Montenegro

Beyond the Peak: Growth Policies and Fiscal Constraints

Public Expenditure and Institutional Review
(Volume II)

CURRENCY EQUIVALENTS
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€1 = US$1.43

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ABBREVIATIONS

BICRA	Banking industry country risk assessment
BOT	Build-operate-transfer
CBCG	Central Bank of Montenegro
DPR	Directorate of Public Roads
EAR	European Agency for Reconstruction
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
EIB	European Investment Bank
EPCG	Power Utility of Montenegro
EU	European Union
EU-8	NMS net of Cyprus, Malta
EU-15	EU net of NMS
FDI	Foreign direct investment
FY	World Bank's fiscal year
GDP	Gross domestic product
GWh	Gigawatt hour
HDM	Highway Design and Management
HR	Human resources
HRMA	Human Resource Management Authority
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IFI	International financial institution
IMF	International Monetary Fund
JSC	Joint stock company
KAP	Aluminum Plant in Podgorica
kV	Kilovolt
LCSSE	Law on Civil Servants and State Employees
MMATT	Ministry of Maritime Affairs, Transportation, and Telecommunication
Monstat	Montenegro Statistical Office
MOSTE	Montenegro Stock Exchange
MWh	Megawatt hours
NEX	Montenegro Stock Exchange
NMS	New (EU) member states
NPI	National Program for Integration
OECD	Organization for Economic Cooperation and Development
OLS	Ordinary least squares
OPRC	Output- and performance-based road contracts
PEIR	Public Expenditure and Institutional Review
PPA	Power-purchase agreement
PPIAF	Public-Private Infrastructure Advisory Facility
PPP	Public-private partnerships
REBIS	Regional Balkans Infrastructure Study
UK	United Kingdom
US	United States
UNDP	United Nations Development Programme
SAA	Stabilization and Association Agreement
SEETO	South East Europe Transport Observatory
SGP	Stability and Growth Pact
SOEs	State-owned enterprises
TEDS	Temporarily available external demand stimuli
TEN	Trans-European Network
TFP	Total factor productivity
TIRS	Transport Infrastructure Regional Study
VAT	Value-added tax
ZCG	Montenegrin Railways

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"You can't always get what you want
But if you try sometimes you might find
You get what you need"

—The Rolling Stones
(playing in Jaz/Budva on June 9, 2007)

EXECUTIVE SUMMARY

The Macroeconomic Context

In 2007, Montenegro was one of the world's fastest growing non-oil economies. The country reaped the benefits from its comprehensive, pre-independence reform program. After the international recognition of statehood had removed the lingering uncertainty over Montenegro's political status, investors reassessed the country's relative attractiveness as a site for business, responding positively to (i) the implementation of the privatization and structural-reform agenda; (ii) the provision of a low-tax, pro-business environment; and (iii) a clearly defined European perspective. In response, investment surged. Capital inflows from foreign direct investment (FDI)—largely absent during the first half of this decade—reached a level of 30 percent of GDP in 2006 and 40 percent in 2007, fueling domestic demand and stimulating economic growth. Real GDP grew at double-digit rates in 2007, an outcome that stands in stark contrast to the period of economic anemia characterizing Montenegro's pre-independence years. In this buoyant environment, commercial banks supported private-sector activities with very large increases in credit to the economy (with 12-month growth rates exceeding 180 percent at end-2007). These helped to finance higher imports of goods and services, leading to a rapid widening in the current-account deficit from 8.5 percent of GDP in 2005 to 40 percent in 2007. The economic dynamism, exceeding all (published) projections, resulted in an unexpected abundance of fiscal revenues and—with generally effective control over public expenditures in 2007—a very substantial overall surplus.

The post-independence economic boom has been fueled by very large—and, to a considerable extent, unsustainable—external capital inflows. Apart from tourism receipts and foreign acquisitions of companies, banks, and shares of publicly traded enterprises, more than one-third of capital inflows consisted of elements that are temporary and will dissipate over the medium term—in particular, purchases of (coastal) real estate by foreigners (20 percent of GDP in 2007) and external borrowing by the domestic banking sector (14 percent of GDP).

- **With a coastline of less than 300 kilometers, the supply of beachfront property is—*per definitionem*—finite**. This implies that purchases of Montenegrin-owned coastal real estate by non-residents (which represented more than one-half of total FDI in 2006 and 2007) cannot be maintained at current levels and will dissipate as a source of capital inflows.
- **Domestic banks will not be able to lend to the private sector as aggressively as they did during the immediate post-independence period.** Credit to the economy had grown at unprecedented rates and, in 2007, considerably faster than

deposits, necessitating increased foreign borrowing by domestic banks. Because of the financial institutions' rapidly increasing degree of external indebtedness, Standard & Poor's rated Montenegro's banking sector as the riskiest in the region. With the stock of external bank debt exceeding 20 percent of GDP at end-2007, and further increasing to 25 percent in mid-2008, the rating agency's critical assessment, made in early August 2008, will make foreign banks more careful to extend further credits to Montenegrin banks, especially in light of an economy that is starting to lose its growth momentum. As observed by other countries, once the economy has moved onto the downward-sloping portion of the business cycle, banks will find it increasingly more difficult to borrow externally to be able to lend domestically. Because of the fallout from the international financial crisis, this development could occur considerably more abruptly than currently foreseen, as liquidity in foreign markets tightens and banks become increasingly more risk averse. For endogenous reasons as well, the need for domestic banks to demand foreign loans will decline, largely because of the maturing of Montenegro's business cycle, which will be accompanied by a decrease in the demand for private-sector credits. In any case, banks have been precluded from increasing credits at rates comparable the immediate post-independence period, as the Central Bank of Montenegro (CBCG) adopted measures in late 2007 that aimed at strengthening prudential ratios, in the context of which policy the monetary authority defined quantitative credit limits in function of the respective banks' stock of outstanding credit. Thus, for both supply- and demand-side reasons, banks will find that they will neither need nor be able to borrow from banks abroad.

Resultant Fiscal-Policy Challenges

The abundance in tax revenues, which accompanied the economic boom, may have obscured the profundity of Montenegro's medium-term fiscal challenge. Abundant government resources inevitably generate political pressures to spend a larger portion of current income than could be maintained beyond the economic expansion phase. Two factors, in particular, have the potential of changing the fiscal dynamics and jeopardizing Montenegro's ability to realize its medium-term policy objectives.

- **Montenegro's "competitive" tax regime adds an element of pro-cyclicality, obliging Government to increasingly rely on imports as a source of fiscal revenue.** Like many other countries in Southeastern Europe, Montenegro has been aggressively reducing its direct tax rates, having introduced a 9-percent flat tax for corporate income (the personal income tax rate will have been reduced to the same level in 2010). Concomitantly, Government eliminated capital gains taxation and kept social contributions at a minimum (rates are foreseen to be lowered even further). In terms of enhancing the relative attractiveness of Montenegro as site for (foreign) direct investment, this has been very beneficial. However, the flat tax has removed automatic stabilizers from the tax system, amplifying elements of pro-cyclicality. The low income tax rates, in particular, have made the budget more susceptible to external demand shocks and increased its reliance on imports as a source of fiscal revenue. This is especially significant as lower capital inflows from the unsustainable sources

mentioned above will lead to an almost corresponding reduction in imports and, in turn, considerably lower tax revenues than during the boom period. Subsequently, Montenegro's policymakers will need to base decisions on permanent spending obligations, including those on the wage bill, on its "structural" tax base—that is, on tax revenues net of influences from temporary and unsustainable external demand stimuli.

- **A large-scale public investment program is being designed with a view to crowding in private investment and increasing the economy's growth potential.** Following the transition towards a functioning market economy, the demands on public infrastructure—weakened by decades of neglect—have increased considerably. Supply constraints have become increasingly evident and, in the absence of further investments, are threatening to asphyxiate the growth momentum. These supply constraints are particularly evident in (i) the energy sector, as evidenced in the growing energy deficit; (ii) the transport sector, with increasing traffic jams (during the peak season) and a very high incidence of accidents; (iii) the water sector, including waste water, affecting principal tourist areas during the summer months; and (iv) sanitary solid-waste deposits, resulting in wild dumps, a spoiled tourism experience, and—ultimately—increased public health risks for Montenegrins. Of these, the former two investments are particularly expensive. As Montenegro aims at developing a high-end tourism sector, it is critical that the necessary investments—within the available fiscal envelope—are made to quickly eliminate these growth-retarding bottlenecks. Moreover, insufficient maintenance has led to an accelerating rate of capital depreciation, and Government has recognized the need to reverse this trend.

With the euro as monetary anchor, fiscal policy is the only policy instrument of macroeconomic management. As such, fiscal policy will have to play a double function—viz., to ensure continued macroeconomic stability and advance the country's socio-economic development (and politico-economic integration) objectives. Government's challenge to maintain macroeconomic stability is made more difficult by that fact that both the tax regime and external bank credits are being strongly pro-cyclical in their effects on the overall economy. For this reason it is important that the medium-term fiscal program reinforces—to the extent possible—counter-cyclical elements, mainly by designing a fiscal program that allows for the implementation of critical public investments, possibly at the expense of moderate fiscal deficits, in an even less benign environment. Such an approach would provide policymakers with some form of a fiscal buffer, given that—in a worst-case scenario with very large and sudden shocks—it is considerably easier to adjust the capital budget than the current one. Similarly, for socio-economic development reasons, it is a central policy objective to protect the capital budget, given the need to reverse decades of negligence of public infrastructure and, in so doing, allow for the increase in the productivity of production factors employed by companies operating in Montenegro—a precondition for any policy approach that includes the crowding-in of private-sector investments as a central objective. To this end, Montenegro prepares to implement very large projects in the transport and energy sectors.

To achieve its twin objectives (to maintain macroeconomic stability and advance socio-economic development), Government needs to lengthen its planning horizon and—as credibly as possible—commit to fiscal-policy benchmarks that would help to create the fiscal space that is necessary for the ultimate realization of these investment projects. Given Montenegro's particular macroeconomic situation and its policy objectives, the present document outlines one such fiscal framework, which is designed around three guiding principles.

- **Fiscal policy stays within the constraints of the Stability and Growth Pact,** a direct consequence of the unilateral euroization decision made in 1999. As Montenegro seeks to join the EU and eventually formalize the use of the euro as the country's legal tender, policymakers are bound—implicitly, at least—by the fiscal-policy constraints as defined by the Stability and Growth Pact (SGP). These were adopted in 1997 to maintain the Economic and Monetary Union (EMU), aimed at achieving a balanced budget over the span of a business cycle. For any given fiscal year, these fiscal criteria limit (i) the overall budget deficit of general government to 3 percent of GDP; and (ii) public debt to 60 percent of GDP. Given Montenegro's end-2007 debt-to-GDP ratio of about one-half the SGP limit, committing to the deficit criterion implies that—under moderately pessimistic assumptions of nominal growth rates and budget deficits—the debt-to-GDP ratio should not increase beyond the current level. Since 2004, fiscal policies have remained consistently within SGP limits. In a worst-case scenario, with the aforementioned unsustainable external capital inflows dissipating abruptly, Government will have to curtail public investments as well to stay within the limits spelt out in the SGP.
- **Tax revenues (net of those derived from temporary factors) finance current expenditure,** implying that Government can only borrow to finance investments. This "modified golden rule" should help to prevent policymakers from committing to recurrent expenditures during boom periods that it cannot be maintain during economic downturns. A similar rule—applied permanently—constrains fiscal policies in many other European countries, facilitating a more medium-term approach to the design of fiscal policies and supporting governments to achieve both macroeconomic stabilization and public investment objectives. Fiscal policies since 2005 have been consistent with this principle, as general government posted a (gradually increasing) *current* structural surplus as budgetary revenues net of temporary factors exceeded public spending net of capital expenditures.
- **The ratio of recurrent expenditure to GDP declines gradually**. In this document, for illustrative purposes, the related benchmark keeps recurrent spending constant in real terms, at least during the implementation phase of the aforementioned priority investments. Given existing pressures for increased expenditure on the wage bill and on goods and services, this principle appears to be the most difficult to attain (and maintain). In 2006 and, more tangibly, in 2007, the ratio of recurrent expenditure to GDP has increased, and it will do so again in 2008. As a result, with more binding budget constraints for recurrent expenditure, Government will have to raise the effectiveness and efficiency of related spending, which should help to achieve the delicate balance between increased

demands on the public sector (EU integration and decentralization) and gradually tighter budgets for recurrent expenditure.

If adopted, such an approach would allow fiscal policy to play its double role, by combining (moderately) pro-cyclical elements (within well-defined overall constraints) with efforts to overcome existing bottlenecks in public infrastructure. Conceptualizing a multi-year capital budget should facilitate the provision of adequate financing for—and increase the overall quality of—realized public investments. Taken together, these principles combine features of short-term budgetary flexibility (by allowing for overall fiscal deficits during economic downturns) with medium-term fiscal discipline (exemplified by the absence of any significant increases in the debt-to-GDP ratio). A corresponding fiscal framework comprising all three elements should thus result in the gradual decline of sovereign risk premia and an improvement in the grades conferred to Montenegro by international credit rating agencies, lowering the budget's debt-service obligations.

The main risks come from insufficient private-sector participation in the public investment program and continued wage pressures. Public investment plans exceed the state's capacity to finance them by a considerably margin, necessitating Government to (i) explore ways to access private-sector capital (privatization, public-private partnerships, and concession arrangements); (ii) lengthen the projects' implementation periods; and (iii) consider, as necessary, a downsizing in the scale and scope of the public investment projects. As experiences elsewhere have shown, hastily negotiated PPPs can include larger-than-foreseen contingent liabilities and narrow the remaining fiscal space. At the same time, the large wage increases granted to employees in the private sector has increased the competition between the private and public sectors for available talent, increasing the need to accelerate the process towards public sector wage decompression. Across-the-board wage increases, similar to those adopted in late 2007, need to be avoided, a difficult challenge an electoral year.

Public Investment Priorities

In the energy sector, major investments are required to ensure both a sufficient availability of reasonably priced energy and a sustainable financial position of the power utility. Reflecting decades of negligence, the recently adopted energy strategy foresees investments of about €1.8 billion (more than 70 percent of 2007 GDP) until 2025 are very high. But the *status quo* is not an option either. Since 2002, the power utility (EPCG) has reported annual losses of about 1 percent of GDP. New investments have been very limited and its assets have deteriorated due to a lack of maintenance and replacements. To improve its physical and financial conditions, EPCG is launching a major investment program, while seeking to address its fragile financial position. Both objectives are interlinked, as an improvement in EPCG's financial situation can only be achieved if the power utility is able to (i) maintain electricity production from local generation plants; (ii) improve its collections; and (iii) reduce its losses. Increasing energy-generation capacities presuppose the diversification of energy sources and active private-sector participation. To this end, Government has adopted a long-term energy-sector development strategy, specifying new investments, with private-sector

participation, in generation capacity, including a second thermal power plant, new hydro power plants, and the development of wind and solar power plants. Among various financing options, and given existing investors' interest, Government might want to consider the full privatization of the power utility (also in light of competing public investment priorities elsewhere) as an alternative to the potential downsizing of investment projects and/or the lengthening in the implementation periods, which might otherwise be required.

For the transport sector, a detailed medium-term budgetary program should be developed as planning tool for prioritizing and sequencing public investments, placing these within pre-specified fiscal constraints, while developing a set of criteria, carefully weighing costs and benefits, according to which decisions on the identification of projects are made. Sound feasibility studies are an essential tool, while appropriate project designs, which integrate measures to increase safety features and decrease maintenance requirements, can reduce future rehabilitation and/or safety improvement works. To the extent possible, carefully negotiated public-private partnerships (PPPs) can play an important role in realizing the investments, particularly for the highway project linking the port of Bar with Belgrade and the European Corridor 10. If the private sector considers these projects as not being economically viable, and private-sector co-financing is not forthcoming, Government will have to consider alternatives, including the phasing or scaling back of these projects. International experience shows that the structuring and procurement of complex PPP projects require time and, typically, a significant participation from the public sector to make the projects financially and economically viable. Given the difficult terrain and Montenegro's small market size, this is likely to prove a particularly binding constraint in the related contract negotiations. To realize the various transport-sector PPPs, Montenegro needs a concession law that draws from best international practice.

The road and railway sectors have long been underfunded, resulting in insufficient backlog, routine, and periodic maintenance and delays in implementing some priority constructions. For the road sector, this has detrimentally affected safety, resulting in accident and fatality rates considerably higher than most countries in the region, with high social and economic costs. Public funds are roughly adequate to ensure proper routine and periodic maintenance, leaving unfunded both backlog maintenance and plans for the construction of new highways. Apart from efforts to increase the efficiency in the provision of maintenance services, possibly by means of outsourcing maintenance services, Government will, in all likelihood, be required to increase budgetary allocations and/or delay the implementation schedule for capital projects.

Implications for the Wage Bill

To create the needed fiscal space for these public investments, it is critical that the wage bill—the single-largest component in the current budget—be curtailed as a share of general government spending. Current levels are very high, even by regional standards. At 11.8 percent of GDP in 2006, the wage bill exceeded levels observed in neighboring countries and most of the new EU member states. However, Government is exposed to increasing pressures to raise salaries in the public sector, which are partly

motivated by the objective to remain competitive with the private sector. As a result, the wage bill is continuing to increase—with the 2008 ratio likely to exceed the outcome of 12.7 percent of GDP in 2007, for principally two reasons:

- **Large across-the-board wage increases have been granted in late 2007**. Partly in reaction to increasing (food and electricity) prices, partly to catch up with wage developments in the private sector, Government agreed to a 30-percent increase in public sector wages. The effects of this decision—together with a 10-percent basic salary increase—will only become apparent in 2008 and subsequent years. To compound matters, the wage negotiation for civil servants in Montenegro itself is highly fragmented, allowing various labor unions to negotiate salary increases outside the control of the Finance Ministry and regular budget preparation processes.
- **Additional public-sector recruitment for reasons of EU integration and decentralization has not been compensated with a corresponding decrease in staff or administrative structures elsewhere,** resulting in an overly complex government organization. While Government effectiveness in Montenegro is still lower than among Eastern European and Baltic countries, it is improving at considerably faster rates, thereby giving encouraging signs that determined efforts can and do pay off**.**

The authorities have already taken important steps towards reforming the public administration by adopting the *Law on the Civil Service* and implementing relevant regulations, including on those defining the civil-service salary system. A set of further policy measures will have to be implemented to (i) increase effectiveness and professionalism of the public administration in key areas critical for achieving the EU integration objective; (ii) prevent a "brain drain" towards the private sector among the high-skilled; and (iii) contain the overall expenses for public-sector employees to a level that is consistent with the realization of the Government's broader fiscal-policy priorities.

To achieve these objectives, Government should initiate a pay and grading reform. The current pay system—based largely on seniority—will need to be replaced by system that links remuneration to performance. The complex collective bargaining process needs to be streamlined. It should start earlier each year and be concluded before the regular budget preparation process. Over a more medium-term horizon, Government needs to reduce public employment in selected areas. Staff reduction could be achieved through a combination of attrition with a partial and selective hiring freeze. Similarly, there is scope for rationalizing the structure of government operations, which would presuppose a comprehensive functional review of the size, functions, and staffing of all government organizations. Government will need to develop policy criteria to facilitate decision-making on whether a given function should be undertaken by central government or be dissolved, devolved to local government, or privatized. Non-civil servant positions in non-core functions could be transferred, by public tender, to the private sector. The main source of inherent cost savings would come from the increased efficiency, with which the private sector can perform these tasks.

I. THE POST-INDEPENDENCE BOOM[1]

When Montenegro secured its internationally recognized statehood in mid-2006, it was able to build on the foundation of comprehensive pre-independence reforms. The implementation of a privatization and structural-reform agenda, the provision of a low-tax, pro-business environment, and a clearly defined European perspective represented factors that allowed—once political uncertainties had been removed—for a surge of pent-up investment, fueling domestic demand and economic growth, at rates much faster than expected. The considerable inflows of foreign capital helped to transform an economy—which had been constrained by a succession of economic crises and set back by regional conflicts and international sanctions—into Europe's most dynamic one. For 2007, real growth has been estimated at double-digit rates. Commercial banks supported these activities with very large increases in credit to the economy, which permitted the financing of higher imports, leading to a rapid widening in the current-account deficit. These trends explain the unforeseen tax-revenue abundance, especially since Montenegro's "regionally competitive" tax regime relies on trade as a primary source of fiscal revenue. The deteriorating international environment (the global credit crunch, rising energy and food prices, and increased regional instability) and the natural process of a maturing business cycle necessitate care in framing fiscal policies over the medium-term horizon, not least because real-estate sales to non-residents and the high rates of external bank borrowing cannot be maintained, thus exposing the economy to vulnerabilities and the risk of a full-blown boom-bust cycle—particularly if recurrent spending is not contained and key (and politically difficult) challenges not addressed while revenues are still buoyant. Fiscal policies, which already have to absorb a 30-percent increase in public-sector salaries and the regularization of pension arrears, will have to play a key role.

A. Macroeconomic Manifestation

1.1. **In 2007, Montenegro was one of the world's fastest growing non-oil economies** (see Figure 1.1)—a development that extended well into the first half of 2008. Fueled by large inflows of foreign capital, the country was able to build on an economic growth momentum that had begun to take hold in late 2005. The economic dynamism resulted in buoyant fiscal revenues and—with effective control over public expenditures in 2007[2]—a very substantial overall surplus of 7.1 percent of GDP. However, unless similar spending discipline is maintained, future budgets risk being strained by revenue volatility, increased pressures on recurrent spending, and an insufficient ability to prioritize investments.

1.2. **The strength of the post-independence recovery in 2007 exceeded all (published) projections.**[3] This outcome reflected increased investors' confidence[4] and

[1] Prepared by Jan-Peter Olters (ECCME).

[2] As will be discussed below, some measures taken in 2007 and included in the supplementary budget (such as the across-the-board increase in public sector salaries) affected mostly the 2008 budget and had thus only relatively minor effects on the overall fiscal outturn in 2007.

[3] At end-2006, the consensus forecast for real growth in 2007 was about 6.0 percent, underpinning the tax-revenue projections in the 2007 budget; see also IMF (2006). According to current data, real GDP has

the belief that the country was on the right track—*en route* to becoming a full member of the European Union (EU) in the foreseeable future. The change in outlook followed propitious political factors, especially those surrounding the successful conclusion of state-building challenges. Montenegro reaped the benefits from having laid the necessary economic foundations during the pre-independence years, during which period important structural reforms were implemented and an ambitious privatization agenda pursued.

1.3. **The economic boom was triggered by the injection of very considerable doses of liquidity into the Montenegrin economy—foreign direct investment (FDI) and credits to the economy;** see Table 1.1.

Table 1.1. Montenegro: Demand Stimuli, 2003–08

	2003	2004	2005	2006	2007 prel.	2008-S1 est.
			(In millions of euro)			
Demand stimuli	106.1	128.6	468.7	1,090.3	2,384.8	907.1
Gross FDI	43.8	52.7	392.7	644.3	1,007.7	465.8
Of which: real estate	5.3	10.9	70.3	337.9	514.4	172.5
Increase in private-sector credits	62.3	75.9	76.0	446.0	1,377.1	441.3
Increase in external borrowing by banks	22.0	18.3	19.8	84.4	356.7	201.6
Increase in banks' domestic liabilities	40.4	57.6	56.2	361.6	1,020.4	239.7
Gross domestic product	1,510.1	1,669.8	1,815.0	2,148.9	2,540.0	2,816.9
	(In percent of annualized GDP; unless otherwise indicated)					
Demand stimuli	7.0	7.7	25.8	50.7	93.9	64.4
Gross FDI	2.9	3.2	21.6	30.0	39.7	33.1
Of which: real estate	0.4	0.7	3.9	15.7	20.3	12.2
Increase in private-sector credits	4.1	4.5	4.2	20.8	54.2	31.3
Increase in external borrowing by banks	1.5	1.1	1.1	3.9	14.0	14.3
Increase in banks' domestic liabilities	2.7	3.5	3.1	16.8	40.2	17.0
Real GDP growth, year-on-year, in percent	2.5	4.4	4.2	8.6	10.3	8.0

Sources: CBCG; Monstat; Ministry of Finance; and World Bank staff estimates.

grown by an estimated 10–12 percent in 2007. This document uses the preliminary—and very cautionary—Ministry of Finance estimate of 10.3 percent real growth in 2007. Montenegro's Statistical Office, MONSTAT, is expected to publish 2007 GDP estimates and growth rates in autumn 2008.

