual reports are not published and financial statements are not properly audited.** Annual reports are not informative, and audits are mainly carried out by state-owned audit companies. Only the accounts of one enterprise (EPCG) – which is listed on the Montenegro Stock Exchange (NEX) – are audited by reputable private auditors, but its annual report is not published.

6.16 **EPCG and PCG are in weak financial health while MA is barely covering its costs** (Table 6.3). EPCG and PCG have been reporting annual operating losses since 2002 (about one percent of GDP in 2004), while MA has started to register minor surpluses after its recapitalization in 2002, but it has a liquidity problem as its cash flow still runs a deficit.

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[76] In the MoF view, only the Montenegro Railroads poses important fiscal risk to the government.

[77] A large part of this debt (6½ percent of GDP) dates from before 1992 and is under negotiation by the government.

6.17 **All three SOEs are vulnerable and cause contingent risks to the government**. MA, as the only SOE not registering operational losses, has a large currency mismatch in its operations. While all its revenues are denominated in euros, about 65 percent of MA spending (i.e., lease contracts until 2007 of two airlines and purchase of fuel) is in US dollars. The appreciation of the Euro against the US dollar during 2002-05 has benefited MA; however a reversal of this trend would have an adverse impact on MA income. Both EPCG and PCG have sizeable contingent liabilities relative to their operating balances. These companies provide essential public services, they are national monopolies in Montenegro, and their size in terms of employment is very large. EPCG sales are also cross-subsidized. In case of a sudden financial weakening in any of these companies, the government cannot but provide them with financial assistance.[78]

[78] In the case of PCG, the new law states the government should compensate for the losses arising from certain services.

Table 6.2. Montenegro: Characteristics of Major State-Owned Enterprises[1/]

Public Enterprise	Production Sector	Managerial Independence						Government Relations			Financial Conditions			Governance Structure				
		Pricing Policy		Empoyment Policy			Only Commercial Objectives	Receives loan guarantees	Engaged in quasi-fiscal activities	Standard tax and regulatory rules as privates	Profitability 3/	Creditworthiness		Stock listed 6/	Outside Audits	Annual Reports	Minority Rights Protected	Contingent Liabilities 7/
		Prices reflect costs	Receives subsidies 2/	Autonomous: Of civil service laws	Autonomous: Wage-setting	Over-staffed						Debt Level 4/	Debt Cost 5/					
ElektroPrivreda Cr	Electricity	No	No	Yes	Yes	Yes	No	Yes	Yes	Yes	0.0%	17.9%	22.90%	Yes	Yes	Yes	NA	Yes 9/
Montenegro Airlin	Air traffic	Yes	No	Yes	Yes	No	Yes	No	No	Yes	0.05%	25.7%	11.36%	No	Yes 8/	Yes	NA	No
Posta Crne Gore	Post	No	No	Yes	Yes	Yes	No	No	Yes	Yes	0.0%	15.0%	2.20%	No	Yes 8/	Yes	NA	Yes 9/

1/ "Yes" means enterprise meets specific test.
2/ If the answer is "Yes", indicate whether the subsidy is compensated with transfers from the budget.
3/ Profitability is defined as the ratio of net profits to net worth in most recent year, in percent.
4/ Debt level is defined as the ratio of total liabilities to total assets in most recent year, in percent.
5/ Debt cost is defined as the ratio fo accrued 4-year financial costs to average total debt, including short and long-term debt, in percent.
6/ Indicate whether in a major Exchange, in the domestic exchange, or neither.
7/ Indicate whether the enterprise faces important contignent liablities, and their nature.
8/ State-owned audit company.
9/ Both enterprises face significant contingent liabilities generated from the regulated pricing of their services.

Table 6.3. Montenegro: Selected Financial Indicators for State-owned Enterprises, 2002-04 (millions €)

	2002	2003	2004
EPCG			
Assets	1,025.8	991.3	1,118.5
Equity	827.9	798.3	918.1
Sales	140.7	157.0	138.9
Operating Balance	-35.9	-25.1	-10.8
Idem (in percent of GDP)	-2.8	-1.7	-0.7
Operating balance + financing cost	-33.5	-30.5	-14.2
Idem (in percent of GDP)	-2.6	-2.1	-0.9
PCG			
Assets	23.5	23.5	24.4
Equity	20.1	18.5	20.7
Sales	13.0	12.7	12.5
Operating Balance	-0.9	-2.4	-0.9
Idem (in percent of GDP)	-0.1	-0.2	-0.1
Operating balance + financing cost	-0.4	-1.6	-0.1
Idem (in percent of GDP)	0.0	-0.1	0.0
Montenegro Airlines			
Assets	30.6	33.8	35.8
Equity	26.5	26.6	26.6
Sales	16.3	24.5	29.6
Operating Balance	0.1	0.1	0.2
Idem (in percent of GDP)	0.01	0.01	0.01
Operating balance + financing cost	0.0	0.0	0.0
Idem (in percent of GDP)	0.00	0.00	0.00
Memorandum			
Nominal GDP	1,302.0	1,441.0	1,531.0
Real GDP growth (in percent)	3.8	2.7	7.2

Source: Enterprises' annual reports.

D. CONCLUSIONS AND RECOMMENDATIONS

Government Oversight

6.18 **The state government urgently needs to strengthen oversight over local governments and SOEs**. The MoF gathers partial information on local governments (i.e., excluding their extra-budgetary activities), does not check its accuracy, nor sanctions delays or inadequate reporting from local governments. In addition, there is no centralized information on the SOE sector, and SOE liabilities guaranteed by the government are the only data available on the SOE sector at the MOF. Thus, if the financial position of local governments or SOEs were to weaken unexpectedly, the state government could find itself in a situation where it is asked to provide financial support without adequate information.