[4] In its 2008 *Doing Business* ranking, the World Bank Group ranked Montenegro 81st out of a total of 178 countries, ahead of Serbia, Croatia, Greece, Bosnia-Herzegovina, and Albania. In the "protecting investors" sub-category, Montenegro fared particularly well, ranking 19th. However, in the 2009 survey, Montenegro—while staying ahead of its regional competitors, except Albania—slipped to 90th rank (out of a total of 181 countries), largely on account of a relatively slower progress in addressing obstacles surrounding construction permits and registering property. A new World Bank project, currently in the final stages of preparation, seeks to address corresponding obstacles and help to modernize real-estate administration and improve the planning and permitting system.

(i) **Gross FDI represented 40 percent of GDP in 2007.** The high-potential tourism sector—together with an open, low-tax, pro-business environment—attracted large inflows of FDI, with payments originating, in roughly equal shares, from the EU-15 member states, mini states and off-shore centers, countries of the former Soviet Union, and others (Table 1.2). Apart from actual investments into an updated, modern hotel infrastructure, the purchase of real estate alone represented more than one-half of all investments. Already in 2006, no other country in Europe and Central Asia (ECA) managed to attract more per capita FDI than Montenegro (Figure 1.2)—prior to net per capita FDI having increased further by 14.7 percent, from €783 to €899 in 2007. Following strategic privatizations during pre-independence years (banks, telecommunications, and heavy industry),[5] the uncontroversial international recognition of independence allowed pent-up investments to be realized. Thus, by 2007, nominal (euro-denominated) FDI stood at a level 2½ times that of 2005—and considerably more than 200 times that of 2001 (Figure 1.3).

Table 1.2. Montenegro: Foreign Direct Investments, 2001–07

	2001	2002	2003	2004	2005	2006	2007
				(In percent of GDP)			
Foreign direct investments (net)	…	…	2.6	3.0	21.0	21.7	20.7
Outflow of investments	…	…	0.3	0.1	0.7	8.3	19.0
Foreign direct investments (gross)	0.4	5.6	2.9	3.2	21.6	30.0	39.7
				(In millions of euro)			
Foreign direct investments (net)	…	…	38.7	50.6	380.9	466.7	524.9
Outflow of investments	…	…	5.1	2.1	11.8	177.6	482.8
Foreign direct investments (gross)	4.7	76.4	43.8	52.7	392.7	644.3	1,007.7
Gross FDI by country groups (origin of transfers of funds	4.7	76.4	43.8	52.7	392.7	644.3	1,007.7
EU-15 member states, excl. dependencies	1.2	69.5	16.4	11.7	140.0	181.7	272.9
Mini states and off-shore centers[1]	0.0	1.3	9.7	10.9	20.7	128.0	265.2
Countries of the former Soviet Union	0.8	0.0	0.4	4.7	16.6	127.0	231.6
Countries in Southeastern Europe[2]	1.5	4.3	15.2	17.9	36.2	50.4	101.6
Other countries and regions	1.1	1.4	2.1	7.5	179.2	157.3	136.4
By sector	4.7	76.4	43.8	52.7	392.7	644.3	1,007.7
In producing sectors	-0.4	3.4	2.2	2.3	68.6	…	…
In service sectors	3.4	69.1	24.2	37.7	193.7	…	…
In financial organizations	1.7	3.8	12.1	1.8	60.1	…	…
For companies and banks	…	…	…	…	…	252.1	377.6
For shares in domestic companies	…	…	…	…	…	6.1	0.0
For domestically-owned real estate abroad	…	…	…	…	…	1.2	0.1
For stocks of publicly traded enterprises	…	…	…	…	…	45.1	115.7
For domestically-owned assets abroad	…	…	…	…	…	2.0	0.0
For real estate	0.0	0.0	5.3	10.9	70.3	337.9	514.4

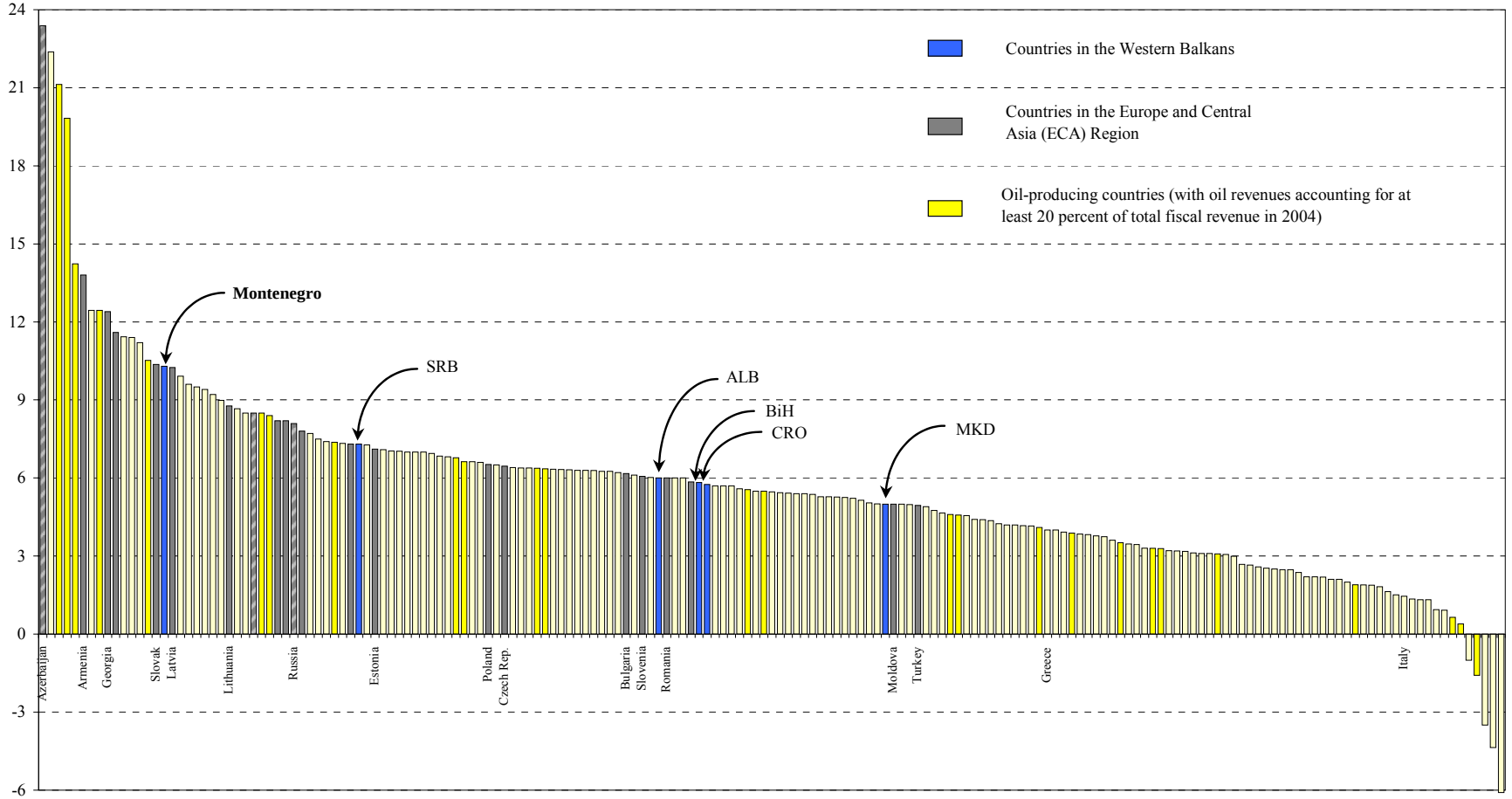
Source: Central Bank of Montenegro; and World Bank staff estimates.

[1] Andorra, Bahamas, Bahrein, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cyprus, Gibraltar, Hong Kong, Kiribati, Kuwait, Lesotho, Liechtenstein, Macao, Malta, M
Monaco, Panama, Réunion, Saint Vincent and the Grenadines, São Tomé and Príncipe, Singapore, Surinam, Switzerland, Turks and Caicos Islands, United Arab Emirates, US Virgin Islanc
[2] Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, Serbia, Slovenia, and Turkey.

[5] In the *National Program for Integration* (NPI), the Government of Montenegro (2008a) states that more than 85 percent of the state-owned capital has been successfully privatized so far.

Figure 1.1 Real GDP Growth Rates, 2007

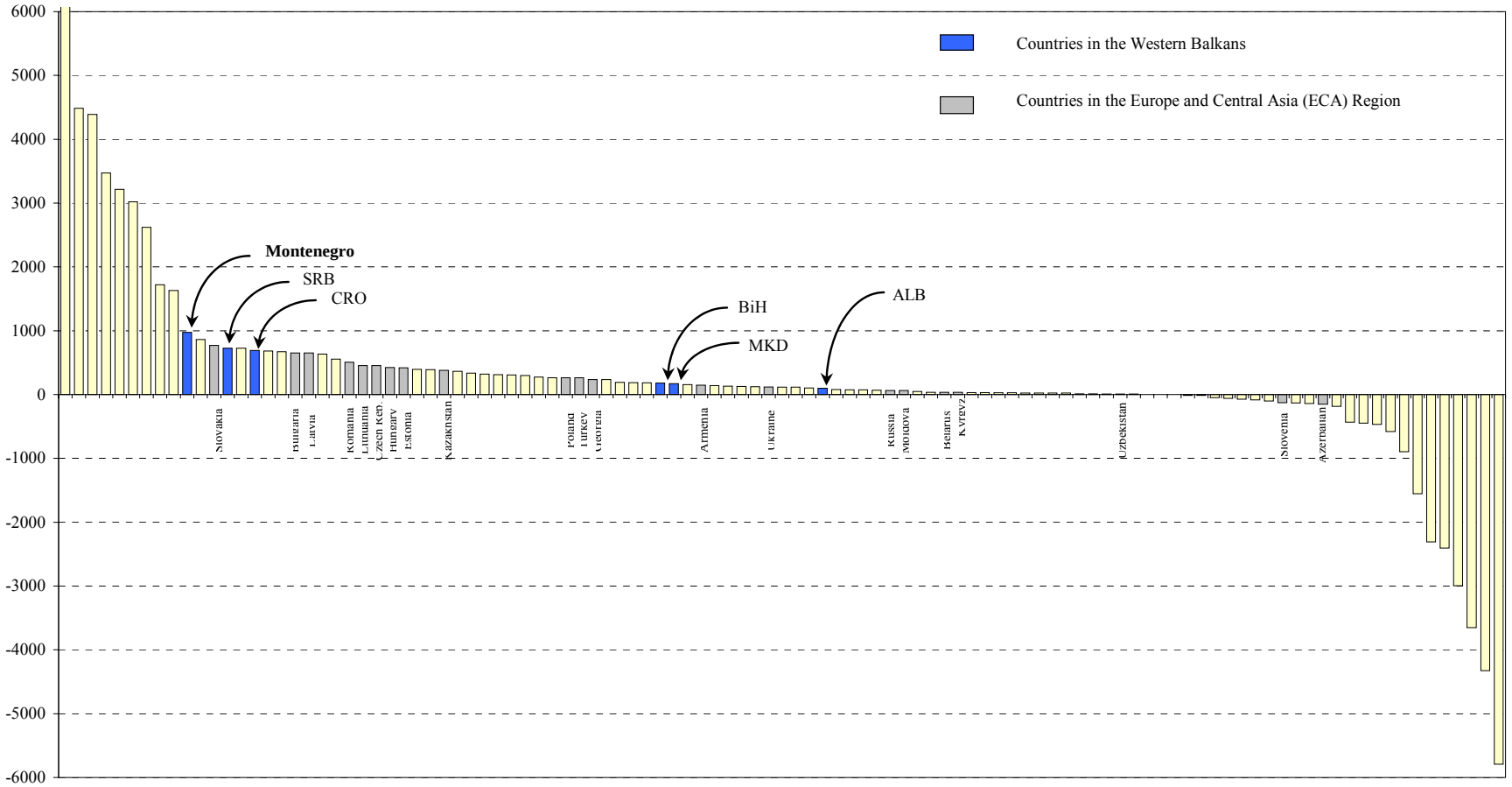
(In percent)



Sources: IMF, World Economic Outlook Database April 2008; Montenegrin authorities; and World Bank staff estimates.

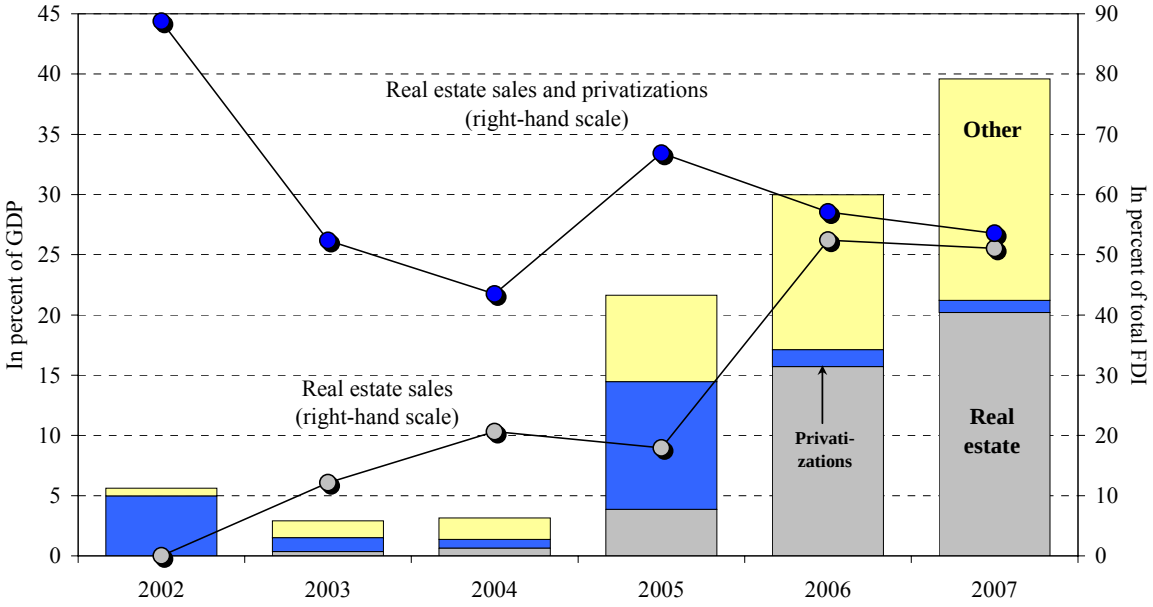
Figure 1.2 Net Per-Capita Foreign Direct Investments, 2006

(In U.S. dollars)



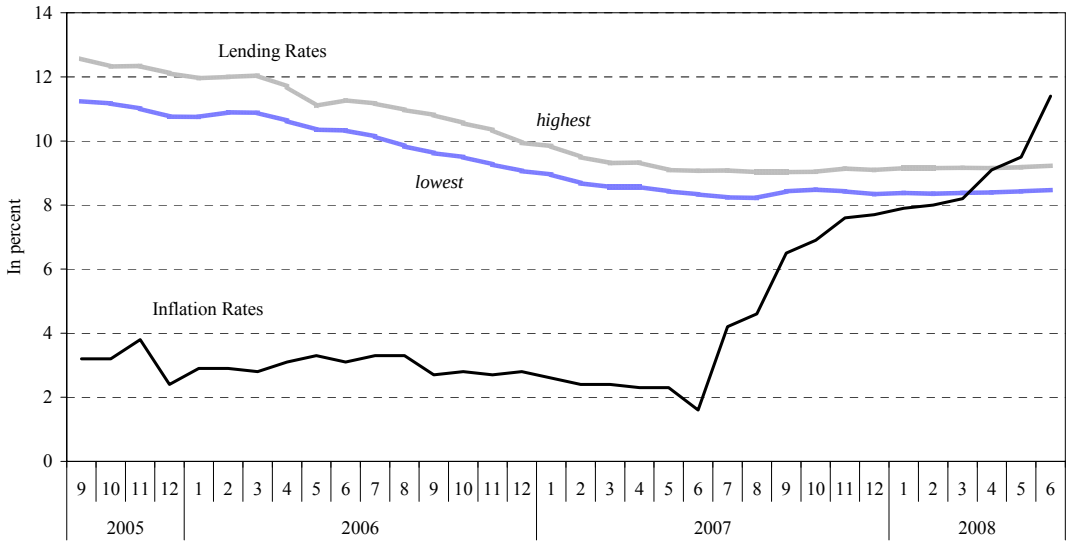
Sources: World Bank, World Development Indicators; Montenegrin authorities; and World Bank staff estimates.

Figure 1.3. Montenegro: Gross Foreign Direct Investment, 2002-07



Sources: Central Bank of Montenegro; Ministry of Finance.

Figure 1.4. Montenegro: Range of Weighted Average Lending Rates, September 2005–June 2008



Sources: Central Bank of Montenegro; MONSTAT; and World Bank staff

(ii) **Domestic credit increased by more than 50 percentage points of GDP in 2007,** private-sector credit by almost 49 percentage points; see Table 1.3. Several factors—including (i) the transfer of bank ownership to the private sector; (ii) the large share of foreign-owned banks in Montenegro's financial sector; and (iii) favorable conditions on the international credit markets—permitted domestic banks to compete and lend aggressively, leading to a steady decline in (nominal) interest rates (Figures 1.4 and 1.5). The wealth effect stemming from the booming

stock exchange (until mid-2007) and the real-estate market resulted in the doubling of deposits, from €0.9 billion at end-2006 to €1.8 billion a year later. With ample liquidity in international markets, foreign (mother) banks supported the domestic banks' decision to push lending to the economy. Thus, during the period between end-2006 and end-2007, the loan-deposit ratio increased from 87 percent to 122 percent. This implies that, in 2007, almost one-quarter of the increase in credits to the economy was financed by bank credits from abroad—this alone represents a demand stimulus equivalent to 14 percent of GDP.

Table 1.3. Montenegro: Credits, Deposits, and External Bank Debt, 2003–08

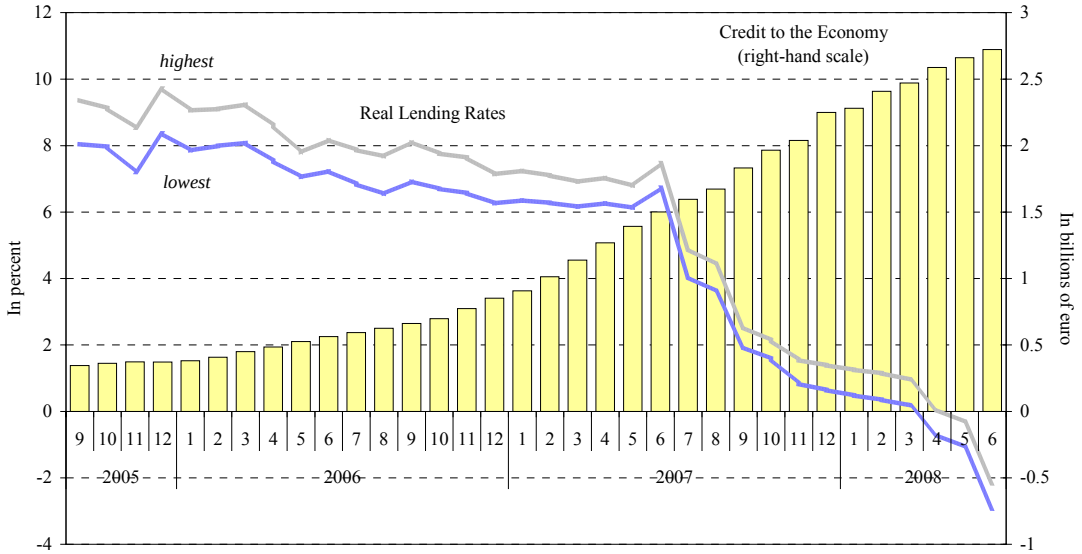
	2003	2004	2005	2006	2007	2008-S1 est.
			(In percent of GDP)			
Stock of domestic credit	15.3	19.1	25.1	48.8	99.3	104.6
Stock of private-sector credit[1]	10.9	14.4	17.4	35.5	84.2	91.6
Deposits in banking sector	11.7	13.0	22.0	40.9	69.0	65.2
Deposits by private sector[1]	3.5	3.3	5.9	13.1	30.3	31.9
External indebtedness by banks	2.2	3.1	4.0	7.3	20.2	25.4
Increase in domest credit[2]	6.1	5.3	7.5	27.6	58.0	30.2
Increase in private-sector credit[1,2]	4.1	4.5	4.2	20.8	54.2	31.3
Increase in deposits in banking sector[2]	2.0	2.4	10.1	22.2	34.4	5.9
Increase in deposits by private sector[1,2]	1.1	0.1	2.9	8.1	19.2	9.1
Increase in external indebtedness by banks[2]	1.5	1.1	1.1	3.9	14.0	14.3
			(In millions of euro)			
Stock of domestic credit	231.7	319.4	454.7	1,048.7	2,521.9	2,947.3
Stock of private-sector credit[1]	164.7	240.6	316.6	762.6	2,139.7	2,581.0
Deposits in banking sector	176.6	217.3	400.2	878.3	1,752.2	1,835.4
Deposits by private sector[1]	52.1	54.6	107.9	282.1	769.8	898.1
External indebtedness by banks	34.0	52.3	72.1	156.5	513.2	714.8
Increase in domest credit	92.5	87.7	135.3	594.0	1,473.2	425.4
Increase in private-sector credit[1]	62.3	75.9	76.0	446.0	1,377.1	441.3
Increase in deposits in banking sector	30.3	40.6	182.9	478.1	873.9	83.2
Increase in deposits by private sector[1]	16.5	2.4	53.3	174.1	487.8	128.3
Increase in external indebtedness by banks	22.0	18.3	19.8	84.4	356.7	201.6
			(In percent)			
Increase in domest credit[2]	66.4	37.9	42.3	130.6	140.5	33.7
Increase in private-sector credit[1,2]	60.9	46.1	31.6	140.9	180.6	41.3
Stock of domestic credit, in percent of deposits	131.2	147.0	113.6	119.4	143.9	160.6
Stock of credit to the economy, in percent of depo	93.2	110.7	79.1	86.8	122.1	140.6

Source: Central Bank of Montenegro (CBCG); and World Bank staff estimates.

[1] "Other non-financial corporations" and "other resident sectors".

[2] For 2008-S1, in percent of annualized GDP or twice the percentage increase for end-December to end-June.

Figure 1.5. Montenegro: Range of Real Weighted Average Lending Rates, September 2005–June 2008



Source: Central Bank of Montenegro; and World Bank staff estimates.

1.4. **The economic boom has allowed basic social and income indicators to improve** (Table 1.4). In particular, the number of employed has increased, representing about one-quarter of the population at end-2007, while the unemployment rate has fallen considerably, from 23 percent at end-2004 to 12 percent in late 2007. Average wages have grown by 16 and 32 percent in 2006 and 2007, respectively. While recorded poverty rates appear to have stagnated between 2005 and 2006 (there are no data yet for 2007), a recent World Bank (2008a) study has shown that the depth and severity of poverty has decreased, a presage of the potential of a more substantial decline of poverty rates in the next few years. According to the same study, inequalities in consumption and income have also declined.[6]

Table 1.4. Montenegro: Selected Social Indicators; 2004–08

	2004	2005	2006	2007	2008-S1 est.
Average wages (gross), in euro*					
Annual average	302.8	326.5	434.2	495.8	589.8
End of period	344.8	387.8	471.0	554.0	623.0
Average wages (net), in euro*					
Annual average	195.4	213.2	283.0	336.8	403.0
End of period	226.3	253.7	307.0	376.0	425.0
Number of employed*	142,438	145,261	150,746	159,223	170,146
Number of unemployed†	58,950	48,825	38,876	31,469	29,088
Unemployment rate, in percent†	22.4	18.5	14.7	11.9	11.0
Poverty rate, in percent‡	…	11.3	11.3	…	…
Average consumption of the poor as percent of average consumption	…	42.8	44.8	…	…
Gini coefficient‡	…	0.259	0.243	…	…

Sources: Monstat*; Employment Agency (ZZZ)†; and World Bank (2008)‡.

[6] For a lack of data, Montenegro was not included in the UNDP's Human Development Index 2007/08.

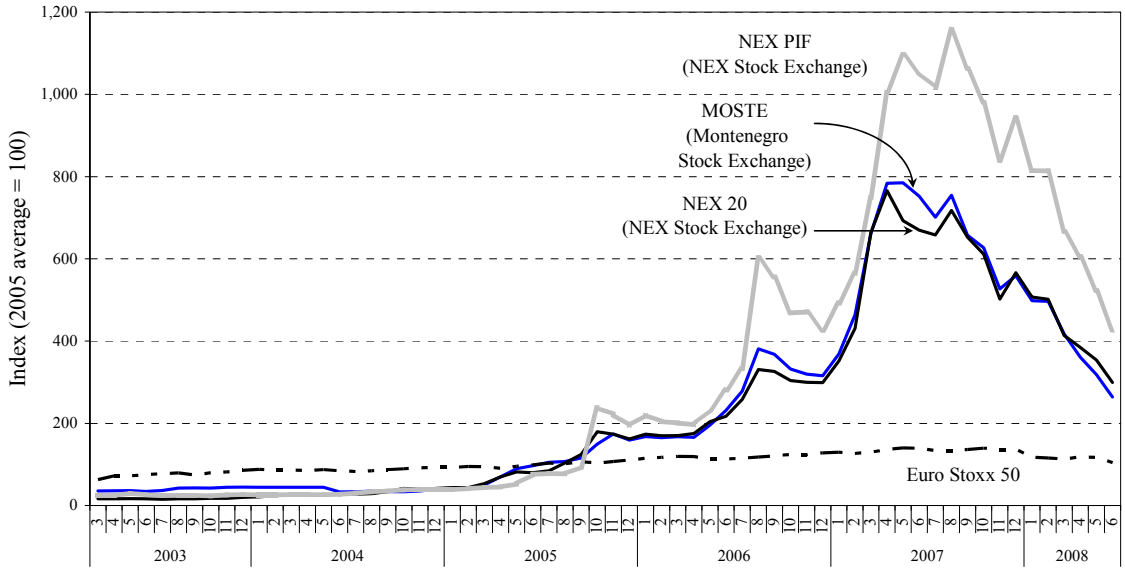
B. Inherent Risks

1.5. **During the immediate post-independence period, Montenegro's economy has exhibited above-potential growth trends.** All the indicators of an impending slowdown of the credit/FDI-financed boom are present—widening current-account deficits, tightening labor markets, increasing wage pressures, and accelerating inflation rates. These developments are likely to be amplified by the concomitant deterioration in the international economic environment (Box 1.1). The sub-prime crisis, which originated in the United States, has led to a credit crunch on international financial markets. In addition, the increasing energy and food prices risk undoing the initial success in improving the income and wealth distribution.

1.6. **Most critically, however, forecasts for asset prices point downwards, both for stocks and real estate.** Thus, removing the wealth affect from rising asset prices and projecting a considerable decrease in external capital inflows imply that, for both domestic and external reasons, economic activities will be less buoyant in the next few years than they had been during 2006–07.

(i) **Stock-market indices in mid-2008 are less than one-half of what they had been at the peak of the cycle during mid-2007.** Especially during the first six months of 2007, the two stock exchanges demonstrated an exceptional escalation in prices—far in excess of more established bourses (Figure 1.6). The wealth effect from the sale of (coastal) real estate (as well as bank credits) had fueled the stock-market boom at that time. Partly caused by a shift towards investments in physical assets (in particular, houses and apartments in Podgorica and elsewhere), funds were withdrawn from the stock markets, contributing to the decline of more than 50 percent in stock-market prices between mid-2007 and June 2008.

Figure 1.6. Montenegro: Stock Exchange Indices; March 2003–June 2008



Source: Central Bank of Montenegro; and World Bank staff estimates.

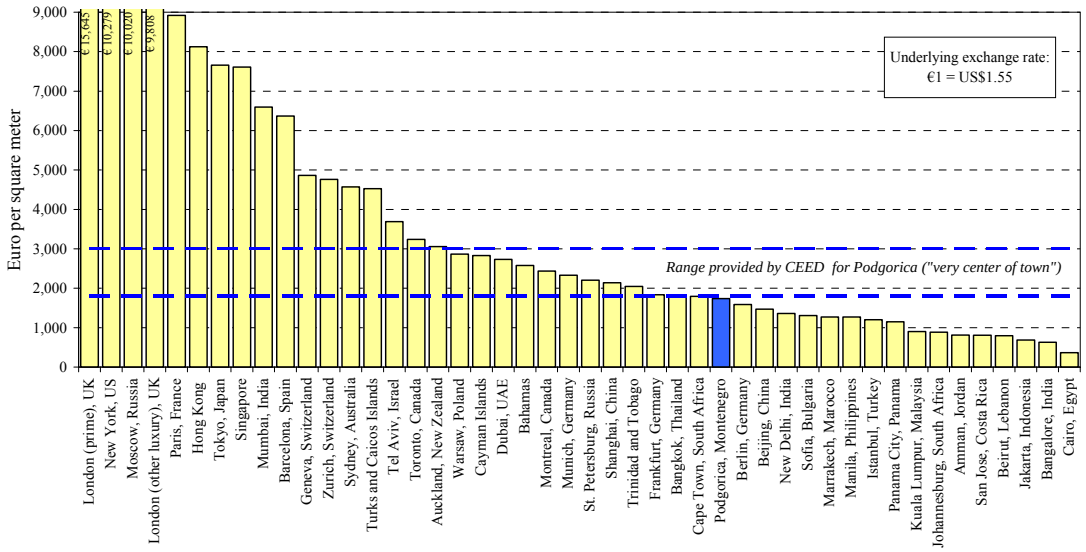
(ii) **Real-estate prices appear to have reached their peak, with the current price level permitting further increases—if at all—only in very few locations along the coast and, possibly, in the capital.**[7] During the last two years, Montenegro found itself in the midst of a real-estate boom, primarily driven by Russian buyers. Real-estate agents reported price increases at par with and, in late 2007, exceeding those on the stock exchanges (Table 1.5). During 2006–07, foreign investors bought more than €850 million worth of real estate (an average 18 percent of GDP), notwithstanding the fact that not all obstacles surrounding land titles for previously expropriated lots had been fully resolved. The wealth effect from the real-estate sales led (i) to an inflow into (and, as of mid-2007, an outflow from) the two stock exchanges; (ii) a construction boom in Podgorica and elsewhere; and (iii) increased imports and a widening of the already large current-account deficit. The boom led to a situation in which—with an estimated average price of €1,738 per square meter—the prices for apartments and houses in Podgorica currently exceed those in Berlin or Beijing (Figure 1.7). There is not much space for further increases, and available indicators point to—possibly considerable—price corrections in Montenegrin real estate.

Table 1.4. Coastal Montenegro: Average Percent Increases in the Price per Square Meter, 2005–07

	Apartments			Houses			Plots			Business premises		
	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007
Average	53	91	80	39	101	133	109	246	64	46	81	107
Ulcinj/Ulqin	17	57	127	18	60	88	225	115	114	33	67	113
Bar	50	106	62	29	89	106	114	407	45	29	94	129
Petrovac	39	68	55	31	100	165	100	100	120	78	41	122
Bečići	43	60	119	29	91	138	88	233	50	41	88	100
Budva	47	82	75	41	133	79	106	243	-8	50	56	43
Tivat	25	93	124	29	118	108	83	218	100	44	52	186
Kotor	41	111	88	50	150	167	133	171	137	59	74	113
Herceg Novi	75	162	64	50	133	114	67	400	10	41	171	85

Source: CEED Consulting (2007).

Figure 1.7. Apartment Prices Per Square Meter in City Center, 2007/08

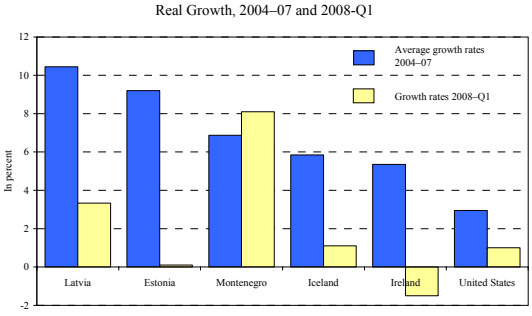


Sources: Global Property Guide, 2008, "Most Expensive Cities in 2008"; and for Podgorica: Central Bank of Montenegro; and CEED Consulting (2007).

[7] See, e.g., Fabris and Kalezić (2008). They report a square meter price of €1,738.27 for Podgorica, €3,232,37 for Budva, €2,614.66 for Herceg Novi, and €2,145.60 for Tivat.

Box 1.1. Housing Prices, Credit Crunch, and the End to Economic Booms

A credit-driven economic boom made Iceland the first victim of the global credit crunch. The island's narrow production base implies a high import propensity. The strong appreciation of the Icelandic króna during 2004–05, creating a seizeable wealth effect, induced Icelanders to consume more, leading to a very large current-account deficit (26 percent of GDP in 2006). The overall fiscal balance remained in surplus (6 percent of GDP in 2006). To finance the current-account deficit, the country's big banks borrowed internationally, stretching themselves beyond their domestic depositor base. The demand pressures led to increasing inflation, which resulted in interest rates to be raised, leading to a further strengthening of the currency. The boom burst with the global credit crunch. Triggered by the U.S. "sub-prime" crisis, European banks ceased to lend to their Icelandic counterparts. In an effort to avert a full-blown crisis, the central bank secured swap agreements with the central banks of Denmark, Norway, and Sweden, which permitted it to exchange Icelandic krónur into euro up to a limit of €500 million each. To bolster central bank reserves, parliament authorized government to borrow up to about €4 billion.



Falling U.S. housing prices triggered the "sub-prime" mortgage crisis, causing liquidity shortages worldwide. Fueled by gains from an earlier stock-market boom and readily available, low-interest mortgages, many lower-/middle-income Americans became homeowners, counting on the ability to refinance existing mortgages against higher house-value estimates. The cooling of the real-estate market led to increasing default rates, especially on higher-risk mortgages (the so-called sub-prime market). More than 100 sub-prime mortgage lenders failed. Sub-prime debts had been included in various investment vehicles and traded internationally. The IMF (2008a) estimated that global losses from the crisis exceeded €600 billion; and there is no end in sight. The 100 biggest banks alone lost €240 billion (Onaran, 2008). Many banks and mortgage lenders had to be bailed out. Even unaffected banks reined in their lending, leading to rising interest rates and widespread difficulty in maintaining credit lines, affecting even companies otherwise entirely unrelated to the crisis.

Rapid rates of growth in real-estate prices tended to accompany the booms in the fastest growing Eastern European economies—together with bank credits from abroad. Many of the transition economies in Europe are thus being regarded as vulnerable to abrupt contractions. During previous years, countries as heterogeneous as the Baltic republics or Bulgaria (as much as Iceland and Ireland) have benefited from easy access to credit, low (or even negative) interest rates, and from the presence of foreign banks, meaning they could borrow from their respective mother banks (Edgeworth, 2008). With high rates of investment and consumer spending, these economies experienced prolonged periods of above-trend growth, accompanied by tightening labor markets. Widespread wage and price pressures, asset bubbles (especially house prices), and the widening of current-account deficits have left these economies fragile and vulnerable to the effects from the current international crisis.

Academics have long stressed the pro-cyclical nature of private-sector credit. The "small shocks, large cycles" story first formalized by Bernanke et al. (1996) implied that economic downturns induced banks to engage in a "flight to quality". Relatively high-risk borrowers, including innovative SMEs, would bear the brunt of the contraction in bank lending. With fewer credits leading to lower rates of investment, Bernanke et al. (1996) demonstrated that high ratios of private-sector credit aggravated the effects from the credit cycle on the real economy. Braun and Larrain (2005) showed that (i) credit-dependent sectors were more sensitive to economy-wide recessions; and (ii) the financial mechanism was "asymmetric over the cycle, stronger during downturns than in booms, and especially strong when recessions are accompanied by credit crunches."

The combination of adverse external shocks and the natural end to the economic expansion foreshadow a worsening of the financial conditions and increased vulnerability. As argued by Edgeworth (2008), in those countries where the credit boom had been biggest—viz., Estonia, Latvia, and Iceland—the contraction thus far has proven especially sharp. Compared to these countries, Montenegro's recent boom was considerably more pronounced, as exemplified by unparalleled rates of private-sector credit growth and a much larger current account deficit.

(iii) **Main elements of FDI will wane.** In particular, purchases of coastal real estate by non-residents represent more than one-half of total FDI in 2006 and 2007. With a coastline of 293 kilometers, the supply of beachfront property is—*per definitionem*—finite.[8]

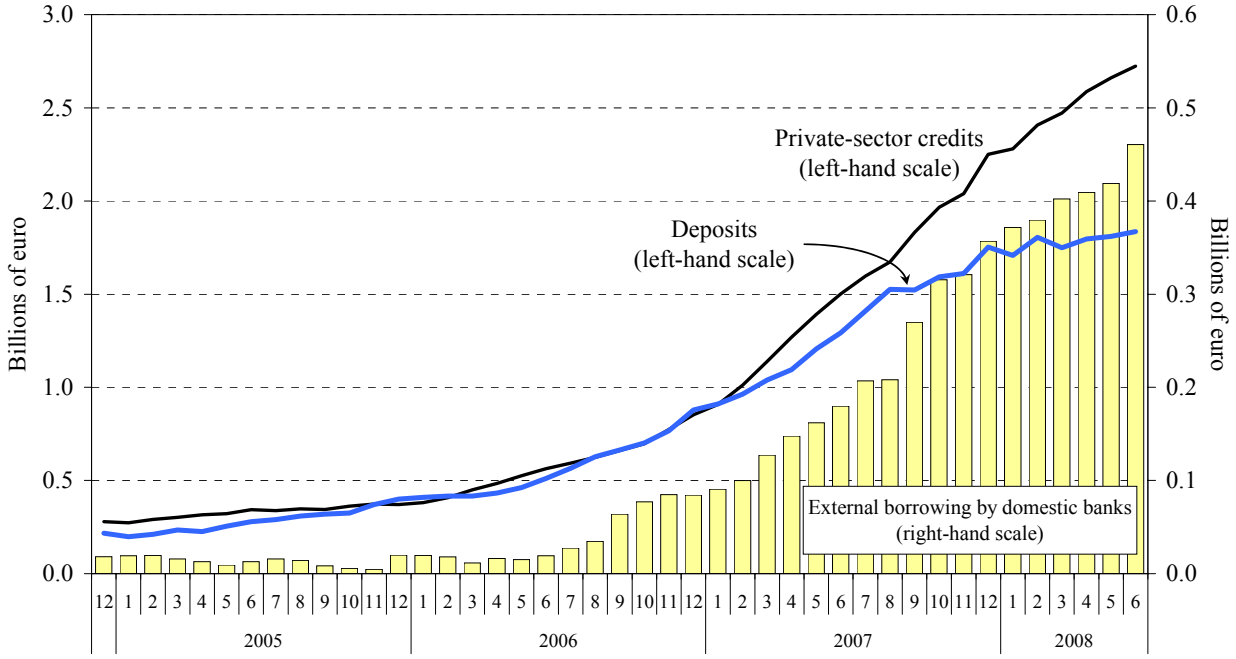
(iv) Domestic banks will not be able to lend to the private sector as aggressively as during the period 2006–07. Credit to the economy had grown at unprecedented rates and, in 2007, considerably faster than deposits. As indicated in Figure 1.8, this implied increased foreign borrowing by domestic banks abroad, often from their mother banks. Because of the financial institutions' rapidly increasing exposure to external credits, Standard & Poor's rated the banking sector the riskiest in the region in August 2008. In its banking industry country risk assessment (BICRA), the rating agency included Montenegro in the so-called "Group 9" of countries with a "high level" of economic and credit risk.[9] This decision followed, for similar reasons, the adoption of pre-emptive measures by the Central Bank of Montenegro (CBCB) more than half a year early. It implemented a set of measures aimed at strengthening prudential ratios reflected the fact that credits had been extended without commercial banks having had access to any central credit registry (which became operational in January 2008). In response to the inherent risks to portfolio quality and concerns about macroeconomic stability, the CBCG tightened definitions of prudential indicators[10] and, in so doing, helped to decelerate private-sector credit growth rates in 2008 (with an objective of having growth rates decelerate from more than 180 percent to about 40 percent). If as successful as Figure 1.9 seems to indicate, the corresponding demand stimulus will be considerably less pronounced.

[8] Principally, a similar argument could be made for privatization receipts—assuming that investors, without the available offers, would not have realized "green field" investments instead. The process of privatizing formerly state-owned enterprises and selling remaining Government shares in publicly (co-)owned enterprises is winding down. "Green field" investments, which will have to give the growth impetus in the medium term, have (thus far) remained disappointing; see also IMF (2008:16): "green field investment, which is instrumental for expanding the productive base, accounted for a meager 10 percent of total FDI."

[9] This risk rating implies that, against the backdrop of the international financial crisis, liquidity available to Montenegrin banks might dry up faster and be unavailable for longer periods than currently expected.

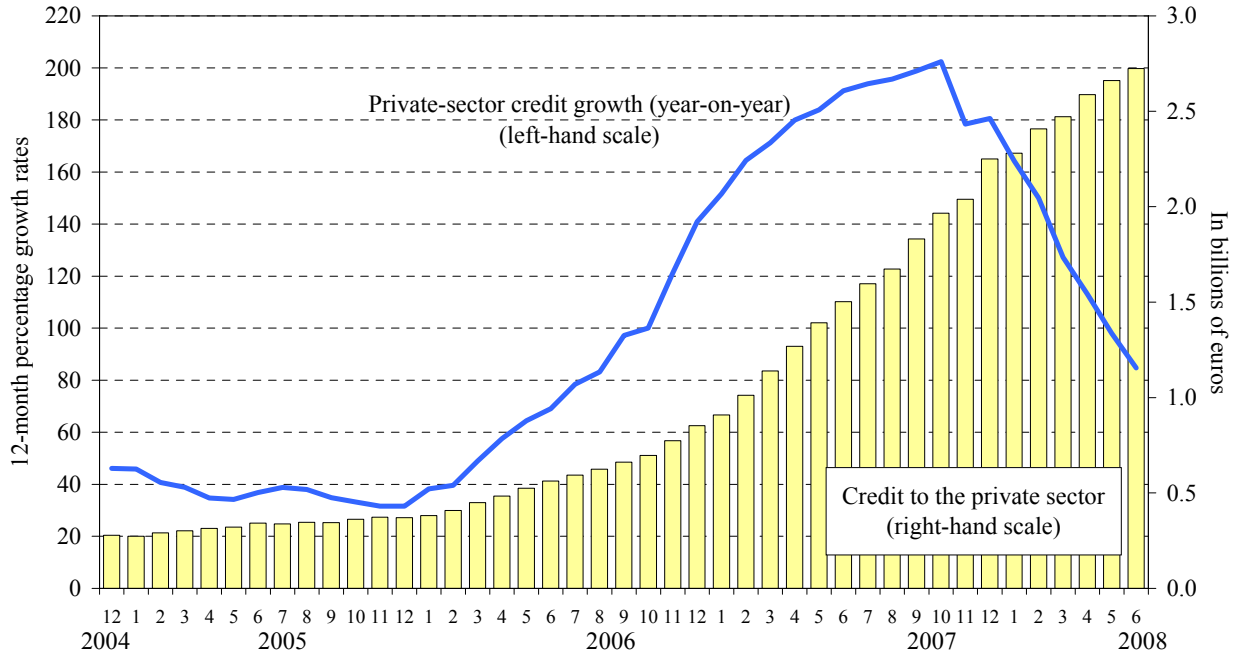
[10] In late 2007, the CBCG tightened definitions of prudential indicators. In particular, it tightened the definition of minimum criteria and the procedures for the classification of assets and off-balance sheet items (which expose banks to credit risks) and broadened the base for reserve requirements by including all public-sector sight deposits (previously, only those public-sector deposits with a maturity of up to one year were included in the base for reserve requirements). The central bank defined solvency ratios as function of annual credit-growth rates, while setting credit-growth ceilings of 30–60 percent relative to the stock of outstanding credits, thus granting higher growth rates to banks with a smaller loan portfolio. Twelve-month growth rates thus decelerated from a peak of 202 percent in October 2007 to 181 percent in December 2007 and 98 percent in May 2008.

Figure 1.8. Montenegro: Deposits and Credits, December 2003–June 2008



Source: Central Bank of Montenegro; and World Bank staff estimates.

Figure 1.9. Montenegro: Private-Sector Credit Growth, December 2004–June 2008



Box 1.2 Growth Engine Tourism

FDI inflows reflect expectations that tourism demand will continue to increase at rates comparable to those seen in previous years. According to Government of Montenegro (2008c) figures, the number of foreign tourists increased by more than 45 percent in both 2005 and 2006 and by almost 55 percent in 2007, while tourists have tended to stay longer than in preceding years. The World Travel and Tourism Council (2008) has remained very optimistic about Montenegro's potential, expecting the tourist sector to grow by 17.0 percent in 2008 and an average 5.6 percent during 2009–2018. The buoyancy in the sales of (coastal) real estate, leading to considerable follow-up investments in refurbishing existing—or constructing new—hotels, apartments, and other tourist facilities, reflects this outlook.

However, tourism demand tends to be unpredictable, and there are some weaknesses in the supply of Montenegro's tourism product. The World Economic Forum (2008), in its 130-country study on tourism and travel competitiveness, highlighted two areas of particular concern that could render aforementioned tourism demand projections as overly optimist, viz., (i) environmental sustainability (where Montenegro ranked 105th); and (ii) price competitiveness (129th). Montenegro has traditionally attracted tourists that enjoyed its splendid nature, focusing its internationally broadcast advertising strategy on the *Wild Beauty* aspect of tourism supply. However, once the wilderness disappears (for instance, as a result of uncontrolled development), including those attractions advertised in official tourist brochures, tourists might reconsider their choice of destination—even more so if the relation between price and service is skewed and tourism supply uncompetitive. As tourism-related FDI is a function of existing supply constraints (as discussed above) and projected tourism demand, a weaker-than-forecast tourism season could quickly translate into less exuberant expectations and, consequently, an ebbing stream of related foreign capital inflows. Economic policy decisions—with respect to macroeconomic management, the implementation of its tourism development strategy, and the uniform enforcement of the recently adopted spatial plan—will have to be made with this in mind.

Southeastern Europe: Tourism and Travel Competiveness, 2008
(Country rank of altogether 130 countries)

	Western Balkans					Regional comparators					
	MNE	AL	BiH	MK	SRB	BG	HR	GR	I	SLO	TR
Overall index	59	92	105	83	78	43	34	22	28	36	54
Regulatory framework	53	81	98	93	73	50	39	17	41	42	56
Policy rules and regulations	37	104	109	75	59	85	66	61	57	87	43
Environmental sustainability	105	93	113	84	128	73	41	40	39	17	90
Safety and security	53	71	57	60	76	90	41	31	81	20	79
Health and hygiene	52	59	55	68	46	12	28	16	19	36	62
Prioritization of travel and tourism	67	104	124	128	114	65	51	1	46	84	45
Business environment and infrastructure	68	105	91	80	72	52	38	30	24	33	57
Air transport	54	112	124	113	92	101	66	20	26	70	44
Ground transport	71	116	115	79	86	77	54	46	40	23	63
Tourism infrastructure	31	86	59	61	52	22	10	9	4	20	50
ICT infrastructure	63	86	62	72	57	44	37	39	25	26	55
Price competitiveness	129	90	107	72	82	69	98	120	124	102	103
Human, cultural, and natural resources	45	71	117	81	68	31	32	18	15	61	44
Human resources	76	58	106	71	45	59	50	43	39	35	73
Affinity for travel and tourism	1	6	93	75	98	16	7	39	67	53	38
Natural resources	69	130	120	85	112	59	68	75	60	76	79
Cultural resources	66	75	70	57	52	29	37	16	8	54	28

Source: World Economic Forum (2008).

(v) **The 2007 tourist season had been exceptional,** partly because of the "newness" of the destination and a number of internationally significant cultural events. However, the materialization of public infrastructure bottlenecks during periods of peak demand, especially related to the provision of water and electricity, uncontrolled construction, and largely unresolved challenges of solid and liquid waste disposal might deter (higher end) tourists from returning. As indicated in Box 1.2, the Montenegrin tourism product is attractive only when compared to other destinations in the Western Balkans, but it is not yet competitive with more established tourist markets in the region. There are serious concerns regarding price competitiveness and environmental sustainability of Montenegro's tourist sector, foreshadowing a slowdown in growth from some key countries of origin.[11] Preliminary data for the 2008 summer season appear to corroborate this.

1.7. **The size of the external capital inflow, relative to GDP, was so substantial that the economy gave clear indications of its difficulty in absorbing the additional demand.** For tradable goods, the consequence was higher imports and a resultant widening of the current-account deficit. For non-tradable goods and services, the additional, unmet demand let to higher prices and accelerating inflation rates.

(i) **The current-account deficit increased from €0.5 billion in 2006 (25 percent of GDP) to €1.0 billion in 2007 (40 percent).** This ratio is higher than in any other country in the ECA region, with only a few tourist-dependent island economies having similar levels of current-account deficits; see Figure 1.10.[12] In 2007, the current-account deficit (€1,007.6 million) was fully financed by FDI (€1,007.7 million), as was the case in 2006 (€531.2 million vs. €644.3 million). A sudden—exogenously induced—decrease in foreign-capital inflows would lead to a corresponding decline in aggregate demand and, subsequently, a reduction in imports. Without the risk of an (expected) devaluation (as is the case in a standard fixed exchange-rate regime), the adjustment will be restricted to the current account and spillovers to the fiscal sector (see below).