6.19 **To strengthen oversight, the MoF should set up a unit to monitor the operations and financial activities of local governments and SOEs**. The unit should collect and compile quarterly statements on consolidated municipal government accounts (including extra-budgetary activities), and liabilities (including arrears and overdrafts). This information should be reconciled with data on municipal bank accounts that would be provided by the central bank. The unit should also create a database on SOEs, collect and compile quarterly information on SOE liabilities including arrears, and receive the income statements from the electricity company, ElektroPrivreda Crne Gore (EPCG).

Coverage of Fiscal Accounts

6.20 **The coverage of the fiscal accounts does not provide an adequate basis for formulating fiscal policy and identifying fiscal risks and needs to be broadened**. The fiscal coverage in reports published by the government includes extra-budgetary funds and partial information on local government, but excludes the SOE sector. Furthermore, the MoF does not report all local government liabilities in the public sector debt statistics. Thus, the government is not in a position to identify key fiscal risks that may be arising from local government and SOE operations.

6.21 **Expanding the coverage of fiscal and debt statistics could be divided into three steps**. These are as follows: (i) include all local government liabilities (of which arrears and bank overdrafts) in the public sector debt data, with the liabilities of SOEs that are not guaranteed by the government and arrears marked as a memorandum item; (ii) include local government extra-budgetary activities in the operations of general government; and (iii) add the operating balance of EPCG in the fiscal tables as a memorandum item. A wider coverage of fiscal operations to include that of SOEs is not recommended in the short run, in light of the other priorities.

Private Participation in Infrastructure

6.22 **There is an urgent need to develop an institutional framework for handling private participation in infrastructure (PPI)**. While local governments intend to foster PPI, there is currently an absence of adequate legal or institutional mechanisms to develop these projects in an orderly fashion. To prevent the emergence of fiscal risks related to these contracts, the government should develop a sound legal and institutional framework that covers the various aspects of PPI. In this context, the government also needs to strengthen its overall investment planning and procurement processes. Furthermore, it should build state and local government capacities to handle PPI projects, including assessing value-for-money and fiscal risks. Over the medium term, when PPI contracts become effective, the government should monitor these activities through its municipal reporting mechanisms.

Table 6.4. Montenegro: Recommendations to Improve Government Monitoring of Local Government and SOE Activities

<table>
<tr><th>Sector</th><th>Recommendations</th></tr>
<tr><td rowspan="4">LOCAL GOVERNMENT</td><td>State government oversight
Prepare a list of municipal extrabudgetary activities (funds, agencies, or other entities) in collaboration with local governments.
Request from the central bank monthly information on municipalities' and their extrabudgetary activities' bank accounts.
Set up a unit at the Ministry of Finance to monitor local government financial conditions (same unit could monitor SOE activities).
Reconcile the information provided by local governments with that received from the central bank.
Revise the law on municipal borrowing to subject local government use of commercial bank overdraft facilities to the approval of state government.</td></tr>
<tr><td>Local government reporting
Require from municipalities monthly information on their liabilities, including use of overdraft facilities and arrears.
Require from municipalities to integrate their extra-budgetary operations into municipal reporting.</td></tr>
<tr><td>Data dissemination
Expand the coverage of general government debt statistics to include all municipal liabilities (overdraft facilities, arrears).
Integrate line-by-line the consolidated municipal finances, including municipal extrabudgetary activities, into the central government account to obtain a comprehensive general government coverage of fiscal operations.</td></tr>
<tr><td>Public Private Partnerships
Develop a sound legal framework that covers all aspects of public-private investment (PPI).
Strengthen MOF and municipalities' capacities in terms of assessing PPIs and public private partnerships and the resulting fiscal risks.
Request reporting on PPIs.</td></tr>
<tr><td rowspan="3">STATE-OWNED ENTERPRISE</td><td>Government oversight
Prepare a list of SOEs in collaboration with other government institutions.
Create a database on SOEs that includes: the number of employees, the legal status, the share of the government ownership, the annual turnover, the operating balance, total liabilities, and arrears.
Set up a unit at the Ministry of Finance to monitor SOE financial conditions.
Oblige SOEs to carry audits by independent reputable private auditors and to publish annual reports.</td></tr>
<tr><td>Reporting
Require from SOEs to submit to the MoF quarterly data on their liabilities, with details on those guaranteed by the government, those that are due to other SOEs or local governments, and the arrears.
Request from EPCG to submit quarterly income and cash flow statements to the MoF.</td></tr>
<tr><td>Data dissemination
Include the liabilities of SOEs that are not guaranteed by the government–excluding intra-enterprise liabilities– as a memorandum item in the public sector debt statistics.
Add the operating balance of EPCG in the memorandum item of the fiscal reports.</td></tr>
</table>