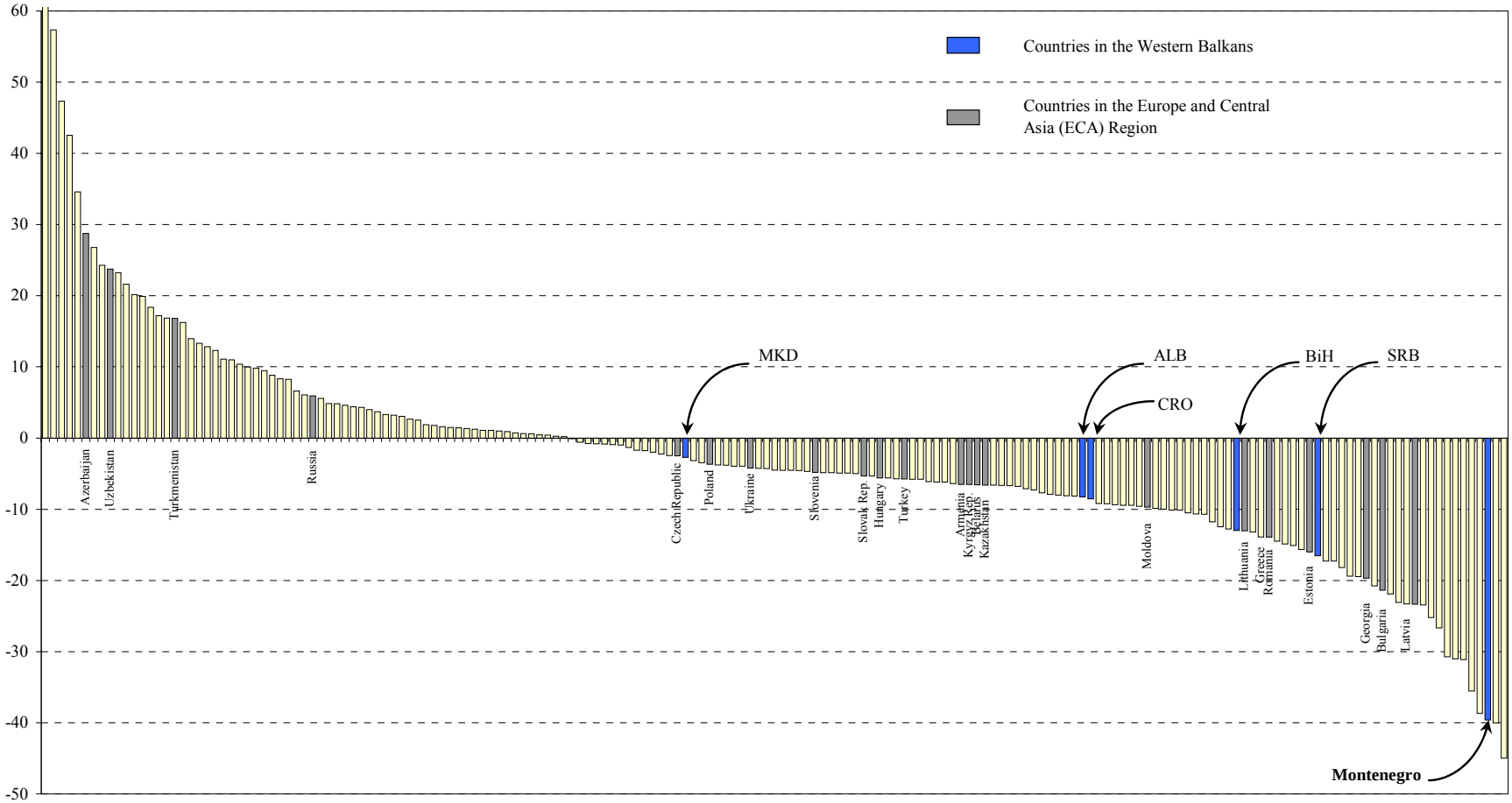
(ii) **Twelve-month inflation rates increased from 2 percent at end-2006 to 11.4 percent in June 2008.** For non-tradable goods, excess demand resulted in price and wage pressures. Price increases affected not only energy and food prices (which have increased on a global scale) but also those for services in non-tradable sectors (representing the market's reacting to developing supply bottlenecks). Similarly, rising wages for public-sector employees and, especially, skilled labor in the private sector foreshadow a considerable tightening of the labor market and further—endogenous—price pressures in subsequent periods.

[11] In late 2007, a large, Western European tour operator removed Montenegro as a tourist destination from its 2008 catalogue—reportedly for reasons of excessive hotel prices, frequent tourist complaints about overcrowded beaches, incessant nocturnal nightclub noise, and other inconveniences.

[12] Preliminary first-quarter 2008 data by the CBCG show that the current-account deficit widened further to an estimated 67 percent of GDP. This widening occurs against increased debt financing of the current-account deficit and the fact that, from November 2007, CBCG reserves—which had increased by more than 200 percent since independence—started to decline, by 6 percent between November 2007 and June 2008. At end-2007, reserves covered about 7½ months of imports of goods and services.

Figure 1.10 Current-Account Balance, 2007

(In percent of GDP)



Sources: IMF, World Economic Outlook Database April 2008; Montenegrin authorities; and World Bank staff estimates.

C. Fiscal Policies

1.8. **Given its 1999 euroization decision, Montenegro's only policy instrument of macroeconomic management is fiscal policy** (Box 1.3). As such, fiscal policy has to play a double function in ensuring continued macroeconomic stability and advancing and socio-economic development, both of which objectives—pulling in different directions—place considerable demands on policymakers.

(i) **Macroeconomic stabilization.** Given Montenegro's increasing vulnerability to external factors[13] and inherent characteristics of pro-cyclicality[14], fiscal policies need to be designed with a view to counterbalancing these effects if a boom-bust cycle is to be avoided. During 2006–07, Government was broadly successful, having posted sizeable overall fiscal surpluses.

(ii) **Socio-economic development.** The Government is conscious of the weaknesses in public infrastructure, placing an undue burden on private-sector activities. It has thus devised an ambitious public investment program to address these challenges. As a result, sufficient fiscal space needs to be created in future budgets to ensure that these large-scale public investments, even if co-financed by the private sector, will be realized so as to be able to contribute to the increase in the productivity of the private sector's invested capital and employed labor.[15] To do this, Government needs to strictly control recurrent spending—and especially the wage bill, where there are considerable pressures to increase both staffing and wage rates.

1.9. **The twin objectives of containing recurrent spending and implementing the integration-inspired institutional reform agenda can only be achieved by further increasing the efficiency of the public administration.** Without the ability to

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[13] These vulnerabilities are particularly pronounced given the backdrop of large, but unsustainable elements of foreign direct investment and external private debt.

[14] The import-reliant tax regime, as discussed below, amplifies the pro-cyclicality in tax revenues, while the role of the real-estate market as source of external capital and the relative importance of credit to finance the private sector's investment and consumption add risks to large fluctuations in economic activities over the course of a business cycle.

[15] Montenegro does not have a development strategy *per se*, which would help in defining criteria according to which Government could prioritize capital spending priorities. Sectoral strategies, to the degree that they have been developed, have yet to be comprised in a single strategy, including respective spending and financing profiles, and represented in a medium-term expenditure framework that would form the critical input into the annual budget preparation process. However, Government defined its overarching policy objective—eventual EU membership—and the necessary steps towards achieving that goal have, however, been devised by ministerial staff, debated in public, and approved by Government during the first half of 2008. With its *National Program for Integration* (NPI), the Government of Montenegro (2008a) seeks to define its strategic development objectives, including relevant policies, reforms, and measures required to accomplish these objectives. The NPI, including the timeline for reform implementation, has been presented as a detailed plan of activities necessary "to enable Montenegro to become ready to assume its commitments emanating from the EU membership by the end of 2012." With this document, the Government established a detailed agenda for the harmonization of Montenegrin legislation with EU standards. In addition, to support private-sector activities, the Government is taking the necessary steps to prepare large-scale public investments, including in the critical areas of energy and transport.

increase recurrent spending in real terms, a particular emphasis needs to be placed on accelerating the process of institutional modernization and implementing reforms that aim at ensuring increased efficiency at a given level of public spending. This is particularly relevant for the wage bill—given (i) additional demands on the public sector for European integration and decentralization purposes, which require further recruitment in certain areas of public administration; (ii) accelerating prices for food and fuel, which have already resulted in mounting political pressure for further across-the-board wage increases; and (iii) increased wage competition from the private sector, particularly for the highly skilled staff. As difficult as this challenge is, there is no alternative: not being able to contain the wage bill would, in the given context, jeopardize the Government's broader policy objectives, prevent the realization of the ambitious public investment program, and create additional risks to macroeconomic stability.

Box 1.3 The Reform Agenda: Economic Constraints and Political Objectives

In the late 1990s, the Government combined measures of post-war economic recovery with those of creating an economic space separate from Serbia's. Economic stabilization and development objectives became a function of the unambiguously pro-European foreign-policy anchor, as manifested in the unilateral euroization decision in 1999. Confronted with the need to asphyxiate hyperinflationary pressures prevailing in FR Yugoslavia's economy, placed under UN sanctions, the Government of Montenegro regularized the *de facto* dollarization and, independently from decisions taken in Belgrade, established its own central bank, adopted the Deutsche Mark (replaced by the euro in 2002) as legal tender, thereby re-establishing price stability.*

This step cemented earlier moves intended to insulate Montenegro's economy from the post-conflict instability in Serbia. Montenegro lowered customs tariffs, adopted a separate state budget, lifted visa requirements for foreign nationals (thereby provoking Serbia to establish border controls inside the state union), implemented an ambitious privatization agenda, introduced the value-added tax (VAT), and introduced a medium-term economic reform program. The undefined political status, however, prevented Montenegro from reaping the full benefits of this agenda, which in itself became an argument for the Government to push for political independence. In the pre-referendum public debate, it portrayed the state union's (political) constraints as principal hindrance towards achieving Montenegro's European integration objectives.

An economy burdened by sanctions and constrained by decades of neglect of public infrastructure urgently requires large-scale investments from abroad. Tax policy became a central element in a strategy aimed at attracting foreign capital. Montenegro thus began to engage in—what German-speaking economists refer to as—*Standortwettbewerb*, that is, the competition with neighboring countries over international capital, know-how, skills, and technology. The Government placed considerable emphasis on improving the overall business climate and, for that reason, engaged in regional tax competition.

* See, for instance, Fabris et al. (2004). The decision on, and the steps towards, unilateral euroization were taken without involving the International Monetary Fund (IMF).

Tax Policy: Providing a Pro-Business Environment

1.10. **Like many other countries in Eastern Europe, Montenegro has been aggressively reducing its direct tax rates**; see Table 1.6. In late 2006, the Government adopted a uniform 9 percent rate on corporate income (the lowest rate in Eastern Europe), effective as of mid-2007, and is planning to gradually reduce the personal income-tax rate from currently 15 percent to 9 percent by 2010. It eliminated capital gains taxation[16] and kept social contributions at a minimum. As recent developments have shown, this decision has been very beneficial in terms of enhancing the relative attractiveness of Montenegro as site for (foreign) direct investments (and the Government's ability to strengthen tax administration).

Table 1.6. Montenegro and Neighboring Countries: Principal Tax Rates, 2008

	Tax rate	Tax base	ALB	BiH	BUL	CRO	MKD	SRB
Corporate tax	9.0	Flat tax on corporate profits; no separate treatment of capital gains; reinvested capital gains excluded from tax base.	10.0	10.0	10.0	20.0	10.0	10.0
Withholding tax	15.0	5 percent on interest income; 15 percent on divident payments, royalties, capital gains, and rent from real-estate leased to non-residents	10.0	10.0	10.0	15.0	10.0	20.0
Personal income tax	15.0	As of 2007, progressive income tax replaced by flat tax, In 2009, rates of 12 percent are foreseen and of 9 percent in 2010.	10.0	depends on entity/canton	10.0	4 brackets 15 - 45	10.0	10.0 (15.0)
Social sec. contributions (employer) Pension, health, unemployment	15.0	Mandatory social insurance, gross personal income is base for calculation of contributions.	21.7	Fed.: 10.0 RS: 42.0	≈ 21	17.2	0.0	17.9
Social sec. contributions (employee) Pension, health, unemployment	19.0	In 2007, employer pays 16.1 percent and employee 20 percent. In 2009, rates are , foreseen to be lowered to 14.5 and 17.5 percent, and in 2010, to 13.5 and 16.5 percent, respectively.	11.2	Fed.: 28.0 RS: 0.0	≈ 13	0.0	11.3	17.9
Value-added tax	17.0 (7.0)	17 percent is the general VAT rate; 7 percent on social necessities, daily publications, computer equipment, marina services; exemption for exports and related services, banking services, rental for	20.0	17.0	20.0	22.0 (10.0)	18.0	18.0 (8.0)
		and related services, banking services, rental for f flats and builidngs for residential purposes, insurance, renting of agricultural, forest, and construction land.	10.0	varied				

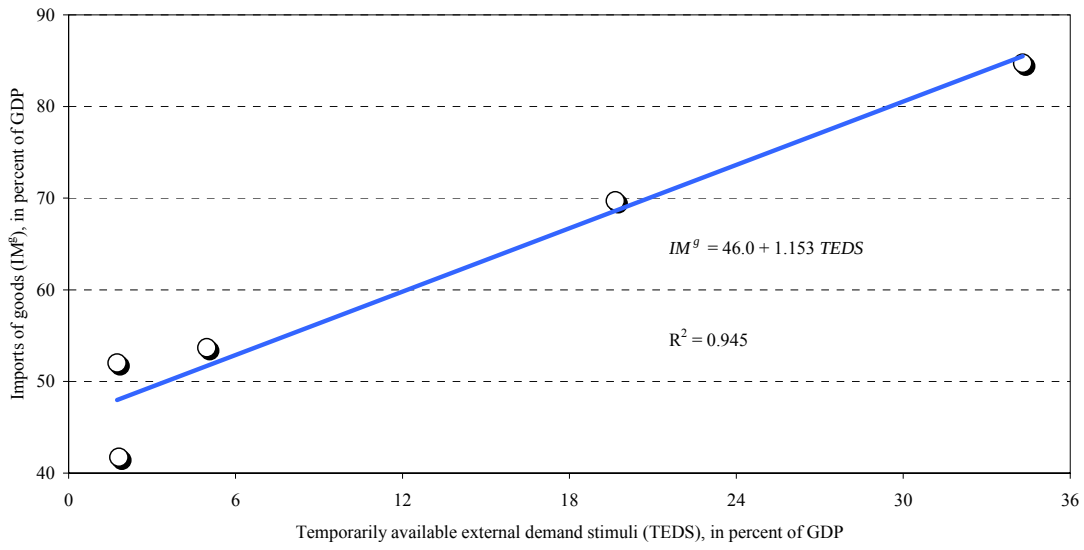
Source: Ministry of Finance; PriceWaterhouseCoopers (2008); and World Bank staff estimates.

1.11. **At the same time, however, the flat tax has removed automatic stabilizers, making Montenegro's tax regime pro-cyclical.** The low tax rates have made the budget more susceptible to external demand shocks and increased its reliance on imports as a source for fiscal revenues, which will amplify the variability of fiscal revenues over time. This point has a particular relevance in light of the underlying factors that have fueled the currently dynamic rates of economic growth. Two of these, in particular, are unsustainable and will wane over the medium-term horizon—viz. FDI in real estate (20 percent of GDP in 2007) and foreign borrowing by domestic banks (14 percent).

[16] Any tax obligations from capital gains are waived if corresponding amounts are reinvested within a year. Otherwise, capital gains are subject to the standard 9 percent corporate income tax.

1.12. **During 2003–07, imports have increased in line with the unsustainable elements of capital inflows.** As shown in Figure 1.11, the regression slope implies that an exogenous change in the non-sustainable elements of external capital inflows[17] leads to a corresponding change in imports. These, in turn, have a strong correlation with tax receipts—and, in particular, with those derived from the value-added tax. According to Figure 1.12, for every €100 million change in imports, there will be a €18.9 million effect on total tax revenues, which would imply that the €871 million in *temporarily available external demand stimuli* (TEDS)—real-estate sales and external bank credits—correspond to €165 million in, or 21 percent of, total tax revenues. These strong correlations help to explain the underprojections of fiscal revenues for both the initial 2006 and 2007 budgets but, simultaneously, frame the risks of any medium-term fiscal strategy. In an adverse situation, Montenegro will encounter immense difficulty in rebalancing the sources of its tax base, not least because the region as a whole is engaged in aggressive tax competition, limiting tax-policy options in instances of unanticipated fiscal shortfalls.[18] Montenegro has gone further in the regional race to the bottom, implying that there could be a modest space for tax-policy adjustments, if needed—in particular, if it succeeds in improving the business climate by implementing crucial public infrastructure investments and strengthening public administration, thereby removing the necessity to engage in *Standortwettbewerb* over the lowest tax rates alone.

Figure 1.11. Montenegro: Temporarily Available External Demand Stimuli and Imports, 2003–07

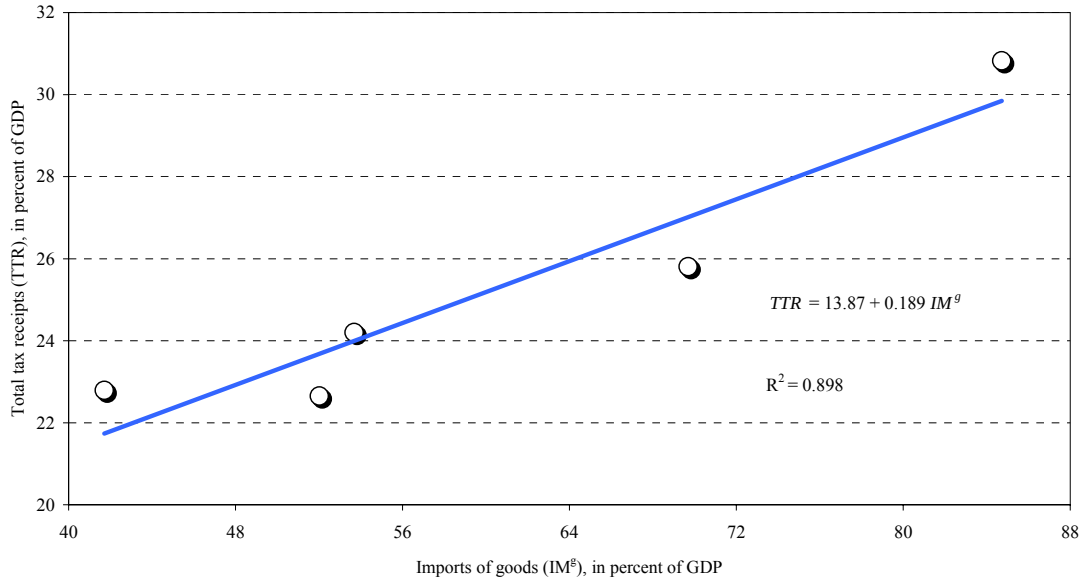


Sources: CGCG, Monstat; and World Bank staff estimates.

[17] Both real-estate purchases by non-residents and external bank credits are henceforth subsumed under the term "temporarily available external demand stimuli" (TEDS).

[18] Current developments point to the opposite direction, as Montenegro's tax regime is to be made even more "competitive". The Government seeks to lower the rates for personal income taxes and social-security contributions (see Table 1.6).

Figure 1.12. Montenegro: Imports and Tax Receipts, 2003–07



Sources: Ministry of Finance; CGCG, Monstat; and World Bank staff estimates.

Expenditure Policy: Increasing Factor Productivity

1.13. **The principal economic policy challenge has consisted of raising total factor productivity (TFP).** This places the relative weights of the wage bill and of capital expenditures at the center of the fiscal-policy debate. Relative to other countries in the region, Montenegro shows higher shares for either category, both in terms of total expenditure and as a share of GDP (Table 1.7), implying tight budgets for maintenance. A policy geared towards increasing TFP needs to ensure that the rates of return on public infrastructure and social investments be increased, with a view to (i) crowding in private-sector investments in both the tourist and non-tourist sectors;[19] and (ii) preparing the economy to absorb a larger share of aggregate demand. In response, the Government has attempted to control expenditures on the wage bill, which increased by an average 11.6 percent in nominal terms during 2004–07 (Table 1.8), less than nominal GDP (14.0 percent). As a result, related expenditures declined both as a share of total expenditures, from 36.2 percent in 2004 to 27.9 percent in 2007, and in percent of GDP, from 14.5 percent in 2004 to 12.7 in 2007 (Table 1.9).[20] Combining all budgetary expenditures directly benefiting individuals (that is, the wage bill, social-security contributions, and transfers to individuals), the relative share has declined from 72.2 percent of total expenditures in 2004 to 55.6 percent in 2007. This has left additional fiscal space for maintenance and, in particular, public investments.

[19] In mid-2007, the Government decided not to request program support from the IMF, largely because key representatives felt that it would place undue upper limits on public investments.

[20] With a 30-percent increase in salaries granted late 2007, some of these gains will, however, be undone, partly reflecting tightening labor markets and the increasing competition with the private sector.

Table 1.7. Regional Comparison of Budget Structures, 2007

	As share of total expenditures		As share of GDP	
	wage bill	investments	wage bill	investments
Montenegro	27.9	16.3	12.7	7.4
Weighted regional average[1]	21.0	12.5	7.0	3.7
Unweighted egional average	21.7	11.6	7.6	3.9
Albania	20.7	19.9	6.1	5.9
Bosnia and Herzegovina	24.2	6.2	12.2	3.1
Bulgaria	16.6	16.1	6.2	5.9
Croatia	23.5	9.9	4.1	1.7
Estonia	17.9	10.1	6.4	3.6
Lithuania	29.7	9.6	9.9	3.2
Macedonia, FYR	20.5	11.9	7.0	4.1
Romania	18.8	10.5	6.3	3.6
Serbia	23.8	9.9	10.1	4.2

Sources: Montenegrin Ministry of Finance; IMF (latest staff reports); and World Bank staff estimates.

[1] Weighted by 2007 GDP (WEO Database, April 2008).

1.14. **Capital expenditures represent a steadily growing share of total expenditures**, increasing from 4.6 percent in 2004 to 16.3 percent in 2007, while remaining insufficient for purposes of realizing the Government's ambitious public investment plans. As a share of GDP, this represents an increase from 1.8 percent in 2004 to 7.4 percent in 2007. At the same time, the Government took steps to strengthen public investments and finance these with proper resources. This reorientation in post-independence expenditure policies, made possible by abundant tax revenues and political efforts to control the (still large) wage bill, frames current fiscal-policy challenges. The comparison to countries in the region supports this view, as capital expenditures have risen to a level that is favorable to that of other countries, while the wage bill—with the 28-percent ratio to total expenditures partly reflecting the small size of the country—remains several percentage points of total expenditures higher than in neighboring countries.

1.15. **These trend shifts in expenditure support the Government's objective in preparing large-scale (public) infrastructure investments over the medium.** They also reflect efforts to implement policies consistent with the recommendations contained in the previous PEIR (World Bank, 2006). In line with this report, the following measures were implemented during 2007:

(i) *Reduce the cost of public employment, while modernizing public administration.* As discussed in Chapter IV, Montenegro has been taking measures aimed at facing the double challenge of controlling the wage bill (also in light of rapid wage increases in the private sector), while strengthening public administration in areas required for structural reforms, the realization of the European integration objective, decentralization, and the modernization in

health and education as well as the administration of the pension and unemployment funds. Between 2002 and 2006, there has been a steady trend decrease in public-sector employment, which declined by 12 percent during this quinquennium—from 48,671 to 42,873. However, the modernization objective resulted in an increase in public-sector employment in 2007, to 44,015, but mainly in areas crucial for the EU integration process, the judiciary (+343), for specialized agencies, the health, pension, and unemployment funds (+218), and for teachers and other education-sector staff (+132). Staff increases by local self-government (+459) accounted for 40 percent of the total rise, while representing only about 10 percent of public-sector employment. Corrective measures took place in other areas: public-sector employment within uniformed services, for instance, fell by 40 percent from 14,638 in 2002 to 8,676 in 2007. As such, public-sector employment fell from around 17½ percent of the total labor force during the pre-independence years to about an average 16½ percent in the post-independence years, with a declining trend. The wage bill, which averaged more than 12 percent of GDP during 2003–05, has been on a declining trend since 2004, representing about 10.5 percent of GDP in 2007.

(ii) *Reform public financial management and procurement.* In early 2008, the Government requested a "Public Expenditure and Financial Accountability" assessment to frame further reforms in this area (World Bank, 2008b), having created the legal base (especially the organic budget law) and necessary public institutions (e.g., the State Audit Institution, the Directorate for Public Procurement, and the Commission for Supervising the Process of Public Procurement). Montenegro has made good progress towards implementing a program budget; this process is to be concluded with the 2009 state budget.

(iii) *Improve institutional capacity for public investment planning.* While there is no comprehensive socio-economic development strategy in the classic sense of Poverty-Reduction Strategy Papers, with poverty assessments and a definition of overarching policy priorities, Government's recent publication of a number of strategic documents, including those of a cross-sectoral nature (Table 1.9), highlights its recognition that a full consistency in its policy framework needs to be assured, not least to guide the Government's progress towards achieving the country's principal politico-economic integration and socio-economic development objectives. The spatial plan outlines the geographic priorities and constraints, balancing goals of economic development and environmental protection, in itself a crucial input to Montenegro's longer-term sustainable development objectives. In several key sectors—particularly in energy—sectoral strategies have been developed that define expenditure need and the challenge to integrate capital expenditures with strategic partnerships with private enterprises (including in the transport and energy sectors). Especially in light of existing capacity constraints, Government officials view these longer-term documents increasingly as helpful internal monitoring devices that help them to achieve a consistent policy mix.

Table 1.8. Montenegro: Consolidated General Government Fiscal Operations, 2003–07
(In millions of euro)

	2003	2004	2005	2006	2007
Total revenues and grants	614.8	662.4	727.0	981.5	1,341.7
Total revenues	599.3	655.3	724.2	980.3	1,340.0
Current revenues	593.3	648.9	718.8	965.1	1,317.2
Taxes	344.2	378.3	439.2	554.5	782.9
Personal income tax	85.3	79.7	85.1	93.0	108.1
Corporate income tax	13.4	16.5	21.3	12.7	39.1
Taxes on property	6.3	3.8	5.0	24.9	40.2
Value added tax	137.2	158.1	193.4	273.2	393.2
Excises	58.2	61.5	65.6	72.4	94.5
Taxes on international trade	39.3	36.7	41.1	56.8	68.5
Local government taxes	4.4	20.5	24.0	17.1	32.6
Other taxes	0.0	1.6	3.7	4.5	6.7
Social security contributions	175.0	195.3	201.4	255.2	306.8
Contributions for pension, disability insurance	105.9	115.9	118.3	138.2	173.5
Contributions for health insurance	65.5	75.2	75.4	110.6	125.5
Contributions for unemployment insurance	3.7	4.1	7.7	6.1	7.5
Other contributions	0.0	0.0	0.0	0.3	0.4
Nontax revenues	74.2	75.4	78.2	155.5	227.5
Duties	10.7	14.3	17.0	29.3	33.8
Administrative duties	2.7	5.7	6.6	9.3	11.6
Court duties	2.0	2.3	1.6	6.0	8.7
Residential duty	1.5	0.9	0.3	1.5	0.8
Local communal duties	3.6	4.2	7.3	10.6	9.3
Other duties	0.9	1.2	1.3	1.9	3.5
Fees	32.6	23.0	34.6	58.0	122.7
Fees for use of goods of common interest	16.6	3.9	8.9	3.8	6.9
Fees for use of natural resources	0.0	0.0	0.0	3.5	3.7
Ecological fees	0.0	0.0	0.0	1.9	2.2
Fee for organizing games of chance	0.0	0.0	0.0	3.4	4.4
Fee for usage of construction land	14.3	16.6	12.3	8.0	15.7
Compensation for maintenance of local roads	1.4	1.6	12.7	3.2	4.8
Road fees	0.0	0.0	0.0	5.4	6.5
Other fees	0.3	0.9	0.7	28.9	78.5
Other revenues	30.9	38.1	26.6	68.2	71.0
Fines and seized property gains	0.1	0.2	0.2	7.9	11.7
Revenues from own activities of government bodies	7.3	15.2	11.9	32.0	23.0
Revenues from capital	0.1	3.1	4.1	8.2	18.7
Other revenues	23.4	19.6	10.5	20.1	17.6
Receipts from repayment of loans (from previous year)	6.0	6.4	5.4	15.1	22.8
Grants	15.5	7.1	2.9	1.2	1.7
Total expenditures and net lending	667.0	688.3	759.7	917.0	1,161.0
Total expenditures	638.7	668.9	743.0	899.4	1,151.4
Current expenditures	317.2	365.1	372.3	445.4	565.3
Wage bill	210.4	242.2	243.8	254.4	321.5
Gross salaries	190.4	219.8	226.4	234.5	287.8
Net salaries	109.0	125.7	140.7	134.9	166.1
Personal income tax	25.2	27.3	24.7	27.4	30.3
Social-security contributions	52.8	63.3	57.0	67.9	87.0
Contributions charged to employee	26.4	31.7	28.5	35.2	45.2
Contributions charged to employer	26.4	31.7	28.5	32.7	41.8
Municipal surtax	3.5	3.5	4.1	4.3	4.4
Other personal income	20.0	22.4	17.4	19.8	33.7
Goods, services, and maintenance	56.5	71.9	87.5	152.3	188.6
Goods and services	56.5	71.9	87.5	127.2	158.5
Current maintenance	0.0	0.0	0.0	25.1	30.1
Interest payments	14.7	25.8	21.7	23.9	27.9
Rent	1.9	1.8	2.0	3.1	5.6
Subsidies to enterprises	23.2	13.7	12.7	6.6	13.9
Other outflows	10.5	9.7	4.7	5.1	7.8
Social security transfers	212.2	231.4	239.9	260.1	298.8
Of which: pension and disability insurance rights	131.5	144.7	147.4	199.4	228.4
Other transfers	60.4	25.3	29.6	64.9	81.2
Transfers to public institutions	12.4	13.2	12.3	29.2	38.5
Transfers to NGOs	1.8	2.6	0.0	6.8	10.5
Transfers to individuals	14.6	9.6	17.3	22.1	19.5
Transfers to public enterprises	0.0	0.0	0.0	6.8	12.7
Transfers to Union budget	31.5	…	…	…	…
Capital expenditures	40.5	30.5	84.2	97.1	187.3
Reserves	8.4	16.7	17.1	32.1	19.0
Net lending	28.3	19.4	16.8	17.6	9.6
Loans and credits	16.9	8.8	10.6	16.5	9.6
Repayment of guarantees	11.5	10.6	6.2	1.1	0.1
Overall balance	-52.2	-25.9	-32.7	64.5	180.7
Financing	52.2	25.9	32.7	-64.5	-180.7

Sources: Ministry of Finance; and World Bank staff estimates.

Table 1.9. Montenegro: Consolidated General Government Fiscal Operations, 2003–07
(In percent of GDP)

	2003	2004	2005	2006	2007
Total revenues and grants	40.7	39.7	40.1	45.7	52.8
Total revenues	39.7	39.2	39.9	45.6	52.8
Current revenues	39.3	38.9	39.6	44.9	51.9
Taxes	22.8	22.7	24.2	25.8	30.8
Personal income tax	5.7	4.8	4.7	4.3	4.3
Corporate income tax	0.9	1.0	1.2	0.6	1.5
Taxes on property	0.4	0.2	0.3	1.2	1.6
Value added tax	9.1	9.5	10.7	12.7	15.5
Excises	3.9	3.7	3.6	3.4	3.7
Taxes on international trade	2.6	2.2	2.3	2.6	2.7
Local government taxes	0.3	1.2	1.3	0.8	1.3
Other taxes	0.0	0.1	0.2	0.2	0.3
Social security contributions	11.6	11.7	11.1	11.9	12.1
Contributions for pension, disability insurance	7.0	6.9	6.5	6.4	6.8
Contributions for health insurance	4.3	4.5	4.2	5.1	4.9
Contributions for unemployment insurance	0.2	0.2	0.4	0.3	0.3
Other contributions	0.0	0.0	0.0	0.0	0.0
Nontax revenues	4.9	4.5	4.3	7.2	9.0
Duties	0.7	0.9	0.9	1.4	1.3
Administrative duties	0.2	0.3	0.4	0.4	0.5
Court duties	0.1	0.1	0.1	0.3	0.3
Residential duty	0.1	0.1	0.0	0.1	0.0
Local communal duties	0.2	0.2	0.4	0.5	0.4
Other duties	0.1	0.1	0.1	0.1	0.1
Fees	2.2	1.4	1.9	2.7	4.8
Fees for use of goods of common interest	1.1	0.2	0.5	0.2	0.3
Fees for use of natural resources	0.0	0.0	0.0	0.2	0.1
Ecological fees	0.0	0.0	0.0	0.1	0.1
Fee for organizing games of chance	0.0	0.0	0.0	0.2	0.2
Fee for usage of construction land	0.9	1.0	0.7	0.4	0.6
Compensation for maintenance of local roads	0.1	0.1	0.7	0.1	0.2
Road fees	0.0	0.0	0.0	0.3	0.3
Other fees	0.0	0.1	0.0	1.3	3.1
Other revenues	2.0	2.3	1.5	3.2	2.8
Fines and seized property gains	0.0	0.0	0.0	0.4	0.5
Revenues from own activities of government bodies	0.5	0.9	0.7	1.5	0.9
Revenues from capital	0.0	0.2	0.2	0.4	0.7
Other revenues	1.6	1.2	0.6	0.9	0.7
Receipts from repayment of loans (from previous year)	0.4	0.4	0.3	0.7	0.9
Grants	1.0	0.4	0.2	0.1	0.1
Total expenditures and net lending	44.2	41.2	41.9	42.7	45.7
Total expenditures	42.3	40.1	40.9	41.9	45.3
Current expenditures	21.0	21.9	20.5	20.7	22.3
Wage bill	13.9	14.5	13.4	11.8	12.7
Gross salaries	12.6	13.2	12.5	10.9	11.3
Net salaries	7.2	7.5	7.8	6.3	6.5
Personal income tax	1.7	1.6	1.4	1.3	1.2
Social-security contributions	3.5	3.8	3.1	3.2	3.4
Contributions charged to employee	1.7	1.9	1.6	1.6	1.8
Contributions charged to employer	1.7	1.9	1.6	1.5	1.6
Municipal surtax	0.2	0.2	0.2	0.2	0.2
Other personal income	1.3	1.3	1.0	0.9	1.3
Goods, services, and maintenance	3.7	4.3	4.8	7.1	7.4
Goods and services	3.7	4.3	4.8	5.9	6.2
Current maintenance	0.0	0.0	0.0	1.2	1.2
Interest payments	1.0	1.5	1.2	1.1	1.1
Rent	0.1	0.1	0.1	0.1	0.2
Subsidies to enterprises	1.5	0.8	0.7	0.3	0.5
Other outflows	0.7	0.6	0.3	0.2	0.3
Social security transfers	14.1	13.9	13.2	12.1	11.8
Of which: pension and disability insurance rights	8.7	8.7	8.1	9.3	9.0
Other transfers	4.0	1.5	1.6	3.0	3.2
Transfers to public institutions	0.8	0.8	0.7	1.4	1.5
Transfers to NGOs	0.1	0.2	0.0	0.3	0.4
Transfers to individuals	1.0	0.6	1.0	1.0	0.8
Transfers to public enterprises	0.0	0.0	0.0	0.3	0.5
Transfers to Union budget	2.1	…	…	…	…
Capital expenditures	2.7	1.8	4.6	4.5	7.4
Reserves	0.6	1.0	0.9	1.5	0.7
Net lending	1.9	1.2	0.9	0.8	0.4
Loans and credits	1.1	0.5	0.6	0.8	0.4
Repayment of guarantees	0.8	0.6	0.3	0.0	0.0
Overall balance	-3.5	-1.6	-1.8	3.0	7.1
Financing	3.5	1.6	1.8	-3.0	-7.1

Sources: Ministry of Finance; and World Bank staff estimates.

Table 1.10. Montenegro: Strategic Strategies Adopted Since PEIR-1, 2007–08

Apr 2008	"National Programme for the Integration of Montenegro into the European Union for the Period 2008-2012"	Government of Montenegro
Mar 2008	"Spatial Plan of Montenegro Until 2020"	Government of Montenegro
Mar 2008	"National Forest and Forest Land Administration Policy"	Ministry of Agriculture, Forestry, and Water Management
Dec 2007	"Energy Development Strategy of Montenegro by 2025: White Book"	Ministry of Economic Development
Nov 2007	"Montenegro Economic and Fiscal Programme 2007-2010"	Ministry of Finance

Source: Government of Montenegro.

(iv) *Monitor and control fiscal risks beyond the national budget.* During the previous year, the Montenegrin authorities have taken a number of steps containing fiscal risks, including by (a) integrating all extra-budgetary funds into the state budget and regulatory agencies and public enterprises into an appendix; (b) using €60 million (2.4 percent of GDP) in unforeseen revenues to prepay external debt owed to the World Bank; (c) integrate €130 million in disputed pension obligations into the fiscal program; and (d) limiting by law annual restitution payments from the budget to one-half of a percent of GDP. In early 2008, against the backdrop of continuously large fiscal surpluses, the Government offered holders of treasury bonds with a maturity to 2016 and 2017 to redeem those prematurely.

D. Looking Forward: Challenges of Managing the Boom

1.16. **From a macroeconomic point of view, Montenegrin policymakers face several critical challenges that necessitate a holistic approach to the design of fiscal policies in the medium term.** Four developments, in particular, place constraints on any medium-term expenditure framework.

(i) **Montenegro is not immune to the effects from the international financial crisis,** foreshadowing a trend reversal in banks' external indebtedness.

(ii) **Wealth effects from the stock and real-estate markets will dissipate and cease to fuel growth.** With some lags, this should translate into a trend reversal in imports as well.

(iii) **With a procyclical tax system, the possible decrease in imports will detrimentally affect tax revenues,** largely because of the impact on the value-added tax. Aggressive regional tax competition limits the use of tax-policy instruments.

(iv) **Budgetary resources are insufficient to finance large-scale public infrastructure investments,** necessitating close cooperation with the private sector and strict control over recurrent expenditure.

Box 1.4. Strong Strategic Policy Anchors

EU membership is a national consensus project and, as such, the overarching focal point of economic policy-making. The implementation of related reforms represents the country's first major policy challenge that does not cause a rift in the electorate and among the 16 political parties in the 81-member parliament (as has been the case with both the struggle towards statehood and the process towards adopting the Constitution). The opposition is supportive and, if anything, apprehensive of the apparent lack of political commitment by Government to implement the corresponding reforms in a timely manner. Delays in submitting the application for membership is a case in point.

During the 2006 campaign for independence, statehood was represented as an integral component of a strategy aimed at accelerating EU integration. In the run-up to this watershed event, gradual steps had been taken in this direction for about a decade. Montenegro had sought to solve the post-war economic crisis by progressively increasing the degree of economic (and, where possible, political) sovereignty. Even before the referendum on independence on May 21, 2008, Montenegro had largely acted as if it already were an independent state. Supported by 55½ percent of the electorate, the country took the final step towards the final dissolution of the loose state union between Serbia and Montenegro, securing full international recognition (including by Serbia). The adoption of the Constitution in late 2007 formally concluded the process of state-building, the irreversibility of which was confirmed by the results of the presidential elections in early April 2008.

Montenegro seeks EU candidate status as quickly as possible. Beyond the political goal of EU membership, the restrictiveness of Montenegro's internal market necessitates market-opening policies, and this gives the regional and EU integration agenda a particular significance. As a result, an open trade regime, including low external tariffs, have complemented Montenegro's EU integration agenda, the implementation of which is to secure the development of profitable niche markets, increased factor productivity, risk diversification, and improved income predictability. In politico-economic terms, Montenegro has lived up to its pre-independence promise and managed to accelerate the approximation process and to secure itself a pole position among the countries in Southeastern Europe. In late 2007, Montenegro signed and ratified the Stability and Association Agreement (SAA) with the EU, joining Albania, Croatia, and Macedonia as the fourth Southeastern European country to have successfully concluded the Stability and Association process (SAp). On various occasions, the Government has re-emphasized its commitment to implement quickly all obligations spelt out in the SAA and Interim Agreement, while seeking to assure the EU candidate status as soon as possible.

Montenegro has prepared a special program for the implementation of reforms required under the SAA. To accelerate the implementation of various obligations spelt out in the SAA, and to harmonize Montenegro's legal framework with the EU's *acquis communautaire*, the Government has sought to engage its citizens in a public debate on this "national consensus" project. It compressed the related reform agenda in a comprehensive 2008–12 National Program for Integration (NPI),[†] which aims at (i) defining developmental and strategic objectives, together with corresponding policies, reforms, and measures; (ii) developing a detailed agenda for the legislation approximation and institutional capacity-building challenges; and (iii) defining the required resources for the successful implementation of the NPI reform agenda. Montenegro seeks to use the SAA implementation and the NPI as motivating argument to submit the formal application for EU membership during the French EU Presidency in 2008-S2.

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* In mid-April 2008, following three years of negotiations, Montenegro and EU signed bilateral agreement on trade tariffs and the reciprocal opening of the services markets accession, thereby opening the doors for Montenegro's membership in the World Trade Organization. This agreement was widely seen as important support to economic and trade reforms and to meeting the Copenhagen economic criteria.

† Every candidate country for EU membership has to prepare national plan for the adoption of *acquis communautaire*. The Government of Montenegro decided to combine the program for SAA implementation with the plan of adoption to the *acquis communautaire* in one single document.

1.17. **Montenegro shows all the signs of above-trend growth.** Following the country's decision to euroize, policymakers have to rely on fiscal policies as the one instrument that can help them to avoid a full-blown boom-bust cycle. A number of factors facilitate this otherwise difficult task, including (i) Government's commitment to overall fiscal surpluses (Government of Montenegro, 2008b); (ii) the continued reduction in the public debt-to-GDP ratio; (iii) a largely foreign-owned and fully private banking system; (iv) the relatively high share of credits extended to enterprises (rather than households); (v) increased central bank attention to the risk of excessive private-sector growth rates; (vi) rising CBCG reserves; and (vii) a considerable number of privatizations (Table 1.11) and large-scale development concessions (including those along the southern shoreline).

Table 1.11 Montenegro. Majority State-Owned Enterprises, April 2008

		Nominal value (in millions of euro)	State share (in percent)	Value of state share (in millions of euro)
State owned companies		1,691.0	63.8	1,078.1
Electroprivreda CG AD Nikšić	Power utility	907.0	67.0	607.7
Željeznice Crne Gore	Railways	319.5	65.0	207.7
Jadransko brodogradiliste AD Bijela	Shipyard	31.6	62.0	19.6
AD Plantaže	Vineyard	68.7	54.0	37.1
AD Luka Bar	Harbor	134.0	54.0	72.3
Duvanski kombinat AD Podgorica	Tobacco	19.8	51.1	10.1
Institut Dr Simo Milošević	Rehabilitation clinic	59.2	56.0	33.2
HTP Budvanska rivijera	Tourism	69.6	58.7	40.9
HTP Ulcinjska rivijera	Tourism	81.5	60.7	49.5

Source: Government of Montenegro (2008a).

1.18. **External shocks coinciding with a maturing boom could lead to a rapid deterioration in the overall economic outlook.** The main risks include (i) spillovers from the international financial crisis and an end to inter-bank credits to financial institutions in Montenegro; (ii) an abrupt reorientation of foreign capital flows to investment destinations other than Montenegro; (iii) a weaker-than-expected tourist seasons, affecting expectations and confidence into the profitability of the Montenegrin market; and (iv) a faster-than-projected deterioration in international competitiveness. These factors would remove key sources of growth.

1.19. **Fiscal policies play a key role in managing the economic cycle.** As will be discussed in the subsequent chapters, the recomposition of public expenditure towards high-impact capital expenditure is critical to crowd in private capital and increase total factor productivity. It is thus crucially important to (i) maintain a macroeconomic equilibrium and financial stability; (ii) sustain the momentum towards European integration, including with the timely adoption and careful implementation of required structural reforms; and (iii) provide the private sector with an overall environment, including public infrastructure, that remains conducive to continuously high rates of foreign direct investment.

1.20. **High overall fiscal surpluses are deceptive.** Given the unusual importance of unsustainable growth stimuli, decisions on (re)current expenditure need to be made

relative to revenues that can be maintained even after these special factors have dissipated. This necessitates a strict focus on the structural balance between "permanent" tax revenues (not dependent on temporary factors) and current expenditures-cum-maintenance investments. As will be shown in Chapter II, the Finance Ministry's advocated strategy of limiting current expenditure to the projected rates of inflation and public investments to nominal GDP growth is clearly a step in the right direction—an important step towards adhering to the advice given by Solow (1974) to those policymakers unlucky enough to be in charge of managing economies abundantly endowed with natural resources: "Someone … must always be taking the long view. They [sic] must somehow notice in advance that the resource economy is moving along a path that is bound to end in disequilibrium of some extreme kind. If they do notice it, and take defensive actions, they will help steer the economy from the wrong path toward the right one."

1.21. **The analysis contained in this second volume of the Public Expenditure and Institutional Review (PEIR-2) aims at contributing to the ongoing debate on a consistent medium-term policy framework.** The PEIR-2 will orient its analysis towards the overarching policy objectives of (i) maintaining a sustainable fiscal policy stance; (ii) enhancing the strategic resource allocation of public funds, with a view to improving the overall business climate and total factor productivity; and (iii) developing operational criteria needed to improve the budgetary composition and fiscal prioritization for a given level of public expenditure. Implicit in these objectives are attempts to avoid a strongly pro-cyclical policy stance. Experience elsewhere has shown that boom-bust cycles impose disproportionate costs to the already most disadvantaged segments of society[21] in instances, in which the boom busts, reverting any progress already made in socio-economic development. Recent contributions in political economy view strongly pro-cyclical fiscal-policy stances as reflecting substantial and unresolved deficiencies in governance.[22]

[21] Boom-and-bust cycles tend to imply an abrupt, often haphazard tightening in fiscal policy, with the result that income and wealth inequalities widen, thereby reversing any momentum towards increasing living standards; see, for instance, Jensen and Rutherford (2002) and Baldacci, de Mello, and Inchauste (2006).

[22] See Alesina and Tabellini (2005). The authors test a political economy model, finding that pro-cyclicality phenomenon by arguing that voters do not trust corrupt Government with resources and, therefore, demand—when the economy is hit by positive shocks—tax cuts, increases in productive Government spending, or transfers because they fear that, otherwise, available resources would be "wasted" in rents.

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II. FISCAL CONSTRAINTS AND GOLDEN RULES[23]

This chapter describes how broad principles underlying the design of fiscal policies over a medium-term horizon could help to achieve both overriding policy objectives—macroeconomic stabilization and socio-economic development. At the same time, such an approach would provide a certain degree of flexibility for instances in which external shocks prove larger than currently expected. Illustrative simulations are based on three such guidelines. First, unilateral euroization and Montenegro's objective to eventually formalize this arrangement imply that the fiscal criteria in the Growth and Stability Pact are binding. Second, tax revenues net of those derived from temporary factors need to be able to finance current expenditure (implying that Government can only borrow to finance investments). This "modified golden rule" should help to avoid committing to recurrent expenditures (for instance, on the wage bill) that cannot be maintained over the entire span of a business cycle. Third, having already accepted additional demands into the 2008 budget, and with a view to creating the necessary fiscal space for the ultimate realization of planned public investments, recurrent spending will be curtailed, thereby providing (i) a buffer for abrupt economic downturns; and (ii) an increasingly larger fiscal space for the implementation of planned public investments over the medium term. Depending on the timing and severity of the eventual downturn, the consistent application of these broad principles would imply (i) moderately counter-cyclical fiscal policies, with overall fiscal surpluses during years, in which capital inflows remain large, and temporary deficits in periods of large and negative external shocks; (ii) a clearly defined fiscal space for public investments; and (iii) and fiscal incentives for the acceleration of institutional reforms aimed at increasing the effectiveness of public administration. The fiscal discipline inherent in this approach should result in the gradual decline in sovereign risk premia and an eventual upgrading of Montenegro's grades by international credit rating agencies.

A. Introduction

2.1. **Future economic developments cannot be forecast as a simple linear extension of current trends**. As argued in Chapter I, key factors that have underpinned Montenegro's impressive post-independence growth—and, with it, its current fiscal-revenue abundance—will dissipate over the medium term, particularly (i) the sales of (coastal) real estate; and (ii) external borrowing by commercial banks.[24] Largely because these two factors hinge on a number of exogenous developments closely tied to, and affected by, the financial crisis currently unfolding in international capital markets, it is extremely difficult to forecast the timing and abruptness of their eventual disappearance. The effects on the Montenegrin economy, however, can be expected to be considerable. In 2007, these two factors represented an injection of liquidity to the economy of about 34 percent of GDP, following an already extraordinary year with capital inflows equivalent to 20 percent of GDP in 2006. This chapter will look at the fiscal implications of two alternative scenarios around a base-case projection—an optimistic scenario with a gradual adjustment in temporarily

[23] Prepared by Jan-Peter Olters (ECCME).