Appendix I. Montenegro: List of State-Owned Enterprises

	Central government ownership (in percent)	Consolidated government ownership (in percent)
Shareholding companies		
1 Agrotransport DD Podgorica	0.0	66.0
2 Bisernica	0.0	76.0
3 Bokeljka, Kotor	0.0	67.8
4 Beranka AD	0.0	80.1
5 HTP Budvanska rivijera	41.6	58.7
6 Igalo AD	0.0	81.0
7 Crnogorska plovidba	89.5	100.0
8 AD Gornji Ibar, Rožaje	3.0	54.1
9 Gros-Market	0.0	65.9
10 HK Agrokombinat 13 jul AD	0.0	77.1
11 HTP Boka AD, Heceg Novi	0.0	59.5
12 AD Ibarmond, Rožaje	0.0	51.0
13 Preduzece za izgradjnu Podgorice AD	0.0	52.8
14 Jadransko brodogradilište ADBijela	0.0	62.7
15 AD Jadran Perast	0.0	70.8
16 Jugooceanija AD, Kotor	26.3	51.0
17 AD Krušik HK 4 novembar, Mojkovac	60.5	66.7
18 AD Lovcen, Podgorica	0.0	76.5
19 AD Luka, Kotor	0.0	80.4
20 AD Maksim, Murino	18.4	51.3
21 AD Marina, Bar	0.0	67.0
22 IMO Metalac	0.0	59.9
23 Montenegro Modern Shoes	55.6	75.2
24 Montepranzo-Bokaprodukt	0.0	75.1
25 DD Nibus, Nikšic	0.0	51.9
26 Željeznica Crne Gore	60.1	65.7
27 HK Željezara Nikšic AD	23.7	59.3
28 Institut crne matalurgije AD	22.0	55.0
29 Zimosport AD	0.0	87.8
30 AD Optel, Pljevlja	53.6	89.9
31 AD Plantaže	0.3	54.4
32 Pljevaljska banka AD, Pljevlja	56.4	78.7
33 AD Polimka, Berane	5.4	50.3
34 Prehrane	0.0	69.0
35 Prva petoljetka, B. Polje	47.0	87.8
36 Prekookeanska plovidva, Bar	18.4	51.3
37 AD Barska plovidva, Bar	18.4	51.2
38 Radoje Dakic AD	31.6	52.2
39 Rivijera AD TRG	0.0	66.3
40 RZ za urbanizam I projektovanje AD	0.0	66.5
41 Sinjajevina, Šavnik	0.0	89.8
42 ŠP- Andrijevica AD	0.0	80.0
43 ŠP AD Bijelo Polje	0.0	85.1
44 ŠP- Danilovgrad	0.0	77.8
45 ŠP- Kolašin	0.0	68.1
46 ŠP AD Nikšic	0.0	82.5
47 ŠP AD Podgorica	0.0	75.1
48 ŠP AD Pljevjla	0.0	81.8
49 ŠP AD Rožaje	0.0	70.0
50 ŠP AD Žabljak	0.0	82.5
51 Turist Bijelo Polje	0.0	76.4
52 HTP Ulcinjska rivijera, Ulcinj	9.7	60.7
53 Uzor	0.0	70.0
54 Vinopromet	0.0	77.2
55 AD Luka Bar, Bar	54.1	54.1
56 Golubovci komerc	18.4	84.4
57 Plodovi Crne Gore	26.0	73.0
58 Elektroprivreda CG Nikšic	67.7	67.7
59 AD za prikazivanje filmova Kultura	0.0	77.7
60 Tržni centar AD Mojkova	0.0	77.3
Limited liability companies		
61 Montrev LLC	100.0	100.0
62 SEKAS, Podgorica	100.0	100.0
63 Montenegrobonus, Cetinje	100.0	100.0
64 Regional Water Supply Company, Budva	100.0	100.0
65 Vodacom	-	100.0
66 Pošta Crne Gore DOO	100.0	100.0
67 Montenegro Airlines	99.8	99.8

Source: Montenegrin Authorities.

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ANNEXES

ANNEX 1. MONTENEGRO: KEY MACROECONOMIC INDICATORS

Indicator	2001	2002	2003	2004	2005
Real sector developments					
GDP, mln EUR	1245	1302	1433	1535	1644
GDP, mln USD	1115	1230	1621	1909	2045
GDP real growth	-0.2	1.7	2.3	3.7	4.1
Industrial production growth (y-o-y)	-2.0	0.6	2.4	13.8	-1.9
Agriculture growth, (y-o-y)	7.0	6.6	1.0	3.5	
Public finances					
Central government revenues, % GDP	23.3	26.7	25.7	24.5	26.5
Central government expenditures, % GDP	26.3	30.8	29.9	26.5	29.8
Budget deficit before grants, % GDP	-3.0	-4.1	-4.2	-2.1	-3.3
General government revenues, % GDP	38.0	35.1	34.8	36.4	37.7
General gov. expenditure (inc.Union), % GDP	42.3	38.6	39.8	39.9	40.4
General government deficit before grants, %GDP		-3.8	-4.9	-3.5	-2.7
General government deficit after.grants, %GDP	-1.6	-1.8	-4.0	-3.1	-2.4
Privatization revenues, EUR mln	0.0	66.4	15.8	7.7	169.4
Privatization revenues, % GDP	0.0	5.1	1.1	0.5	10.3
Debt service, EUR mln	59.5	48.9	55.7	52.0	
Prices					
Inflation (CPI, eop)	24.0	9.4	6.7	4.3	1.8
Inflation (CPI, average)	22.9	17.5	7.0	3.1	3.4
Costs of living (eop)	26.6	9.5	6.2	1.5	2.4
Foreign Trade					
Export of goods, mln USD	210.8	305.1	263.5	504.0	536.0
Import of goods, mln USD	-647.4	-706.7	-762.7	-1064.3	-1175.1
Trade deficit, mln USD	-436.6	-401.6	-499.3	-560.3	-639.0
CAD before grants, mln USD	-307.5	-247.9	-234.0	-260.8	-250.2
CAD, as % GDP	-27.6	-20.1	-16.2	-13.7	-12.2
CAD after grants, mln USD	-175.0	-161.1	-202.9	-203.1	-198.8
CAD after grants, as % GDP	-15.7	-13.1	-12.5	-10.7	-9.7
Export of goods, mln EUR	235.3	320.8	270.6	452.1	434.5
Import of goods, mln EUR	726.3	742.8	-629.9	-868.6	-940.3
Trade deficit, mln EUR	-491.0	-422.0	-359.3	-416.4	-505.9
Export of goods in EUR, as % GDP	18.9	24.7	18.9	29.5	26.4
Import of goods in EUR, as % GDP	58.3	57.1	-44.0	-56.6	-57.2
Trade deficit, as %GDP	-39.4	-32.4	-25.1	-27.1	-30.8