[24] These two factors will be subsumed under the term "unsustainable external demand stimuli" (EDS).

available external demand stimuli (TEDS) and a pessimistic one with an abrupt end to these external capital inflows.

2.2. **Montenegro is not alone in having to manage large—but only temporary—streams of revenue.** Whether for reasons of (i) creating pre-electoral booms, as suggested by models in the tradition of Nordhaus' (1975) political business cycle; (ii) strategic debt accumulation (Persson and Svensson, 1989); and/or (iii) mollifying voters' suspicions regarding underlying government motives (Alesina and Tabellini, 2005),[25] policymakers are faced with numerous (short-term) incentives to spend more during an upswing than they will be able to maintain during downturns. Depending on the existing level of public indebtedness and the country's international creditworthiness,[26] the inherent cyclicality in economic development is frequently amplified by the risk aversion in capital markets. While in good times, many countries (including their financial sectors) find it relatively easy to borrow externally, in bad times, when credits would be needed most, they can do so at only prohibitively high interest rates or not at all (Gavin and Perotti, 1997). The Iceland example discussed in Box 1.1 is a case in point. Any such situation tends to result in a situation that requires policymakers to agree on *ad hoc* spending cuts, typically at the expense of those items that have the highest impact on socio-economic development.[27] Such a response would delay the achievement of the Government of Montenegro's (2008a) underlying policy objectives, as these fiscal contractions preclude the (timely) implementation of the highest-priority public investment plans. Economic history is littered with such examples (see, e.g., Jensen and Rutherford, 2002, and Baldacci et al., 2006).

2.3. **At this point in Montenegro's economic cycle, the principal fiscal-policy challenge consists of ensuring that future budgets will provide sufficient budgetary space for public investments.** As discussed in Chapter I, large capital inflows and essentially proportional increases in imports (Figure 1.11) have permitted Government to collect tax revenues at levels far above budgetary projections.[28] Looking forward, it is crucial to ensure that recurrent ("permanent") spending

[25] A recent survey of political economy models can be found in Olters (2004).

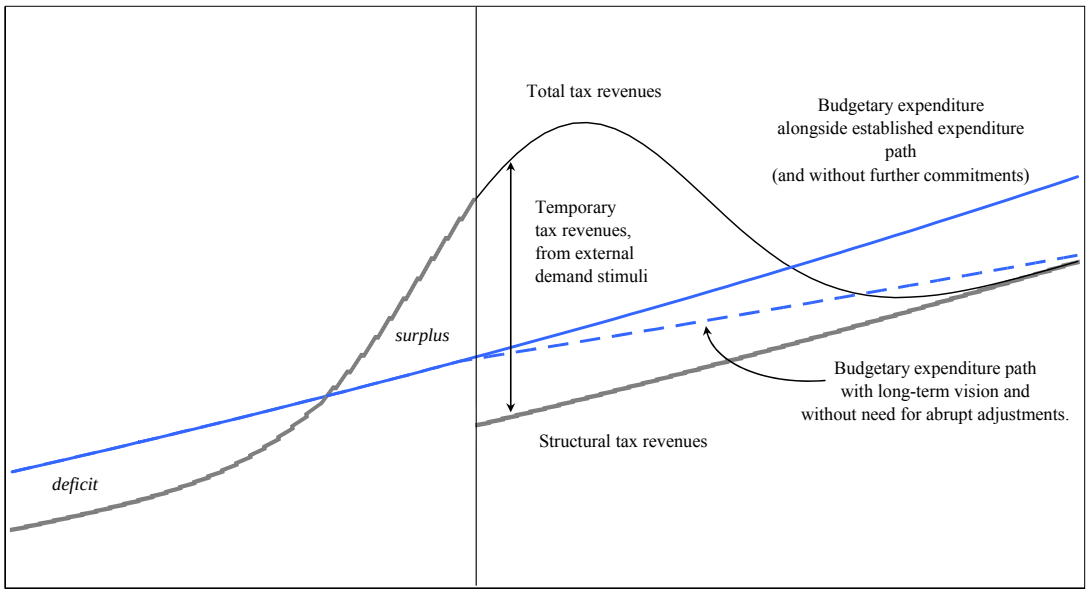
[26] For international capital market, Montenegro's sovereign credit risk is not yet investment grade, thus increasing the risk and/or cost of borrowing in an economic downturn. At the moment, Standard & Poor's has rated Montenegro stable at a high non-investment grade (BB+ on its long-term and B on its short-term debt), emphasizing the inherent risks stemming from external imbalances caused by rapid credit growth and rising incomes, while noting strong growth, the government's budgetary surplus, political stability, and good prospects for EU accession. Moody's assigned a Baa1 country ceiling for long-term foreign currency debt (low investment grade) and a Ba2 issuer rating for the foreign currency debt obligations by government (high speculative grade). The agency had warned Montenegro that its economy had to remain sufficiently flexible to cope with any change in investors' sentiment that could lead to an outflow of capital, adding that such an event would force a real adjustment in the economy that could be severe. Over the longer-term, Moody's argued that structural reform would be critical for improving productivity and raising incomes towards the European average.

[27] Many budgetary items—such as the wage bill or interest payments—are pre-committed and cannot be cut quickly. This implies that, in such instances, capital expenditures and social benefits are the first items to be adjusted, at great cost to a country's socio-economic development potential.

[28] In 2007, realized tax revenues exceeded the initial budget by more than 30 percent, which Government succeeded in translating into considerable overall fiscal surpluses—despite adoption of a supplementary budget in late 2007 that increased current spending by 2 percentage points of GDP.

obligations are not financed by temporary sources of income. Figure 2.1 summarizes the corresponding threat to macroeconomic stability and fiscal sustainability. It represents recent fiscal developments—in a stylized manner—to the left of the vertical line. To its right, it outlines the inherent risks stemming from the temporary nature of the current boom. The Ministry of Finance recognized this explicitly on several occasions and considered implications in its internal macroeconomic simulations,[29] concurring that a forward-looking fiscal strategy needs to take into account the pro-cyclical nature of the underlying tax regime and the degree to which external demand stimuli are sustainable (Figure 2.2).

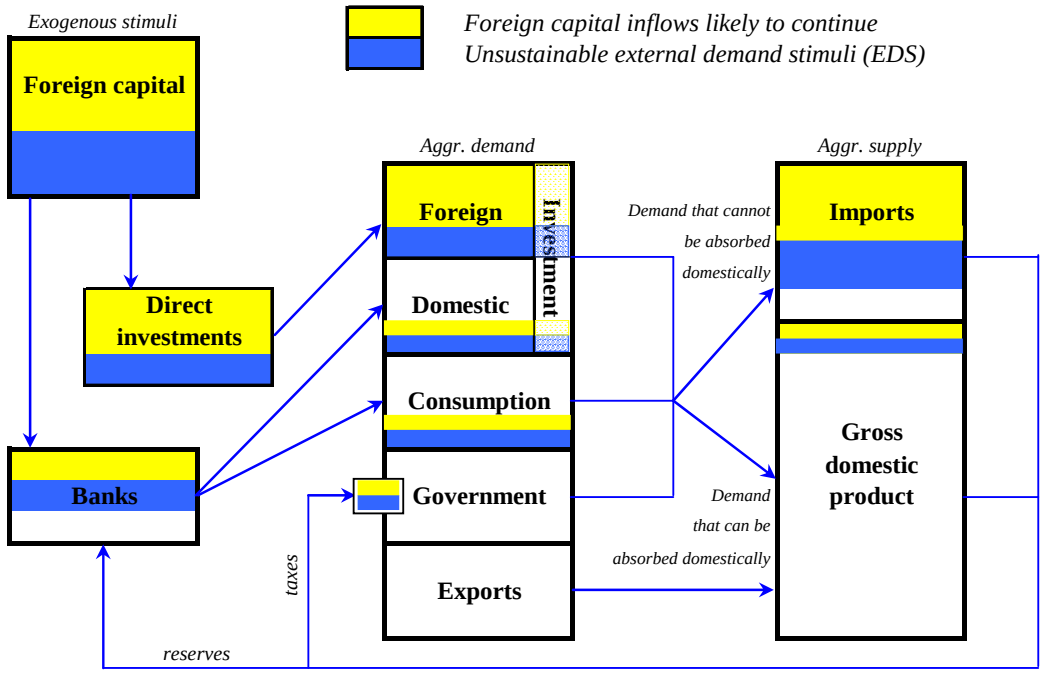
Figure 2.1. Inherent Risks to Long-Term Fiscal Dynamics



2.4. **This chapter seeks to frame a sustainable, forward-looking fiscal strategy.** Such a fiscal-policy approach needs to (i) maintain macroeconomic stability; (ii) increase total factor productivity and advance socio-economic development; and (iii) be sufficiently flexible to react to potentially large external shocks. Section B will thus estimate the impact of temporary factors on tax revenues. Section C looks at options to devise a sustainable strategy, weighing the inherent advantages and disadvantages of possible fiscal benchmarks underlying such a framework. Section D concludes, while placing Chapters III and IV into the context of a medium-term fiscal strategy.

[29] For instance, in his opening Speech for a seminar on *Strategic Planning and Medium-Term Budget Framework* on April 23, 2008, Finance Minister Lukšić (2008) stressed that, "the boom that occurs when foreign capital first arrives is temporary in nature and this period must be used to put the economy, and the government's finances, on a solid medium-term footing. High wage increases could undermine the medium-term competitiveness of the economy and the temporary surplus in the budget must not lead to high and unsustainable levels of government expenditure." On the same occasion, O'Callaghan (2008) presented a macroeconomic model that quantified (i) the temporary nature of FDI; (ii) the close correspondence between FDI and imports; and (iii) the resultant temporary surge in VAT revenues. Similarly, in Government of Montenegro (2008b), it was argued that the main potential risk Montenegro was exposed to the sudden decrease of economic growth due to its great dependency to fluctuations within several economic sectors.

Figure 2.2. Montenegro: Stylized (First-Round) Pass-Through of Foreign Capital Inflow



B. Structural Tax Revenues

2.5. **Fiscal policies are currently being described by a combination of large *overall* fiscal surpluses and modest *structural* deficits.** Analogous to Figure 2.1, the structural balance captures the difference between budgetary revenues net of tax receipts derived from temporary factors (in this case, the TEDS) and total expenditures. Applying this definition, Montenegro has maintained a moderate structural deficit, averaging about 2.2 percent of GDP during 2003–07. In 2007, this deficit was even lower, at about 0.8 percent of GDP. As summarized in Table 2.1, tax revenues from TEDS-financed imports represented about 26 percent of total tax revenues (or 8 percent of GDP). This implies that the Ministry of Finance would have had to absorb a tax revenue shortfall of about €200 million if the TEDS had not materialized in 2007.[30]

2.6. **A more relevant indicator, however, is the *current structural* balance, for which Government could post a modest surplus during both boom years** (Table 2.1). The *structural* balance rule removes cyclical effects (that is, tax revenues from TEDS-financed imports) from government revenue, while the *current* balance expresses expenditures net of investments. In assessing the fiscal stance of an economy benefiting from temporary streams of revenue,[31] it is crucial to see that these *transient*

[30] This result has been calculated on the basis of estimates summarized in Figure 2.3, with an estimated slope for the trend line of 0.231.

[31] For this reason, privatization revenues are typically recorded below the line.

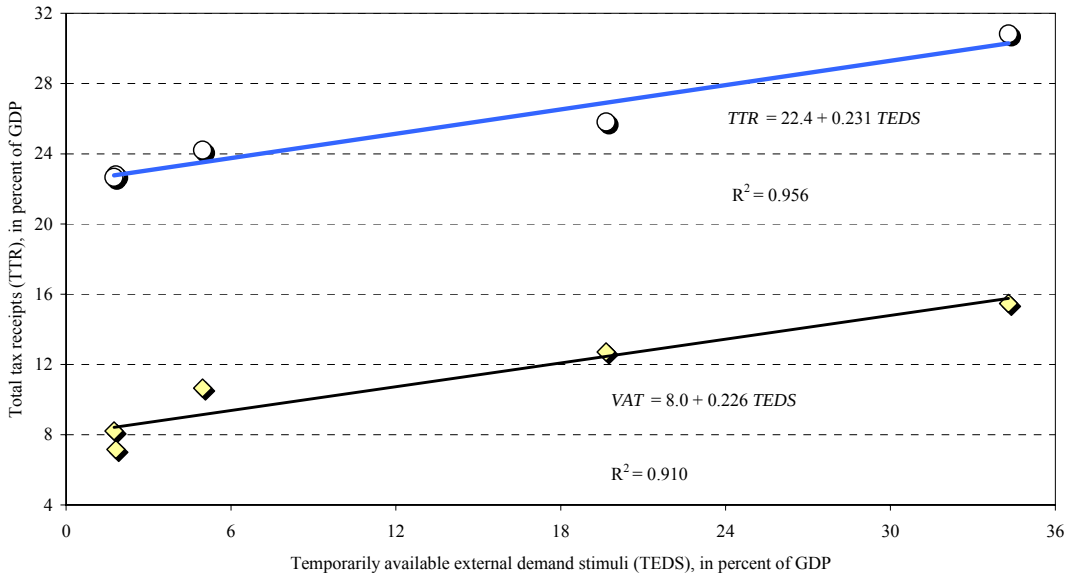
sources of finance do not translate into *permanent* spending obligations, which cannot be maintained at the downward-sloping portion of the business cycle. The *current structural* balance—the difference between budgetary revenues net of temporary tax receipts and total expenditures net of public investments—is such a measure. Montenegro has been able, on average, to pay its current obligations with structural fiscal revenues. During 2006–07, the Ministry of Finance could post an average current structural surplus of 4.8 percent of GDP, considerably improved from the average 0.1-percent surplus posted during 2003–05.

Table 2.1 Montenegro: Structural Fiscal Balance, 2003–07
(In millions of euro; unless otherwise indicated)

	2003	2004	2005	2006	2007
Overall fiscal balance	-52.2	-25.9	-32.7	64.5	180.7
In percent of GDP	-3.5	-1.6	-1.8	3.0	7.1
Unsustainable external demand stimuli (EDS)	27.3	29.2	90.2	422.3	871.1
Real estate sales	5.3	10.9	70.3	337.9	514.4
External bank credits	22.0	18.3	19.8	84.4	356.7
Related tax revenues	6.3	6.7	20.8	97.5	201.0
Structural fiscal balance	-58.5	-32.7	-53.5	-33.0	-20.4
In percent of GDP	-3.9	-2.0	-2.9	-1.5	-0.8
Capital expenditures	40.5	30.5	84.2	97.1	187.3
In percent of GDP	2.7	1.8	4.6	4.5	7.4
Current structural balance	-18.0	-2.2	30.6	64.1	166.9
In percent of GDP	-1.2	-0.1	1.7	3.0	6.6

Source: Montenegrin authorities; and World Bank staff estimations.

Figure 2.3. Montenegro: Non-Sustainable External Demand Stimuli and Tax Receipts, 2003-07



C. Medium-Term Fiscal Programming

2.7. **Looking forward, policymakers would benefit from clear benchmarks against which to judge the implementation of fiscal policy.** A Government's definition of, and its political commitment to, such a "fiscal anchor" would allow policymakers to (i) strengthen fiscal credibility; (ii) help to reduce sovereign risk premia by improving the country's standing vis-à-vis international credit agencies; and (iii) lengthen investors' confidence and time horizons. By devising a long-term approach to fiscal discipline, Government would permit parliamentarians, the public, and potential investors to measure fiscal-policy implementation, distinguish sound and forward-looking fiscal policies from short-sighted ones designed to address only immediate demands, and assess the degree of fiscal consolidation that would be required for development and sustainability reasons.

2.8. **A sustainable fiscal-policy approach in a small, open economy with a few dominant sectors susceptible to exogenous shocks requires a less pro-cyclical and a somewhat more flexible policy rule than a simple balanced-budget requirement.** The high degree of pro-cyclicality inherent in Montenegro's tax regime and the large public investment program suggest designing fiscal policies over the course of an entire economic cycle, with a view to maintaining an average overall surplus, while targeting growth rates of current expenditure. The three guidelines summarized below represent one possibility of such a policy anchor that would help to ensure a sufficient degree of fiscal discipline, preclude a strongly pro-cyclical fiscal-policy stance, and ensure sufficient fiscal space for large-scale public investment projects.

(i) ***Fiscal policy stays within the criteria defined in the Stability and Growth Pact (SGP).*** Two key policy decisions—the unilateral euroization in 2000 and the ratification of the SAA in 2007—define the Montenegro's broader fiscal framework. As it seeks to join the EU and eventually formalize the use of the euro, Montenegro will have to shadow the obligations spelt out in the Stability and Growth Pact (SGP). This agreement on the conduct of fiscal policy, adopted in 1997, outlined policy principles considered essential to maintain the Economic and Monetary Union. SGP signatories sought to ensure that fiscal discipline would be maintained and enforced by all member states that have adopting the euro, defining as policy objective a balanced budget over the span of a business cycle. Montenegro's particular position vis-à-vis EU institutions define the implicitly binding nature of the fiscal criteria, which limit (i) the overall annual budget deficit of general government to 3 percent of GDP; and (ii) public debt to 60 percent of GDP (or approaching that value).[32]

[32] Given Montenegro's end-2007 debt-to-GDP ratio of about one-half the SGP limit, committing to the deficit criterion implies that—under moderately pessimistic assumptions of nominal growth rates and budget deficits—the debt-to-GDP ratio should not increase beyond the current level. For example, Montenegro could theoretically have a 3(2)-percent budget deficit every single year and keep the debt-to-GDP ratio constant, provided that *nominal* GDP grew at annual rates slightly higher than 11 (7) percent. Since 2004, fiscal policies have remained consistently within SGP limits. In a worst-case scenario, with the aforementioned unsustainable external capital inflows dissipating abruptly, Government will have to curtail public investments as well to stay within the limits spelt out in the SGP.

(ii) ***The current structural balance remains in surplus.*** This "modified golden rule" specifies that borrowing cannot exceed capital expenditure. As such, this fiscal-policy principle could be thought of as a "permanent" anchor.

(iii) ***The ratio of recurrent expenditure to GDP declines gradually.*** The simulations derived for illustrative purposes are based on the assumption that recurrent spending is kept constant in real terms—with a view to creating the fiscal space necessary for the implementation of the ambitious public investment program. Following its implementation, this rule can be relaxed to avoid a situation, in which the state becomes "too small."

2.9. **The adoption of appropriate fiscal benchmarks—together with measures to access private-sector capital—could contribute to the development of a consistent policy framework over the business cycle.** As argued in Box 2.1, *public-private partnerships* (PPPs) can form a critical element in a strategy aimed at fostering economic diversification and growth, by helping Government to accelerate the implementation of important public investments beyond the capacity of state budgets. However, as seen elsewhere, PPPs are not a panacea and—if ill-designed—contain large and uncontrollable contingent liabilities. Still, these arrangements could nicely complement a possible decision on the use of explicit fiscal rules (Box 2.2), adopted with a view to reducing Government's ability to pursue excessively discretionary fiscal policies and protecting (and improving) the country's international creditworthiness.

2.10. **Current expenditures should not exceed a level that can be financed with sustainable budgetary resources.** Analogous to the way the privatization receipts are recorded "below the line", commitments on recurrent spending obligations must not exceed revenues that can be permanently expected. A fiscal-policy anchor of this type would be particularly binding during boom periods as it aims at precluding the need for sharp adjustments in expenditures during less favorable periods while, more generally, enshrining the principle that any government borrowing can only occur to finance investments. In that, it is related to the "Golden Rule" discussed in Box 2.1. Inversely, such an approach would not be inconsistent with overall fiscal deficits during periods of relative stagnation, thereby ensuring that Government can continue to implement (multi-annual) public investment projects over the course of a business cycle. This is a critical condition for reasons of macroeconomic management (allowing government spending to be counter-cyclical) and socio-economic development (given that capital expenditures tend to be the spending items with the highest impact on future growth potentials). Especially given the size of the public investments, Government has to ensure a surplus over the course of an economic cycle.

2.11. **The ambitious plans for the large-scale public investments can only be realized if sufficient fiscal space is ensured.** This section will thus discuss a central projection with two surrounding policy scenarios—a pessimistic outlook (the TEDS come to an abrupt and complete end in 2009) and an optimistic one (with a gradual waning of these factors). In all likelihood, the realized deceleration in these two sources of capital inflows will be somewhere between these two

scenarios. For the purpose of the policy simulations, the following assumptions have been made, including those on underlying fiscal rules for budgeting of current and capital expenditures.

(i) *Real-estate sales to foreigners*. As argued above, much property along the 293-kilometer coastline has already been sold. Many factors—both exogenous and those under the control of Government (public infrastructure, control of illegal construction, and property registration)—will affect this market, complicating the task of accurate forecasts. Under the optimistic scenario, it will be assumed that Montenegro will be able to maintain real-estate sales at the nominal level realized in 2007 (€514.4 million). As summarized in Table 2.3a, as a share of GDP, this implies a gradual reduction from 16.9 percent in 2008 to 10.2 percent in 2012. In the pessimistic scenario, real-estate sales in 2008 will be no more than €300million, and there will be no further real-estate sales to foreigners during 2009–12 (Table 2.3b). The base-case scenario just lies between these two assumptions (Table 2.2).

(ii) *External bank borrowing*. Here as well, a number of factors affect the ultimate path of external bank borrowing by domestic banks. These include changes to domestic credit demand, deposit growth, and central bank policy as well as the ultimate consequences from the international credit crunch on Montenegro's economy. While there are—as discussed above—already some indications as to the deceleration in deposit and private-sector credit growth, it can be expected that effects will become more visible during the second half of 2008 and during the following years. In the optimistic scenario, it will thus be assumed that banks increase their stock of debt vis-à-vis foreign banks by altogether €300 million (this implies that the increase in external bank borrowing by banks during the second semester of 2008 will be one-half of the increase seen during the first six months). In subsequent years, the nominal increase in external borrowing is assumed to be one-half of that in the respective previous year. In the pessimistic scenario, there will not be any external borrowing by the commercial banks after September 2008, implying an estimated amount of additional external bank debt of €220 million in 2008 and zero thereafter. As before, the base-case scenario assumes a path of external bank borrowing between these two extremes. Figure 2.4 summarizes the combined effects of the TEDS disappearance.

(iii) *Recurrent expenditures*. As discussed above, a number of factors (public sector wage increases, pension arrears, and restitution claims) have led to an increase in current expenditure in 2008. For 2009–12, current expenditure will be held constant in real terms, thus implying a gradual decrease in the share of current expenditure to GDP. Whether or not Government—if it decided to adhere to such a rule—would be able to succeed in limiting current spending increases to expected inflation hinges, to a large extent, on the ability to contain the wage bill (Chapter IV).