Indicator	2001	2002	2003	2004	2005
CAD after grants, mln EUR	-175.0	-161.1	-102.0	-119.6	-140.7
CAD after grants, as % GDP	-15.7	-13.1	-7.1	-7.8	-8.6
Gross official reserves, mln EUR	34.5	43.0	38.5	53.5	
FDI, mln EUR	10.6	87.3	38.7	50.6	374.7
FDI, % GDP	9.5	6.7	2.7	3.3	22.8
Tourism income, mln USD	94.9	144.0	151.2	179.7	
Monetary					
M1	na	402.0	386.1	430.7	595.1
M2, mln EUR	na	496.0	460.8	535.5	801.1
M2, as %GDP	na	38.1	32.2	34.9	48.7
Wages					
Average net wage in EUR	108.0	142,2**	173.9	195.9	213.0
Average pension, EUR	98.4	108.7	112.0	123.0	
Employment					
Average employment (official), 000	141.1	140.1	142.7	143.5	143.7
Registered unemployment, average in 000	81.6	80.9	71.7	65.0	55.0
LFS unemployment rate	24.6	24.5	26.9	27.7	
Indebtedness					
Total External Debt, EUR mln		903.2	510.1	601.7	683.9
Total External Debt, % GDP		69.4	35.6	39.2	41.6
Public external debt, EUR mln	674.4	893.6	461.5	488.1	526.1
Public external debt, % GDP	54.2	68.7	32.2	31.8	32.0
Public debt, EUR mln	na	1149.2	711.2	742.9	695.4
Public debt, %GDP	na	88.3	49.6	48.4	42.3
Memorandum items:					
Population	613328	615534	61774	620145	
USD per 1 EUR, end of period	0.883	1.043	1.250	1.362	1.186
USD per 1 EUR, period average	0.896	0.946	1.131	1.244	1.244

ANNEX 2. PROJECTIONS OF SCHOOL-AGE POPULATION, STUDENTS, AND TEACHERS

Projected population for Montenegro in School-Age Cohorts

Age	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
6-14 years	80,811	79,701	76,027	74,901	73,821	72,283	71,516	70,981	70,691	70,632
15-18 years	39,871	39,193	37,030	36,229	35,555	34,748	34,053	33,400	32,731	32,021
19-22 years	40,347	40,610	40,578	40,131	39,470	38,337	37,177	36,095	35,156	34,354

Source: MONSTAT estimations for 2003 and 2004. Own estimations for the later years, based on population growth rate for Serbia

Projections of Numbers of School Pupils and Teachers, assuming current enrollment ratios and improving enrollment ratios, 2004-2012

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Scenario 1: Current enrollment and pupil-teacher ratios									
Primary									
Students	74,205	74,630	73,524	72,416	70,810	69,305	68,663	68,297	68,209
Teachers	4,796	4,846	4,774	4,702	4,598	4,500	4,459	4,435	4,429
Teacher reduction (increase) from previous year		(50)	72	72	104	98	42	24	6
Cumulative teacher reduction (increase)		(50)	22	94	198	296	337	361	367
Secondary									
Students	32,078	31,903	31,430	30,957	30,270	29,627	29,352	29,196	29,158
Teachers	2,245	2,231	2,198	2,165	2,117	2,072	2,053	2,042	2,039
Teacher reduction (increase) from previous year		14	33	33	48	45	19	11	3
Cumulative teacher reduction (increase)		14	47	80	128	173	192	203	206
Scenario 2: Increase enrollment to 100% in primary and 88% in secondary by 2012; current pupil-teacher ratios									
Primary									
Students	74,205	74,630	74,062	74,185	73,759	72,559	72,250	72,227	72,279
Teachers	4,796	4,846	4,809	4,817	4,790	4,712	4,692	4,690	4,693
Teacher reduction (increase) from previous year		(50)	37	(8)	28	78	20	2	(3)
Cumulative teacher reduction (increase)		(50)	(13)	(21)	6	84	104	106	103
Secondary									
Students	32,078	31,903	30,278	30,458	30,492	30,238	30,356	29,748	29,103
Teachers	2,245	2,231	2,117	2,130	2,132	2,115	2,123	2,080	2,035
Teacher reduction (increase) from previous year		14	114	(13)	(2)	18	(8)	43	45
Cumulative teacher reduction (increase)		14	128	115	113	130	122	165	210

ANNEX 3. COSTS OF ALTERNATIVE SCHOOL REFORM SCENARIO, 2007-2012

Type of expenditure	**2004 (20 primary schools)**	**2005 (27 primary schools)**	**2006 (27 primary schools and 30 gymnasia)**	**2007 (20 primary schools)**	**2008 (20 primary schools)**	**2009 (20 primary schools)**	**2010 (20 primary schools)**	**2011 (8 primary schools)**	**2012**	**Total**
School reconstruction and upgrading	1,217,960	1,133,841	1,096,768	979,354	1,031,871	1,107,871	1,042,374	208,475	31,271	7,849,784
Training for teachers and directors	213,780	194,000	198,000	298,000	338,000	318,000	298,000	288,000	238,000	2,383,780
Teaching aids		107,087	135,000	71,000	62,600	65,320	61,464	9,798	8,000	520,269
School furniture		205,892	420,000	152,513	342,222	183,015	342,222			1,645,864
Computer equipment		195,000	1,325,000	2,956,000	2,655,000	2,585,000	2,675,000	1,250,000	1,240,000	14,881,000
Free textbooks provision		7,236	100,000	70,000	80,000	100,000	80,000	80,000	80,000	597,236
Library materials		27,120	38,000	20,089	22,098	0				
Civil works supervision		14,515	21,000	19,587		22,157				77,260
Total	1,431,740	1,884,691	3,333,768	4,566,542	4,531,791	4,381,363	4,499,060	1,836,273	1,597,271	27,955,193

ANNEX 4. MONTENEGRO'S TRANSPORT INFRASTRUCTURE NETWORK, AND REGULATORY AND INSTITUTIONAL FRAMEWORK

A. Transport Infrastructure Network

Road Infrastructure

Montenegro's state road infrastructure extends for 6,848 km, out of which 964km are regional roads and 884 km are highways (magistral) (Table A4.1). The total network also contains 312 bridges, 136 tunnels, and about 5000 km of local roads. Half of the local roads are unpaved and are managed by the 21 municipalities. There are currently around 100,000 registered vehicles in Montenegro out of which 89 percent are private passenger vehicles.

The mountainous nature of the terrain, coupled with the maintenance backlog during the last decades, results in higher costs for road users, creates a contingent liability and reduces Montenegro's comparative advantages against other transit corridors. The physical characteristics of most of the regional roads (steep slopes, absence of shoulders, tight curves, low radii, relatively high pavement degradation) results in an average speed of less than 50 kilometers per hour. Furthermore, there are no routes through the country designated as part of the Trans-European Network (TEN) corridors, but some of the main routes are part of the South East Europe Transport Observatory (SEETO) defined regional 'core' network. Support from the EU funding agencies, notably the European Agency for Reconstruction (EAR), has been targeted at emergency repairs. Without adequate maintenance, roads deteriorate at an increasing rate until reconstruction is necessary, at considerably greater expense than any short term saving in maintenance expenditure[79], creating a contingent liability. In addition, failure to maintain a paved road is estimated to increases user costs by a factor of three, in terms of additional time, fuel, and vehicular wear and tear.

Table A4.1: Road Network in the Republic of Montenegro by Category and Class

Category/Class	European	Highway (Magistral)	Regional (Provincial)	Total
Primary	20	593		613
Secondary	53	129	144	326
Tertiary		88	820	908
Total	**73**	**811**	**964**	**1848**

Source: Department of Roads and Railway Infrastructure (DRRI), 2004.

[79] Heggie and Vickers (1998). report that rehabilitating a paved road is 3 times more expensive than maintaining it, in current terms, and around 35% more in net present value terms.

Local roads planning, financing and construction are the responsibilities of the municipalities. Local roads are defined as those that either (i) connect settlements and villages to the trunk road network , or (ii) streets within settlements and villages. The most important municipalities in terms of local roads network are: Niksic with 1200 km of local roads, and Podgorica with 900 km of local roads. The municipality of Bar has 164 km. No data was collected from other municipalities for the purposes of this review. Municipalities, although in charge of the construction and maintenance of local roads, do not receive any funds from the central Government and in some cases their mandate is unfunded.

The current road network in terms of density appears to be low. On one measure of density, road kilometers per 1000 square km, Montenegro does not compare favorably with most neighboring countries (except the FYR Macedonia and Bosnia and Herzegovina) (Table A4.2.). In terms of road kilometers per 1000 people, Montenegro performs better than many of the regional comparators (Croatia, Albania, BiH, and FYR Macedonia) and well above the average for lower middle income countries. In both cases, it falls well short of OECD levels.

Table A4.2. Montenegro Road Infrastructure Density Compared to Others (latest observation available 1997-2003)

	Road Density	
	(Road - km/1000 sq km)	**(Road- km/1000 People)**
Montenegro	**495.8**	**11.0**
Albania	657	3.5
Bosnia and Herzegovina	426.7	5.6
FYR Macedonia	341.5	4.3
Czech Republic	1646.0	12.5
Croatia	506	6.4
Estonia	1319.7	41.2
Hungary	1732.6	15.7
Slovenia	1006.5	10.2
Europe & Central Asia	580.3	8.6
Upper middle income	1076.4	9.2
Lower Middle income	327.7	4.9
High income: OECD	1340.4	17.3

Source: WDI and IEF databases.

Railway Infrastructure

The total length of the railway network in Montenegro is 250 km (330 km including station sidings and marshalling areas). The railway network comprises 169.2 km of electrified lines, 81.2 km of non electrified lines. The network connects the Adriatic Port of Bar to the West, with Podgorica, and then onto the border with Serbia and the TEN Corridor X in Serbia. As such, the line is a defined part of the SEETO Regional Core Network.

The railway network forms an ‘X’ comprising: (i) The Vrbnica-Bar line that is 169 km long, fully electrified and operational since 1976, and includes 107 bridges, 106 tunnels, 9 galleries, 371 passages; (ii) The Niksic-Podgorica that is 56 km, operational since 1948; and (iii) The Podgorica –Skadar line connecting Podgorica to the State border with Albania, which is 25 km, operational since 1986, but is now used only for freight traffic since 2002.

As for the rail network, the nature of the terrain and track altitudes of 1000m above the sea level, imply high operation and maintenance costs. During the last 15 years, due to inadequate routine maintenance, there has been progressive deterioration of the quality of service with repeated traffic breakdowns particularly during the winter seasons. Average traveling speed is about 50 km per hour between Bar and Bijelo Polje and 30 km per hour between Podgorica and Niksic, and the infrastructure is in urgent need of rehabilitation.

Maritime Infrastructure

There are four ports on the Montenegrin coast for international transportation, and two shipyards. The Port of Bar is the major maritime infrastructure in Montenegro, with an annual capacity of 5 million tons, handling 90 percent of the maritime freight. It is the only deep water port of the region. It extends over an area of 200 ha with good rail and road connections and has an outstanding potential for extension (600 ha). The three other ports of national interest are situated in the larger Kotor bay: the Ports of Kotor, Zelenika and Risan. The Port of Kotor can accommodate cruise ships and large private yachts. But there is strong competition for these ports from elsewhere in the Adriatic.