(iv) *Capital spending*. Chapter III refers to some of the public-investment projects foreseen in the energy and transport sectors alone. At this stage, it is unclear to which degree the private sector, by means of PPP arrangements, will be able to co-finance these investments. Still, it is clear that, in order to realize these investments, Government requires increasing budgetary space for these (and

other) investments. The fiscal simulations, based on the expectation of realized capital expenditures of around 7 percent of GDP in 2008, program capital expenditures to increase by an annual 0.25 percentage points of GDP during the forecast period 2009–12. The trend increase in the implicit floor on capital expenditures, expressed as a share of GDP, together with the concomitant compression of recurrent expenditures, is consistent with the medium-term fiscal program outlined in Government of Montenegro (2008b).[33]

Figure 2.4. Montenegro: The Size of TEDS, 2006–12

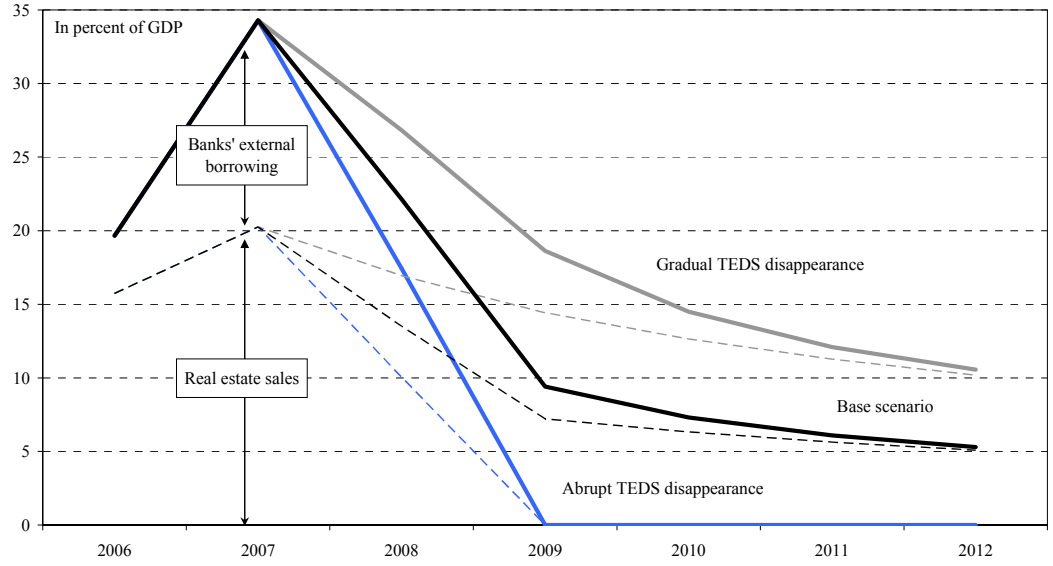
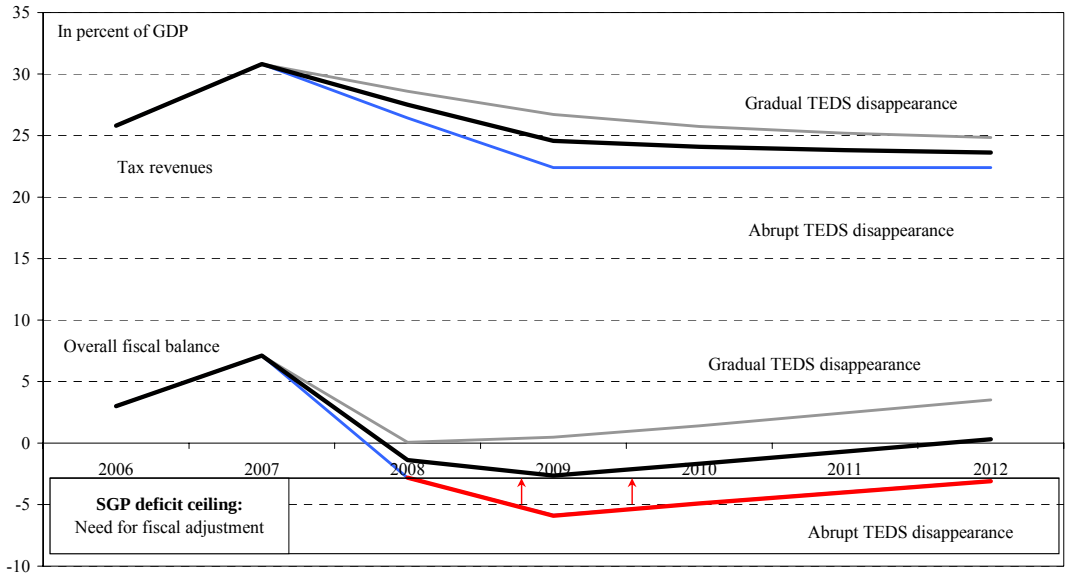


Figure 2.5. Montenegro: The Impact of TEDS on Taxes and Fiscal Balances, 2006–12



[33] Due to differences in underlying assumptions and classifications, the macro economic framework and fiscal programming cannot be directly compared. However, the fiscal program outlined in this chapter is consistent with the broad outline of fiscal policies over the medium term.

Box 2.1 Benefits and Risks of Public-Private Partnerships

Public-private partnerships (PPPs) are potentially very important tools for governments to improve, in a substantial manner, (previously neglected) public infrastructure, crowd in private-sector investments, and accelerate the rate of socio-economic development. Currently, public investment plans in Montenegro exceed the actual size of the capital budget by very large margins. Therefore, to implement the foreseen investments for the Bar–Boljare motorway *en route* to Belgrade, at a cost of about 79 percent of 2007 GDP, the Adriatic-Ionian highway (30 percent of 2007 GDP), and the electricity sector (70 of 2007 GDP), Government relies on the active participation of the private sector. The two most frequently used PPPs are the following:

(i) ***Standard "build-operate-transfer (BOT)" PPPs.*** These types of PPPs are currently sought, e.g., for the road transport sector. They promise large efficiency gains from the involvement of the private sector. At the same time, these BOT PPPs—if not carefully negotiated—entail significant risks of "hidden" costs and contingent liabilities.

(ii) ***Concessions.*** These are considered by Government (once the Concession Law has been approved by Parliament) for the operation of complementary transport projects, including the port of Bar, the railway, and the airports. These types of contracts encourage private-sector management, while ensuring that the infrastructure remains in public hands.

Under standard PPP arrangements, the private sector—taking on standard risks of doing business—finances, constructs, and maintains the infrastructure as well as offers, for a pre-specified amount of time, the corresponding services. A PPP contract provides the private company with economic incentives to seek efficiency gains in the design, construction, and operation of a particular asset. A critical determinant in the final assessment of the desirability of a given PPP arrangement is the negotiated distribution of risks between the government and the private sector. For road-transport PPPs, for instance, explicit contingent liabilities might contain stipulations regarding guaranteed minimum traffic volumes, thereby transferring typical business risks back to government. However, governments should typically bear any "political" risk for developments that are under their direct control.

Managing fiscal risks of PPPs requires strong institutions, a sound legal framework, and overall political commitment, including the development of (i) effective planning mechanisms for public investments so as to ensure that the highest-quality projects are prioritized; (ii) required institutional capacity to manage PPPs; (iii) sufficiently robust accounting and reporting systems to accurately reflect all PPP-related fiscal implications; and (iv) a strong legal framework enshrining procedures for the management of fiscal risks. It is well documented that PPPs tend to fail in countries with weak governance and widespread corruption, in countries with an insufficient degree of political commitment to reject pressures to undertake those PPPs that have adverse fiscal implications ("white elephants").

Experience has shown that highway PPPs are often based on overly optimistic assumptions; see Queiroz (2005). Three reasons are typically mentioned for this outcome. First, preliminary calculations are based on incorrect assumptions and/or poor data. This applies, e.g., to the price elasticity of traffic to tolls. Second, too much "political capital" has been invested in a particular project to be able to reverse the decision to construct or to lengthen the implementation phase (which would, e.g., allow for the adherence of sound bidding practices). And third, motorway PPPs tend to be more vulnerable to changes in the political, financial, or economic environment than was initially assumed.

Box 2.2 Can Fiscal Rules Help to Realize Ambitious Public Investment Plans?

As a small, open economy that is dependent on tourism and metal production, Montenegro is susceptible to large (external) shocks and abrupt changes to the overall economic environment. It counts on the revenue streams from the current FDI-/credit-financed boom to start to lay the foundation for economic diversification and increased factor productivity, with plans for large-scale public investment projects in transport and energy. Government will have to rely on proper budgetary resources and—to the extent possible—private-sector co-financing. The sheer size of these projects risks the unavailability of sufficient public funds during realization periods, delaying implementation, inherent rates of return, and—ultimately—the country's socio-economic development potential. As financial commitments for these large-scale public investment projects span over business and electoral cycles, Government might want to consider following the example of other countries that have experimented with explicit fiscal rule, with a view to ensuring that sufficient public funds are available in future budgets to continue to finance these investments as currently foreseen.

Fiscal rules **are generally understood as "a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance** (Kopits and Symansky, 1998), introduced to (i) signal commitment to fiscal discipline; (ii) contain policy discretion; and (iii) prevent pro-cyclical fiscal policies (and, in so doing, avoid the negative consequences of full-blown boom-bust cycles). Hallerberg and Wolff (2006) show that fiscal rules tend to be perceived by capital markets as improving long-term fiscal perspectives, thus leading to a reduction in sovereign risk premia and lower interest rates. Economic history is littered with examples in which a number of factors—typically grounded in political economy considerations—created sufficient incentives for electoral cycles (Nordhaus, 1975), excessively pro-cyclical fiscal policies (especially during upturns), and large, persistent deficits over the economic cycle.

International Comparison of Fiscal Rules

	Rules on			Imposed on which government		
	Deficit	Debt	Expenditure	General	Central	Local
Euro zone	annual	annual	…	treaty	…	…
Finland	multiyear	multiyear	…	…	agreement	…
	multiyear	…	…	…	…	law
France	annual	…	…	…	…	law
Germany	annual	…	…	…	constitution	…
Netherlands	…	…	multiyear	agreement	…	…
Slovenia	…	multiyear	…	agreement	…	…
	…	annual	…	…	…	law
Spain	over cycle	…	…	law	…	…
	…	annual	…	…	…	law
Australia	over cycle	over cycle	…	law	…	…
Brazil	…	annual	…	…	law	
Denmark	multiyear	…	…	agreement	…	…
Estonia	multiyear	…	…	agreement	…	…
	…	annual	…	…	…	law
Lithuania	annual	…	…	…	law	law
New Zealand	over cycle	…	…	law	…	…
Poland	…	annual	…	constitution	…	…
Slovak	…	annual	…	…	…	law
Sweden	over cycle	…	…	agreement	…	…
Switzerland	over cycle	…	…	…	constitution	…
UK	over cycle	over cycle	…	law	…	…

Sources: Debrun, Epstein, and Symansky (2008); and World Bank staff.

Fiscal rules tend to cover budget deficits, public debt, and/or public expenditures. For reasons of transparency and monitorability (and therefore as a strong, forward-looking signal to capital markets), budget-deficit and/or public-debt ceilings are the most frequently used rules. Germany's Basic Law, approved in 1949, stipulates that borrowing must not exceed budgeted investments (unless to avert an overall economic disequilibrium). In 2000, the United Kingdom introduced its influential "*Golden Rule*" that also restricted borrowing for reasons other than investments, implying that current budgets must be balanced in any given fiscal year and, over the span of an economic cycle, be brought into surplus. The fiscal condition in the Stability and Growth Pact "Maastricht Treaty") requires member countries in, and candidates to, the euro zone to adhere to the objective of sound budgetary positions by keeping the budget "close to balance or in surplus". The Treaty allows the countries to deal with normal cyclical fluctuations by defining a government deficit ceiling of 3 percent of GDP, while specifying sanctions for euro zone countries unwilling to comply with these stipulations. The requirement for current surpluses during boom periods has also macroeconomic advantages in that it helps to counter pressures for interest rates to increase, thus avoiding the unnecessary crowding-out of private investments.

On the whole, empirical studies have shown that rules have improved the conduct of fiscal policies over the course of an economic cycle. Responding to the economic legacies of the 1970s and 1980s, policymakers in the 1990s have largely acknowledged the socio-economic costs inherent in rising levels of public debt and excessively pro-cyclical fiscal policies. For reasons not too dissimilar from those justifying independent central banks, many countries have thus introduced some form of fiscal rules, often accompanied with efforts to strengthen their multi-annual expenditure frameworks; see also Kumar and Ter-Minassian (2007). Debrun et al. (2008) provide evidence that suggests a causality running from rules to fiscal behavior. They find that rules specifically designed to prevent conflicts with the stabilization function of fiscal policy are indeed associated with less pro-cyclical policies. As such, fiscal rules outweigh inherent risks and (political) costs.

Box 2.3. Designing A Successful Fiscal Framework in Montenegro

Fiscal policy frameworks differ widely across countries, partly reflecting differences in the economic structure, public institutions charged with economic management, and overall policy objectives. In providing a preliminary assessment of the underlying strength of the EU's Stability and Growth Pact, Annett and Jaeger (2004) find that it "combines discipline and flexibility by requiring countries to reach fiscal positions 'close to balance or in surplus' (a reference to the underlying or structural fiscal position) and keep actual deficits below 3 percent of GDP, except in the case of unusually large shocks." For them, the litmus test for any successful fiscal framework consists of two criteria, viz., whether a policy framework is (i) capable of ensuring medium-term fiscal discipline; and (ii) flexible enough to help to smooth short-term business cycle fluctuations. The graph above summarizes the interrelation between both policy objectives.

Design of Fiscal Frameworks

Goals of fiscal policy rules		Medium-term fiscal discipline	
		Yes	No
Short-term fiscal flexibility	Yes	Ideal fiscal framework	Counter-cyclical, but anchorless fiscal framework
	No	Overly rigid, pro-procyclical fiscal framework	Poor fiscal framework, policy drift

Source: Annett and Jaeger (2004).

The fiscal guidelines discussed in this chapter are consistent with both objectives. The assumption that increases in recurrent spending—equivalent to about 85 percent of all government expenditure in 2007—is limited to expected inflation helps to define a medium-term path that allows for an increased envelope for capital expenditure and/or a gradual improvement in fiscal imbalances, should these occur in future budgets. In addition, the Government's commitment to maintaining a current structural balance ensures that any borrowing will be restricted to financing (high-impact) public investments. At the same time, these rules permit a considerable degree of flexibility in that they allow overall fiscal deficits to occur in years with particularly negative external shocks. This way, there is increased budgetary security for the purpose of implementing multi-annual public investment projects, while providing a fiscal (credit-financed) stimulus only in the case of unusually large shocks.

The proposed principles, apart from those relating to the SGP, avoid the need of defining fiscal-policy objectives as a share of GDP. Montenegro's statistical institute is currently undergoing comprehensive reforms aimed at improving its GDP estimates. Any objective of spending, deficit, or debt that is expressed as a percentage of GDP would "politicize" the reform process, while reducing the implicit strength of the fiscal-policy anchor. Other possible definitions of fiscal rules tilt the balance of inherent costs and benefits towards the former. Given the large degree of pro-cyclicality that is already inherent in Montenegro's tax system, annual deficit targets would amplify the fluctuations in economic activity and fiscal revenue. With the statistical information still weak, and their regular availability not (yet) assured, defining similar targets over an entire economic cycle—as done in a number of countries—is impractical as a policy tool and subject to dispute. A fiscal rule that allows for a modest increase in the real recurrent-expenditure envelope is a political decision, limiting Government's ability to implement the envisaged public investment projects.

2.12. **The implications of such a policy approach are summarized in Tables 2.2–2.3 and Figures 2.5–2.7.** Except for situations, in which TEDS—in their entirety—disappear abruptly, these simple guidelines allow for the design of a fiscal policy program that would ensure flexibility, sustainability, and a certain degree of counter-cyclicality. Simulations for the base-case scenario show that, for a four-year transition period, there would be a modest overall deficit. These results emphasize the importance of including precautionary motives into the design of a medium-term fiscal

program and of formalizing mechanisms to control recurrent spending. The illustrative fiscal rules, as specified in this document, are insufficiently stringent to ensure the adherence (without further adjustment) to the fiscal SGP criterion in instances, in which the deterioration in the external environment results in the drying up of both external bank credits and real-estate sales to non-residents. The intensity with which the international financial crisis will affect the Montenegrin economy remains unclear, but the potential of very strong, adverse shocks necessitates the inclusion of fiscal "buffers" in recurrent spending, capital expenditure, and/or tax policy to avert a breach of the fiscal SGP criterion, which would jeopardize the chances of reaching a formalization agreement with the EU on Montenegro's monetary arrangement, increasing uncertainty and dampening investors' confidence.

Figure 2.6. Montenegro: The Impact of TEDS and the Budget Structure, 2006–12

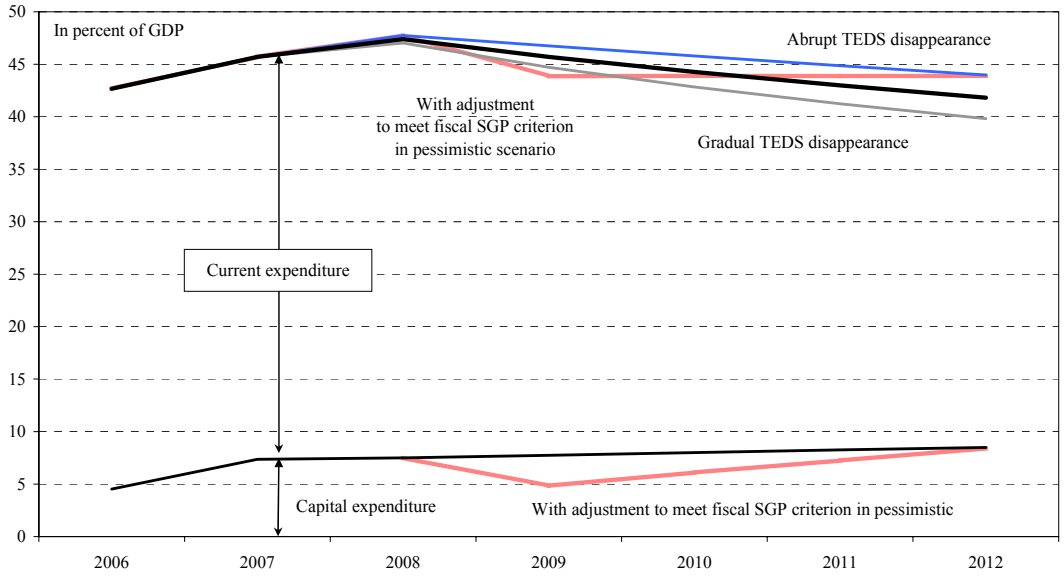


Figure 2.7. Montenegro: The Impact of TEDS and Relative Budget Structure, 2006–12

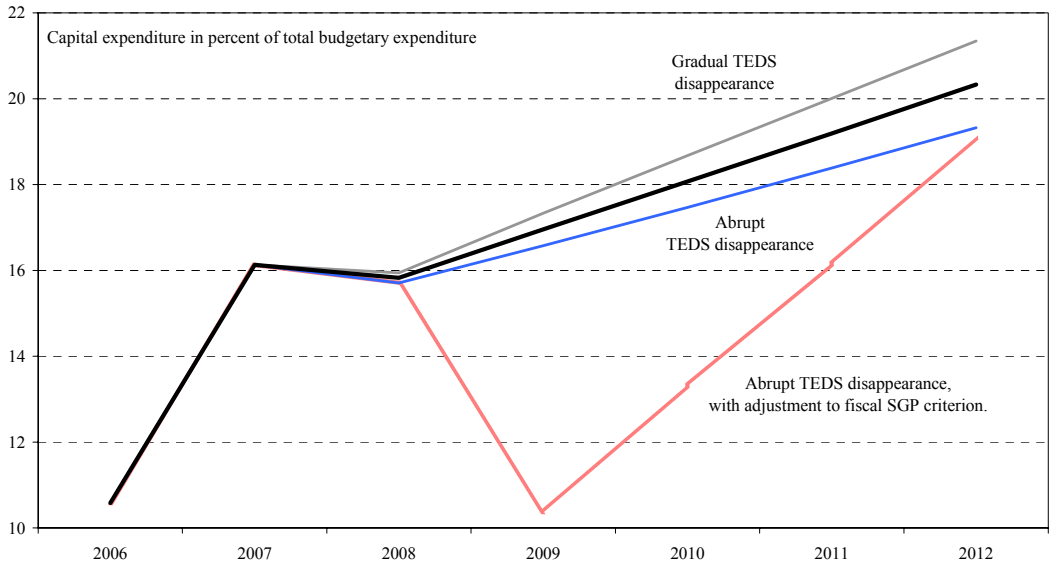


Table 2.2. Montenegro: Base Case Macro Framework With Semi-Abrupt End to TEDS, 2006–12
(In percent of GDP; unless otherwise indicated)

	2006	2007 Prel.	2008	2009	2010	2011	2012
			Projections				
Real sector							
Gross domestic product	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Private sector consumption and investment	87.7	97.0	88.6	73.7	70.8	70.8	71.2
Government	42.7	45.7	47.4	45.7	44.3	43.0	41.8
Exports	49.6	51.3	45.0	47.0	49.0	49.0	49.0
Imports	80.0	93.9	81.0	66.4	64.1	62.8	62.0
Monetary sector							
Net foreign assets	-1.4	-18.0	-22.3	-21.4	-20.0	-18.4	-16.9
Claims	13.2	13.5	13.4	13.4	13.4	13.4	13.4
Liabilities	14.7	31.5	35.7	34.8	33.4	31.8	30.3
Loans by domestic banks	7.3	20.2	25.7	24.8	23.4	21.8	20.3
***Of which:* change in external indebtedness**	**3.9**	**14.0**	**8.6**	**2.2**	**1.0**	**0.5**	**0.2**
Other	7.4	11.2	10.0	10.0	10.0	10.0	10.0
Net domestic assets	42.3	87.0	110.9	105.4	99.1	92.9	86.7
Domestic credit	48.8	99.3	110.9	105.4	99.1	92.9	86.7
Net claims on central bank	10.8	13.5	13.4	13.4	13.4	13.4	13.4
Net claims on central government	-1.7	-2.8	0.0	0.0	0.0	0.0	0.0
Net claims on other sectors	39.7	88.6	97.5	92.0	85.7	79.5	73.3
Of which : credit to the economy	35.5	84.2	92.7	87.5	81.5	75.6	69.7
Other items (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Broad money	40.9	69.1	88.6	84.0	79.2	74.5	69.8
Deposits	40.7	68.6	88.2	83.6	78.8	74.1	69.4
Other	0.2	0.4	0.4	0.4	0.4	0.4	0.4
External sector							
Current account	-24.7	-39.7	-32.0	-15.4	-11.1	-9.8	-9.0
Trade balance	-30.4	-42.7	-36.0	-19.4	-15.1	-13.8	-13.0
Exports of goods and services	49.6	51.3	45.0	47.0	49.0	49.0	49.0
Imports of goods and services	80.0	93.9	81.0	66.4	64.1	62.8	62.0
Imports of goods	69.7	84.7	71.5	56.8	54.4	53.0	52.1
Structural imports	47.1	45.2	46.0	46.0	46.0	46.0	46.0
EDS-financed	22.6	39.5	*25.5*	*10.8*	*8.4*	*7.0*	*6.1*
Imports of services	10.3	9.2	9.5	9.6	9.7	9.8	9.9
Income (net)	1.4	0.7	1.0	1.0	1.0	1.0	1.0
Transfers (net)	4.2	2.3	3.0	3.0	3.0	3.0	3.0
Capital and financial account	28.6	34.6	32.3	11.8	9.0	8.4	8.0
Foreign direct investments (net)	21.7	20.7	14.0	7.7	6.8	6.1	5.6
Foreign direct investments (gross)	30.0	39.7	33.0	26.7	25.8	25.1	24.6
Purchases of real estate by foreigners	**15.7**	**20.3**	**13.5**	**7.2**	**6.3**	**5.6**	**5.1**
Other FDI	14.3	19.4	19.5	19.5	19.5	19.5	19.5
Outflow of investments	8.3	19.0	19.0	19.0	19.0	19.0	19.0
Portfolio and other investments	6.9	13.9	18.3	4.1	2.2	2.3	2.4
Net errors and omissions	-0.5	21.9	0.0	0.0	0.0	0.0	0.0
Financing (change in net foreign assets)	3.4	16.8	-0.3	3.6	2.1	1.4	1.0
Fiscal sector							
Budgetary revenues	45.7	52.8	46.0	43.1	42.6	42.3	42.1
Tax revenue	25.8	30.8	27.5	24.6	24.1	23.8	23.6
Structural	25.8	30.8	22.4	22.4	22.4	22.4	22.4
Temporal (from EDS-financed imports)	*6.2*	*10.8*	*5.1*	*2.2*	*1.7*	*1.4*	*1.2*
Other budgetary revenues	19.9	22.0	18.5	18.5	18.5	18.5	18.5
Total expenditures and net lending	42.7	45.7	47.4	45.7	44.3	43.0	41.8
Current expenditures, transfers, and other expenditure	38.2	38.3	39.9	38.0	36.3	34.7	33.3
Wage bill	11.8	12.7	13.9	13.2	12.6	12.1	11.6
Other current expenditure	26.3	25.7	26.0	24.7	23.6	22.6	21.7
Capital expenditures	4.5	7.4	7.5	7.8	8.0	8.3	8.5
Overall balance (≥ -3)	3.0	7.1	-1.4	-2.6	-1.7	-0.7	0.3
Current structural balance (≥ 0)	1.3	3.7	1.0	2.9	4.6	6.2	7.6
Memorandum items, in millions of euro; unless otherwise specified:							
Real GDP growth rate, in percent	8.6	10.3	7.7	5.1	4.7	4.4	4.3
GDP deflator, in percent	9.0	7.2	10.0	8.0	6.0	5.0	4.0
Nominal GDP	2,148.9	2,540.0	3,009.2	3,415.4	3,789.2	4,154.5	4,504.7
Change in net foreign assets	-73.0	-426.1	9.5	-123.5	-79.3	-56.9	-45.4
Stock of net foreign assets	-30.8	-456.9	-447.4	-570.9	-650.3	-707.2	-752.6
Stock of private-sector credit	762.6	2,165.0	2,789.1	2,989.1	3,089.1	3,139.1	3,139.1
Annual change in private-sector credit	446.0	1,402.3	624.1	200.0	100.0	50.0	0.0
Stock of external loans by banks (eop)	156.5	513.2	773.2	848.2	885.7	904.5	913.9
Annual change in external borrowing	**84.4**	**356.7**	**260.0**	**75.0**	**37.5**	**18.8**	**9.4**
Wage bill	254.4	321.5	418.0	451.4	478.5	502.4	522.5
Other current expenditure	565.6	652.3	782.5	845.1	895.8	940.6	978.2
Capital expenditure	97.1	187.3	225.7	264.7	303.1	342.7	382.9

Sources: Ministry of Finance; CBCG; Monstat; IMF; and World Bank staff estimates and projections.