Airport Infrastructure

Montenegro has two international airports, one in Podgorica and a smaller one in Tivat near Kotor Bay, mainly for charter flights during the summer tourist season. Podgorica airport is regarded as the principal gateway to Montenegro for all class of air transport (tourism, business, corporate, general aviation and cargo), and the home base for the national airlines, Montenegro Airlines. Both airports are being improved to meet the high standards of passenger facilitation and all International Civil Aviation Organization (ICAO) requirements for operations, safety and security. New terminals in Podgorica and Tivat airports are expected to open by the end of May 2006. Passenger traffic was around 700,000 passengers in 2005, equally shared between the two airports, with international traffic representing one third of the total. There is currently little air freight.

B. The Institutional and Regulatory Framework

A transport strategy is being developed by the Ministry of Transport and Maritime Affairs (MMAT), with the help of the EAR. In line with the key principles of this strategy[80], the Republic of Montenegro signed in 2005 a Memorandum of Understanding (MoU) on the development of the South East Europe Core network which aims to support implementation of “the most efficient and environmentally friendly transport modes on a regional scale”. The scope of the MoU covers infrastructure and related services, including administrative and regulatory procedures. Harmonization and standardization of technical standards and regulatory or administrative provisions affecting the flow of transport in and across the region, in accordance

[80] Some of the key principles underlying the transport strategy are: Regional cooperation and integration to increase of trade and transit; safety concerns as a major cross-cutting issue; concession and further privatization when it proves appropriate, of all public undertakings still providing transport services or managing transport terminals (ports, airports); commercialization of infrastructure management through the user charges principles and the use of private contractors for maintenance; environment friendly transport modes by focusing on measures that bring environment benefits as well as mitigating direct and indirect impacts of infrastructure projects; involvement of all stakeholders and the private sector, particularly in infrastructure’s users funds; and, improvement of data collection and management capacity for relevant and reliable planning.

with EU standards and directives, was defined as an important role for transport facilitation. The following sections present for each sub-sector the important new reforms and laws.

Road Sector

The transport regulatory framework is being renewed in order to introduce the main principles of liberalization, fair competition, and privatization, in line with international standards. Up to 2004, the Administration for Maritime Security, the Directorate of State Roads, and the Directorate of Highways were under the supervision of the MMTA,.The Directorate of State Roads in charge of road maintenance, improvement and construction. The relevant changes to the regulatory framework for transport are summarized below:

- A new law on State Roads was adopted in mid 2004 to harmonize the national law with European directives. This established the Directorate of Public Roads (DPR) as the unique body in charge of managing, maintaining, and building State and regional roads. Local roads remain under the responsibility of municipalities.

- In January 2005, the new law on State Roads was implemented and the new Directorate of Public Roads became operational as a line department of the Ministry of Maritime Affairs and Transport, fully regulated by public administration laws and regulations.

- The former Directorate of Highways Construction is in the process of being transformed into the Sozina Tunnel Management Company, and after completion of the ongoing Risan-Vilusi project, it will cease to be involved in any road contracts.

- The Directorate of Public Works (DPW) is in charge of professional activities relating to construction, and reconstruction of facilities of primary technical infrastructure, SOE facilities, health, education, culture and sports complexes. After the enactment of the new law on State Roads, the DPW became less involved in the construction of highways but remained involved, when requested by municipalities, in the construction of roads that connect municipalities to the trunk road network, as well as roads that connect municipalities to villages. The Local Roads maintenance, improvements, and construction are under the responsibility of the municipalities.

The planning and budgetary process in the sector is weak, with a number of deficiencies that undermine the efficiency of expenditures within the sector including, *inter alia*: (i) the absence of a sector policy and strategy for development; (ii) weaknesses in project identification and assessment; (iii) poor budgetary control; and (iv) limitations in the management of the assets in the sector.

There is a lack of professional management of assets in the sector. In the road sector, there is little regular monitoring of the condition of the assets, there is no road and structure inventory database, and the little information that is gathered on traffic volumes and axle loads is done in a less than systematic and robust manner.

Accordingly, the limited use of formal techniques of economic appraisal in project identification and prioritization is one of the main weaknesses in the budgetary process.

Setting up a road and structures database is a prerequisite to a professional approach to asset management. The general approach involves the introduction of robust data collection systems on the condition and use of the assets. The identification of priorities for maintenance expenditures in the sector can then be made on a sound assessment of economic viability given the available budgetary envelope. A similar, but simpler, data collection exercise could be undertaken for local roads, which would allow a simpler system to be employed to manage the local road network.

The State Law on Roads includes provisions for the use of public private partnerships (PPPs) to develop road infrastructure. Previously, there was no effective institutional set up to involve private sector participation or even consultation in infrastructure policies. In addition, "Crnagoraput", a public owned company, holds a virtual monopoly on all road maintenance and construction in the republic. A five year contract of routine maintenance of public roads was signed in April 2005 with Crnagoraput, for an annual amount of Euros 9 million. The Republic should consider introducing competition from private sector road contractors for road maintenance and construction with a view to improving efficiency and reducing costs of road works.

Railways Sector

The regulatory framework for the railway sector is also going through changes following the adoption of new laws in 2005. Historically, and in common with the Railways of other Republics within the former Yugoslavia, ZCG, the Railway Company of Montenegro, did not have any recognized international status since Yugoslavia Railways "JZ" represented all former Yugoslavia railways. ZCG was itself controlled by Serbian Railways "ZTP Belgrade". Recently, ZCG was afforded entry to international railways institutions, including the International Union of Railways, "Union Internationale des Chemins de Fer" (UIC), and Community of European Railways (CER). ZCG will also be involved in negotiating multi-lateral agreements with adjoining countries, such as Albania and Serbia, to regulate passenger and freight lines between the two countries.

A new Railway Law was adopted in Montenegro in 2005, consistent with the relevant EU Directives (e.g. EU Dir.91/440). It mandates an accounting separation between infrastructure and operations, and between lines of business. The law allows for the opening of the railway infrastructure to licensed local and international operators. Therefore, since January 2006, ZCG became a Holding company with two shareholder companies, one for operations and one for infrastructure. A program addressing labor surplus is being implemented resulting in 191 employees declared redundant, with compensation benefits to be paid costing as much as 1.5 million Euros.

ZCG has very low traffic volume, about evenly split between passenger and freight when measured by traffic units. However, passenger trains account for 84 percent of train-km.) In 2004, ZCG carried 1.2 million passengers (94 million passenger-km). This was down 10 percent from the passengers carried in 2003, 44 percent fewer than in 2001, and less than half the passengers carried in 1989. The railway forecasts that passenger totals will shrink another 10 percent in 2005 to some 1.1 million.

Most of the railway's passenger traffic occurs on the main north-south line, with Bar, Podgorica and Bijelo Polje stations generating about 95 percent of the volume.[81] Average distance traveled is about 100 km. During the summer the Podgorica-Bar line carries tourist traffic to the coast.[82] ZCG competes with bus and private automobiles, and holds rail prices lower than bus prices.[83] Price per passenger-km has more than doubled since 2001, however.

As a result ZCG is a low density poorly performing railway operation. Productivity indicators such as the traffic-units per track km or traffic units per locomotive (Table A4.3) show that ZCG is not one of the poorest performers in the region, but it is not one of the best either. Whilst this partly reflects the current lull in bulk traffic, the atomization of the former Yugoslavian Railways has fragmented rail service, reducing competitiveness and contributing to a further direct loss of traffic. In addition, road competition is fierce, and likely to intensify for passenger traffic, with rising levels of car-ownership.

Table A4.3: Selected productivity indices for Western Balkans and Benchmark Railways (2003 unless indicated)

Railway	Year	Track-km	Electrified (km)	Traffic Units (Ms)	Traffic Units pr track-km (Ms)	Traffic Units per locomotive (Ms)	Traffic Units per Employee (000s)	Traffic unit per $ of Wage
Albania	2003	447	0	136	0.3	5.5	60.6	42
B&H – ZBH	2002/03	608	441	231	0.8	4.6	59.4	23
B&H – ZRS	2002/03	448	362	140	0.5	2.7	57.1	na
Croatia	2003	4,060	622	3,911	1	21.3	262.4	18
Kosovo	2004	333	0	60	0.2	12.8	140	40.5*
Macedonia	2003	925	318	447	0.5	13.2	116.1	24
Montenegro	**2004**	**330**	**167**	**226**	**0.6**	**15.2**	**121.4**	**18**
Serbia	2003	3,809	1247	3,494	1.1	37.3	123.8	25
Denmark	2003	3,240	624	7,479	2.3	38.5	893.7	-
Finland	2003	8,707	2400	13,385	1.5	31.2	973.7	-
Sweden	2003	15,359	7739	18,562	1.2	31.9	1,472.40	-
Germany	2003	65,782	19378	149,398	2.3	29.9	615.4	-

**Traffic unit per € of Wage.*

Maritime Sector

The Institutional Framework for the Maritime sector is also being revised to separate operational management and planning from regulatory functions. Ports administration is done by two Port Director's offices (Kotor with branch offices in Herceg-Novi, Zelenika and Tivat; Bar with branch offices in Budva, Ulcinje and Virpazar), which are regional organizations under the MMTA. These offices perform inspection, and administrative duties of the State

[81] Rebis Study, p. 55.

[82] Serbian Railways reports that the line carries significant summer tourist traffic from Serbia as well.

[83] Rebis Study, p. 55.

Control functions. These duties cover construction, setting and maintenance of maritime lighting on navigable routes, technical examination of navigable and floating objects. The dedicated department of the Ministry comprises three services: (i) Technical inspection of vessels and implementation of international regulation, (ii) safe navigation, and (iii) general affairs and administration.

Several laws are being drafted in line with the MoU and EU directives: (i) the law of Port operarions regulating the functioning of ports and establishing a new government agency, namely the Port administration that will enforce the application of international codes and conventions; (ii) the law of sea use which will determine the sovereignty of the state, the coastal sea ways of use, exploitation, protection and quality improvements, (iii) law of navigational safety and security regarding all navigational requirements and enforcement, and (iv) law of hydrographic activities defining them according to the convention on protecting human lives on the sea. In addition, the laws on vessels registration, sea pollution prevention and maritime navigation defining routes, rights and obligations of sea users are at their final stage of drafting.

Air Transport Sector

The national airports are managed by Airports of Montenegro, a state owned company created in 1999. The Government, through Airports of Montenegro, purchased Podgorica and Tivat airports from JAT Airlines in 2003. In November 2003, the Government adopted a strategic Master Plan for the development of the sector. Immediately after this, Airports of Montenegro assumed responsibility for the Modernization Project of Podgorica and Tivat Airports, which had started in April 2003.

Civil aviation regulation is undertaken by an authority established jointly by the States of Serbia and Montenegro. The international collaboration between the Civil Air traffic directorate and Agency for Air Traffic Control has been intensified since 2005. The agreement regarding the liberalization of air traffic between the member countries of the European Union and the Balkan countries was to be signed on May 5, 2006, and is founded on free access to the entire market which will include the EU and all neighboring countries, including the West Balkans. The agreement also allows the founding of new companies, fair conditions for competition and equal rights in the fields of security and safety in civil air travel, airport politics, a new concept for air traffic control systems and the preservation of natural resources. The Serbian and Montenegrin civil air traffic directorates acknowledge that because of this agreement the market will be more open and that the competition will be stronger, but that the air travel companies and airports will have ample time to adjust to the new conditions.

Currently, Montenegro Airlines is the only national carrier, created by the Government in 1994 but operational since 2000. It operates 4 Fokker 100 on regular lines to European destinations: Zurich, Frankfurt, Rome, Paris, Ljubljana, Skopje, Budapest, and Vienna. The current dominant position of Montenegro Airlines, in view of its reliability, may diminish after the newly signed agreement that would liberalize the sector and increase competition. There is no budget transfer to the airline from the Republican treasury.

C. Public Expenditure on Transport (2003-05)

In 2003, 93 percent of the transport sector spending went to Roads, Railways and Administration all together, while 4 percent went to civil aviation and around 3 percent to maritime transport. The budget structure comprised roads, railways and administration, together, while Airports of Montenegro and Maritime transport (Ports of Bar and Kotor) were counted separately. For all sub-sectors but civil aviation, expenditures were basically recurrent expenditures (Table A4.4). This confirms that very little was devoted for roads and railways improvement and maintenance. Expenditures on Airports of Montenegro composed of 84 percent capital investments and 16 percent recurrent expenditures.

Table A4.4. Montenegro Transport Sector Public Expenditures, 2003

	2003		
Description	**Actual (euros)**	**% of Total Transport**	**% of GDP**
Roads, Railways and Administration			
Recurrent expenditures	5817356	92.54	
Capital expenditures	50000	0.80	
Total expenditures	5867356	93.34	0.41
Civil Aviation			
Total recurrent expenditures-JP	37781	0.60	
Capital expenditures	200000	3.18	
Total Civil Aviation	237781	3.78	0.02
Maritime Transport			
Recurrent expenditures	177498	2.82	
Capital expenditures	3669	0.06	
Total Maritime Transport	181166	2.88	0.01
Total Transport sector			
Recurrent expenditures	6032634	95.96	
Capital expenditures	253669	4.04	
Total expenditures	**6286303**		**0.44**

Source: Ministry of Finance, April 2006.

In 2004, of total transport sector spending, 51 percent went to roads, 40 percent to railways, 6 percent to maritime and 2.5 percent to administration (Table A4.5). The Ministry of Transport and Maritime Affairs introduced a program-budget in the transport sector in 2004. Accordingly, the budget structure comprised four programs: (i) National and Regional roads; (ii) Railways; (iii) Maritime transport; and (iv) Administration. About 20 percent of transport sector expenditures were capital expenditures while 80 percent were recurrent expenditures. Capital investments occurred in the Roads and Railways sub-sectors. Starting 2004, civil aviation (at the union level with Serbia) and airports became self-sufficient with user charges and do not get any budget from the national budget.

In 2005, of total transport sector expenditure, 58 percent went to roads, 38 percent to railways, 3 percent to maritime transport and 1 percent to administration. The latter two decreased by half relative to 2004. About 48 percent of transport sector expenditures were capital expenditures while 52 percent were recurrent expenditures (Table A4.5). More capital investments were made in 2005 for the Roads sector with the construction of the Sozina Tunnel with the assistance of

EIB. The Sozina Tunnel, improving the access road between Podgorica and the Port of Bar, is 12 km long and was constructed between 2001 and 2005 for a total cost of 75 million euros, of which 51 million euros were financed from the national budget and 24 million euros from EIB. No capital investments in the maritime sub-sector were allocated in 2005 from the National Budget.

Table A4.5. Montenegro Transport Sector Public Expenditures, 2004 and 2005

	2004			**2005**		
Description	Actual (euros)	% Total Transport	% GDP	Actual	% Total Transport	% GDP
Roads						
Recurrent expenditures	4993640.62	41.21		3919155	18.44	
Capital expenditures	1197015.69	9.88		8463533	39.83	
Total expenditures	6190656.31	51.08	0.40	12382688	58.27	0.75
Railways						
Recurrent expenditures	4008959.28	33.08		6438419	30.30	
Capital expenditures	859999.16	7.10		1600000	7.53	
Total Railways expenditures	4868958.44	40.18	0.32	8038419	37.83	0
Maritime Transport						
Recurrent expenditures	680128.71	5.61		632010	2.97	
Capital expenditures	78228	0.65		0	0.00	
Total Maritime Transport	758357	6.26	0.05	632010	2.97	0.04
Administration						
Recurrent expenditures	292977	2.42		197295	0.93	
Capital expenditures	7918	0.07		0	0.00	
Total Administration	300895	2.48	0.02	197295	0.93	0.01
Total Transport sector						
Recurrent expenditures	9975706	82.32		11186880	52.64	
Capital expenditures	2143161	17.68		10063533	47.36	
Total expenditures	12118867		0.79	21250413		1.29

Source: Ministry of Finance, April 2006.

Table A4.6. Transport investment projects by foreign financing source, 2000-2005

Financing Source	Year	Contracted amount (mill euros)
European Investment Bank (Loans)		**67.0**
1. Urgent rehabilitation traffic		16.0
Port of Bar	2002	6.0
Roads rehabilitation	2001-2002	10.0
2. Project of European Roads-Sozina Tunnel	2005	24.0
3. Modernization of Montenegro airports		12.0
4. Reconstruction of railways	2003-2005	15.0
European Bank for Reconstruction and Development (Loans)		**11**
Modernization of airports in Montenegro		11.0
KFW		**7**
Reconstruction of Lokue tunnel and construction of third road strip tunnel	2002-2005	7
Total Loans		**85**
European Agency for Reconstruction (EAR) (Grants)		
Investment in Road Rehabilitation	2000	9.8
Technical assistance (roads)	2000	0.7
Investment in Road Rehabilitation	2001	7.8
Technical assistance (roads)	2001	1.0
Technical assistance (roads)	2002	0.7
Technical assistance (railways)	2002	1.5
Investment in Road Rehabilitation	2004	1.0
Technical assistance (roads)	2004	0.5
Technical assistance (railways)	2004	1.5
Technical assistance (airports)	2004	0.7
Investment in Road Rehabilitation	2005	2.7
Technical assistance (roads & railways)	2005	1.3
Total EAR Grants		**29.2**

Source: EAR. 2005, and Ministry of Finance.