Table 2.3a. Montenegro: Macro Framework With a Gradual End to TEDS, 2006–12
(In percent of GDP; unless otherwise specified)

	2006	2007 Prel.	2008	2009	2010 Projections	2011	2012
Real sector							
Gross domestic product	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Private sector consumption and investment	87.7	97.0	94.3	85.3	80.5	79.5	79.2
Government	42.7	45.7	47.0	44.7	42.8	41.2	39.8
Exports	49.6	51.3	45.0	47.0	49.0	49.0	49.0
Imports	80.0	93.9	86.4	77.0	72.4	69.7	68.0
Monetary sector							
Net foreign assets	-1.4	-18.0	-23.4	-23.6	-22.1	-20.2	-18.3
Claims	13.2	13.5	13.4	13.4	13.4	13.4	13.4
Liabilities	14.7	31.5	36.8	37.0	35.5	33.6	31.7
Loans by domestic banks	7.3	20.2	26.8	27.0	25.5	23.6	21.7
Of which: change in external indebtedness	**3.9**	**14.0**	**9.9**	**4.2**	**1.8**	**0.8**	**0.4**
Other	7.4	11.2	10.0	10.0	10.0	10.0	10.0
Net domestic assets	42.3	87.0	110.0	101.5	93.3	85.7	78.7
Domestic credit	48.8	99.3	110.0	101.5	93.3	85.7	78.7
Net claims on central bank	10.8	13.5	13.4	13.4	13.4	13.4	13.4
Net claims on central government	-1.7	-2.8	0.0	0.0	0.0	0.0	0.0
Net claims on other sectors	39.7	88.6	96.6	88.1	79.9	72.3	65.3
Of which : credit to the economy	35.5	84.2	91.9	83.8	75.9	68.8	62.1
Other items (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Broad money	40.9	69.1	86.6	77.9	71.2	65.6	60.5
Deposits	40.7	68.6	86.2	77.5	70.8	65.2	60.1
Other	0.2	0.4	0.4	0.4	0.4	0.4	0.4
External sector							
Current account	-24.7	-39.7	-37.4	-26.0	-19.4	-16.7	-15.0
Trade balance	-30.4	-42.7	-41.4	-30.0	-23.4	-20.7	-19.0
Exports of goods and services	49.6	51.3	45.0	47.0	49.0	49.0	49.0
Imports of goods and services	80.0	93.9	86.4	77.0	72.4	69.7	68.0
Imports of goods	69.7	84.7	76.9	67.4	62.7	59.9	58.1
Structural imports	47.1	45.2	46.0	46.0	46.0	46.0	46.0
EDS-financed	22.6	39.5	*30.9*	*21.4*	*16.7*	*13.9*	*12.1*
Imports of services	10.3	9.2	9.5	9.6	9.7	9.8	9.9
Income (net)	1.4	0.7	1.0	1.0	1.0	1.0	1.0
Transfers (net)	4.2	2.3	3.0	3.0	3.0	3.0	3.0
Capital and financial account	28.6	34.6	35.7	19.0	15.3	14.1	13.1
Foreign direct investments (net)	21.7	20.7	17.4	14.9	13.1	11.8	10.7
Foreign direct investments (gross)	30.0	39.7	36.4	33.9	32.1	30.8	29.7
Purchases of real estate by foreigners	**15.7**	**20.3**	**16.9**	**14.4**	**12.6**	**11.3**	**10.2**
Other FDI	14.3	19.4	19.5	19.5	19.5	19.5	19.5
Outflow of investments	8.3	19.0	19.0	19.0	19.0	19.0	19.0
Portfolio and other investments	6.9	13.9	18.3	4.1	2.2	2.3	2.4
Net errors and omissions	-0.5	21.9	0.0	0.0	0.0	0.0	0.0
Financing (change in net foreign assets)	3.4	16.8	1.6	7.0	4.0	2.6	2.0
Fiscal sector							
Budgetary revenues	45.7	52.8	47.1	45.2	44.2	43.7	43.3
Tax revenue	25.8	30.8	28.6	26.7	25.7	25.2	24.8
Structural	25.8	30.8	22.4	22.4	22.4	22.4	22.4
Temporal (from EDS-financed imports)	6.2	10.8	*6.2*	*4.3*	*3.3*	*2.8*	*2.4*
Other budgetary revenues	19.9	22.0	18.5	18.5	18.5	18.5	18.5
Total expenditures and net lending	42.7	45.7	47.0	44.7	42.8	41.2	39.8
Current expenditures, transfers, and other expenditure	38.2	38.3	39.5	37.0	34.8	33.0	31.3
Wage bill	11.8	12.7	13.8	12.9	12.1	11.5	10.9
Other current expenditure	26.3	25.7	25.8	24.1	22.7	21.5	20.4
Capital expenditures	4.5	7.4	7.5	7.8	8.0	8.3	8.5
Overall balance (≥ –3)	3.0	7.1	0.1	0.5	1.4	2.5	3.5
Current structural balance (≥ 0)	1.3	3.7	1.4	3.9	6.1	7.9	9.6
Memorandum items, in millions of euro; unless otherwise specified:							
Real GDP growth rate, in percent	8.6	10.3	8.7	7.0	6.1	5.6	5.3
GDP deflator, in percent	9.0	7.2	10.0	9.8	7.5	6.2	5.1
Nominal GDP	2,148.9	2,540.0	3,036.2	3,566.9	4,067.4	4,564.5	5,052.4
Change in net foreign assets	-73.0	-426.1	-49.6	-250.3	-164.0	-120.8	-99.3
Stock of net foreign assets	-30.8	-456.9	-506.5	-756.8	-920.8	-1,041.7	-1,140.9
Stock of private-sector credit	762.6	2,165.0	2,789.1	2,989.1	3,089.1	3,139.1	3,139.1
Annual change in private-sector credit	446.0	1,402.3	624.1	200.0	100.0	50.0	0.0
Stock of external loans by banks (eop)	156.5	513.2	813.2	963.3	1,038.3	1,075.8	1,094.5
Annual change in external borrowing	**84.4**	**356.7**	**300.0**	**150.0**	**75.0**	**37.5**	**18.8**
Wage bill	254.4	321.5	418.0	459.1	493.3	524.2	550.9
Other current expenditure	565.6	652.3	782.5	859.5	923.7	981.4	1,031.5
Capital expenditure	97.1	187.3	227.7	276.4	325.4	376.6	429.5

Sources: Ministry of Finance; CBCG; Monstat; IMF; and World Bank staff estimates and projections.

Table 2.3b. Montenegro: Macro Framework With an Abrupt End to TEDS, 2006–12
(In percent of GDP; unless otherwise indicated)

	2006	2007 Prel.	2008	2009	2010	2011	2012
			Projections				
Real sector							
Gross domestic product	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Private sector consumption and investment	87.7	97.0	82.8	64.7	62.8	62.9	63.0
Government	42.7	45.7	47.8	43.9	43.9	43.9	43.9
Exports	49.6	51.3	45.0	47.0	49.0	49.0	49.0
Imports	80.0	93.9	75.6	55.6	55.7	55.8	55.9
Monetary sector							
Net foreign assets	-1.4	-18.0	-23.9	-21.5	-19.7	-18.2	-16.9
Claims	13.2	13.5	13.4	13.4	13.4	13.4	13.4
Liabilities	14.7	31.5	37.3	34.9	33.1	31.6	30.3
Loans by domestic banks	7.3	20.2	27.3	24.9	23.1	21.6	20.3
***Of which:* change in external indebtedness**	**3.9**	**14.0**	**7.4**	**0.0**	**0.0**	**0.0**	**0.0**
Other	7.4	11.2	10.0	10.0	10.0	10.0	10.0
Net domestic assets	42.3	87.0	111.8	109.6	105.6	100.9	95.8
Domestic credit	48.8	99.3	111.8	109.6	105.6	100.9	95.8
Net claims on central bank	10.8	13.5	13.4	13.4	13.4	13.4	13.4
Net claims on central government	-1.7	-2.8	0.0	0.0	0.0	0.0	0.0
Net claims on other sectors	39.7	88.6	98.4	96.2	92.2	87.5	82.4
Of which : credit to the economy	35.5	84.2	93.5	91.5	87.6	83.2	78.3
Other items (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Broad money	40.9	69.1	87.9	88.1	85.9	82.7	78.9
Deposits	40.7	68.6	87.5	87.7	85.5	82.3	78.5
Other	0.2	0.4	0.4	0.4	0.4	0.4	0.4
External sector							
Current account	-24.7	-39.7	-26.6	-4.6	-2.7	-2.8	-2.9
Trade balance	-30.4	-42.7	-30.6	-8.6	-6.7	-6.8	-6.9
Exports of goods and services	49.6	51.3	45.0	47.0	49.0	49.0	49.0
Imports of goods and services	80.0	93.9	75.6	55.6	55.7	55.8	55.9
Imports of goods	69.7	84.7	66.1	46.0	46.0	46.0	46.0
Structural imports	47.1	45.2	46.0	46.0	46.0	46.0	46.0
EDS-financed	*22.6*	*39.5*	*20.1*	*0.0*	*0.0*	*0.0*	*0.0*
Imports of services	10.3	9.2	9.5	9.6	9.7	9.8	9.9
Income (net)	1.4	0.7	1.0	1.0	1.0	1.0	1.0
Transfers (net)	4.2	2.3	3.0	3.0	3.0	3.0	3.0
Capital and financial account	28.6	34.6	28.9	4.6	2.7	2.8	2.9
Foreign direct investments (net)	21.7	20.7	10.6	0.5	0.5	0.5	0.5
Foreign direct investments (gross)	30.0	39.7	29.6	19.5	19.5	19.5	19.5
Purchases of real estate by foreigners	**15.7**	**20.3**	**10.1**	**0.0**	**0.0**	**0.0**	**0.0**
Other FDI	14.3	19.4	19.5	19.5	19.5	19.5	19.5
Outflow of investments	8.3	19.0	19.0	19.0	19.0	19.0	19.0
Portfolio and other investments	6.9	13.9	18.3	4.1	2.2	2.3	2.4
Net errors and omissions	-0.5	21.9	0.0	0.0	0.0	0.0	0.0
Financing (change in net foreign assets)	3.4	16.8	-2.3	0.0	0.0	0.0	0.0
Fiscal sector							
Budgetary revenues, including grants	45.7	52.8	44.9	40.9	40.9	40.9	40.9
Tax revenue	25.8	30.8	26.4	22.4	22.4	22.4	22.4
Structural	25.8	30.8	22.4	22.4	22.4	22.4	22.4
Temporal (from EDS-financed imports)	*6.2*	*10.8*	*4.0*	*0.0*	*0.0*	*0.0*	*0.0*
Other budgetary revenues	19.9	22.0	18.5	18.5	18.5	18.5	18.5
Total expenditures and net lending	42.7	45.7	47.8	43.9	43.9	43.9	43.9
Current expenditures, transfers, and other expenditure	38.2	38.3	40.3	39.0	37.8	36.6	35.5
Wage bill	11.8	12.7	14.0	13.6	13.2	12.8	12.4
Other current expenditure	26.3	25.7	26.2	25.4	24.6	23.9	23.1
Capital expenditures	4.5	7.4	7.5	4.9	6.1	7.3	8.4
Overall balance (≥ -3)	3.0	7.1	-2.8	-3.0	-3.0	-3.0	-3.0
Current structural balance (≥ 0)	1.3	3.7	0.6	1.9	3.1	4.3	5.4
Memorandum items, in millions of euro; unless otherwise specified:							
Real GDP growth rate, in percent	8.6	10.3	6.7	3.2	3.2	3.2	3.2
GDP deflator, in percent	9.0	7.2	10.0	6.2	4.5	3.7	2.9
Nominal GDP	2,148.9	2,540.0	2,982.3	3,267.3	3,524.5	3,773.6	4,007.0
Change in net foreign assets	-73.0	-426.1	68.3	0.0	0.0	0.0	0.0
Stock of net foreign assets	-30.8	-456.9	-388.6	-388.6	-388.6	-388.6	-388.6
Stock of private-sector credit	762.6	2,165.0	2,789.1	2,989.1	3,089.1	3,139.1	3,139.1
Annual change in private-sector credit	446.0	1,402.3	624.1	200.0	100.0	50.0	0.0
Stock of external loans by banks (eop)	156.5	513.2	813.2	813.2	813.2	813.2	813.2
Annual change in external borrowing	**84.4**	**356.7**	**220.0**	**0.0**	**0.0**	**0.0**	**0.0**
Wage bill	254.4	321.5	418.0	443.7	463.8	481.2	495.1
Other current expenditure	565.6	652.3	782.5	830.7	868.3	900.9	926.9
Capital expenditure	97.1	187.3	223.7	158.5	215.0	273.6	336.6

Sources: Ministry of Finance; CBCG; Monstat; IMF; and World Bank staff estimates and projections.

2.13. **The three scenarios differ in the assumed inflow of capital from abroad.** The sum of the changes to the external indebtedness by banks and purchases of real-estate by foreigners represent additional liquidity that lead to increased imports, with coefficients used as estimated by the regressions summarized above. These, in turn, affect not only fiscal revenues but also the development of the real economy. Given Montenegro's high import elasticity of demand, with imports of goods representing close to 100 percent of GDP, the overall impact on domestic economic activities, both up and down, from changes to external capital inflows is somewhat lower than in countries with lower elasticities (as, for instance, in Estonia, where imports of goods represent about 70 percent of GDP).

2.14. **For reasons of political economy, the most difficult challenge consists of containing current expenditures.** With the additional demands placed on the budget, there are indications that, in 2008, Montenegro will post a (modest) current structural deficit. Increasing demands are placed on public administration, and wage increases in the private sector outpace that to what Government is able to commit (unless the overall size of the public administration is reduced). There are plans to decrease tax rates even further (for instance, on personal-income taxes and social-security contributions), thereby placing even tighter constraints on the fiscal envelope for recurrent spending. In addition, with legislative elections foreseen during the second half of 2009, there always exist incentives for policymakers to relax budgetary constraints. If Montenegro wants to realize its priority objectives, it cannot afford to do so.

D. Concluding Remarks

2.15. **Montenegro has developed an ambitious plan aimed at modernizing public infrastructure.** The costs for the planned investments in the electricity and transport sectors alone exceed current GDP at quite a substantial margin. It will take years and several budgets to implement these investments and, even if PPPs can finance substantial portions, Government contributions will remain very large. To allow for effective planning and timely realization, it is crucial that the fiscal space for these (and other) investments be secured, including through their explicit representation in a medium-term budgetary program. The fiscal framework as presented here allows for gradually increasing capital expenditures as a share of GDP.

2.16. **The large reliance on imports as a source for fiscal revenues results in a pro-cyclical bias of the tax regime.** The clear definition of a capital budget as described above ensures a certain extent of counter-cyclicality in expenses—in the sense that, in years with low capital inflows and reduced imports, the overall balance will be permitted to be in deficit. The commitment to a current structural balance ensures that any net borrowing is done only for the purpose of (high-impact) investments.

2.17. **Precluding any further increase in real recurrent spending ensures that any overall fiscal deficit for years with adverse economic shocks will be temporary,** as the share of recurrent spending to GDP will gradually decline. Such an expenditure envelope can usefully frame reform efforts, including those for human

resource management in the public administration, and should help Government to implement reforms aimed at making the public sector more effective.

2.18. **Effects on the Montenegrin economy from the dramatically deteriorating international environment remain unclear, but they increase the importance of adding precautionary motives into the design of a medium-term fiscal program.** Simulations have shown that an abrupt disappearance of all temporarily available external demand stimuli would result in the breaching of the fiscal SGP criterion of an overall fiscal deficit by general government of less than 3 percent of GDP for several years in a row, requiring a corresponding adjustment of the capital budget. Without tight control over recurrent spending, without efforts to access private-sector capital to financing the public investment projects, and without a strong emphasis to ensure a high effectiveness of all public expenditure, Montenegro will not be able to successfully implement its ambitious reform and modernization agenda. Also domestically, increasing economic imbalances, as signified by increasing inflation rates and current-account deficits, require Montenegro to use its one remaining instrument of macroeconomic management—fiscal policy—for this purpose. During recent years, Government has pursued a moderately counter-cyclical fiscal policy, having accumulated sizeable overall fiscal surpluses. During the boom years, however, pressures for additional spending have increased, as exemplified by the changes to recurrent spending limits in the supplementary budgets 2007 and 2008. Montenegro will not be able to do this any longer.

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III. PUBLIC INVESTMENTS

Following the transition towards a functioning market economy, the demands on public infrastructure—weakened by decades of neglect—have increased considerably. Supply constraints have become increasingly evident and, in the absence of further investments, are threatening to asphyxiate the growth momentum. These supply constraints are particularly evident in (i) the energy sector, as evidenced in the growing energy deficit; (ii) the transport sector, with increasing traffic jams (during the peak season) and a very high incidence of accidents; and (iii) the water sector, including waste water; and (iv) sanitary solid waste deposits. As Montenegro aims at developing a high-end tourism sector that is to provide the economy's growth engine, it is crucial that the necessary investments—within the available fiscal envelope—are made to eliminate these bottlenecks quickly. On the whole, public infrastructure has not received sufficient attention in recent years, especially in sectors requiring very large amounts of budgetary funds for rehabilitation and modernization purposes. Insufficient maintenance has led to an accelerating rate of capital depreciation, and Government has recognized the need to reverse this trend. This chapter summarizes identified investment needs in the electricity and transport sectors (which require the largest investments). At the same time, the overall budget envelope defines limits to the capital budget, despite efforts aimed at increasing the fiscal space, necessitating intensified efforts to (i) attract private-sector co-financing; (ii) devise criteria according to which capital expenditures could be prioritized; and (iii) assess available options—if need be—to downsize or delay public investments.

A. The Energy Sector[34]

3.1 **Major investments need to be financed to ensure (i) an adequate availability of reasonably priced energy to a rapidly growing economy; and (ii) a sustainable financial position of the power utility.** Montenegro's energy infrastructure has been severely neglected for more than a decade of under-investment and deferred maintenance. The *status quo* is not an option, and—to be able to finance the required investments—Government needs to strengthen the fiscal elements of the sector strategy, combining (i) improved financial management by EPCG; (ii) the implementation of complementing structural reforms; (iii) the careful costing and prioritization of all proposed investment projects, which might a corresponding adjustment to the energy strategy; (iv) the development of public-private partnerships, where possible; and (v) the re-opening a debate within Government on the possible private-sector participation in EPCG beyond the 45 percent currently foreseen.

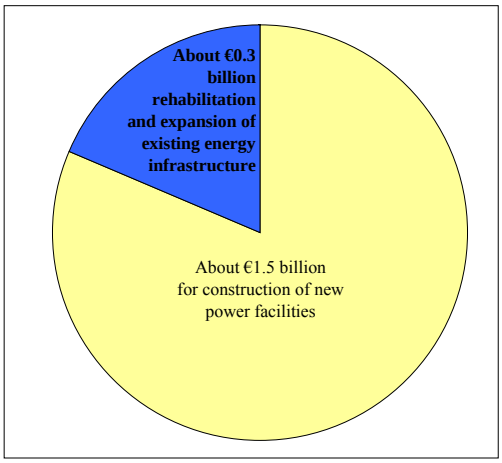
3.2 **Notwithstanding considerable progress made in recent years to enhance the financial viability of the power utility,[35] the sector continues to generate**

[34] Prepared by Husam Beides (ECSSD) and Richard Wong (ECSSD).

[35] Montenegro finds itself in the midst of a comprehensive reform process of the electricity sector, as many obstacles to an efficient and sufficient production of electricity have been tackled on partially. In particular, there remain issues of cross-subsidization among various categories of users, periodic blackouts and their impact on economic activities particularly in the high-potential tourism sector, social issues related to tariff increases, or the extent of technical and non-technical losses, billings and collections.

significant quasi-fiscal deficits. With recent reforms, the EPCG does no longer present a direct burden on the budget, except for very limited resources required to finance a minimal social-safety net for the most vulnerable consumers that are worst affected by the tariff increases. However, the sector continues to generate significant quasi-fiscal deficits, as EPCG's current revenues do not cover its needs, neither for normal and backlog maintenance nor for new generation, transmission, and distribution capacities that would be required to meet growing—and spatially shifting—power demand. Without the implementation of both urgently required investments and complementing reforms, the sector would have to rely increasingly on power imports. Given the already tight and volatile regional market, this would complicate EPCG's cash-flow management further and increase the risks for higher deficits and a resultant widening of the external current-account deficit.

3.3 **Faced with the poor financial performance of the power utility, Government has initiated a reform process in the energy sector.** EPCG's inability to rehabilitate and upgrade its generation and transmission facilities followed poor operational and financial performance. This development was amplified by administrative tariffs that were—for social-policy reasons—set at levels below cost recovery. [36] Against this background, Government initiated a reform process for the energy sector during previous years that aimed at (i) restructuring EPCG; (ii) supporting the privatization and commercialization of the aluminum smelter KAP (consuming about one-third of the electricity demanded in Montenegro); and (iii) requiring KAP to gradually import, on its own account and at international market prices, increasing portions of the electricity it consumes from the regional market. This has relieved EPCG from some of its supply obligations to KAP, contributing to the gradual improvement of EPCG's financial performance.



3.4 **The energy strategy identified necessary investments of about €1.8 billion up until 2025**[37]—that is, an annual average of about €106 million. With the energy-sector

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[36] Social-policy considerations, a prerogative of Government, should not directly impact the discussion on the structure of electricity tariffs. The social implications of tariff increases, however, represent an additional challenge to Government. Any increases in the tariffs for households should therefore take into account their impact on the poorest consumers. The existing social safety net supported by the Ministry of Health, Labor, and Social Welfare provides targeted subsidies for vulnerable electricity consumers, which need to be continuously re-evaluated to ensure the accurate coverage of low-income consumers. These programs represent an important element of the Government support to the electricity-sector reforms, ensuring ensure their socio-political sustainability.

[37] An even larger figure of €3.6 billion was mentioned in the context of an international energy conference "Energy Development in Montenegro: Future, Opportunities, and Challenges" in Kolašin during July 10–13, 2008, which had invited, inter alia, potential private-sector investors in this sector. The additional energy-sector investments are those offered to the private sector to be implemented on the basis of individual calculations of economic profitability.

reform, Government sought to address broader institutional constraints as well. It signed and ratified the Energy Community of South East Europe Treaty and created the Energy Regulatory Agency. It approved a new tariff methodology, which established in June 2007 a new unbundled transmission tariff and a new retail tariff. Also in 2007, Government adopted the Ministry of Economic Development's (2007) Energy Development Strategy, which calls for a total of €1.8 billion of investments[38] in (i) the rehabilitation and expansion of existing energy infrastructure (€0.3 billion); and (ii) the construction of new power-generation capacities (€1.5 billion). These investments are needed to meet growing energy demand and improve the security of electricity supply.

3.5 **Investment needs in the electricity sector exceed the financial resources of Government and the power utility.** This section will therefore seek to (i) provide a review of EPCG's financial performance, including medium-term forecasts; (ii) examine the link between EPCG's financial situation and its ability to invest in the infrastructure, which is needed to provide a sustained, reliable, and profitable supply of electricity in Montenegro; and (iii) derive policy recommendations for future restructuring and reform. The focus of this section will be on the electricity sub-sector, for reasons for this being the most critical area to the development of a policy mix aimed at ensuring dynamic rates of sustainable growth and the only area, in which the energy sector requires large-scale public expenditures.

Financial Performance of the Power Utility

3.6 **Reform steps are being implemented to improve EPCG's financial performance.** During 2007–11, EPCG's investment plan projects capital expenditures of €334 million aimed at rehabilitating and expanding existing generation, transmission and distribution systems.[39] These investments will be necessary during the coming four years to improve EPCG's operational performance and expand its generation capacity. For the purpose of this document, the team reviewed the power utility's financial ability to carry out these investments. This financial review is intended to provide an overview of the company's financial prospect and its ability to finance critical investments. Table 3.1 provides the review[40] of EPCG's past and expected future financial performance.

3.7 **As part of the reform process, EPCG completed the financial and accounting unbundling of its functional units.** Government is now in the process of *legally* unbundling EPCG's functional units. It is expected to start this process with the

[38] The related €1.816 billion in investments foreseen for the period 2007–25 investments include (i) €166 million in the rehabilitation of existing generation plants; (ii) €960 million in new power plants; (iii) €199 million in power transmission network; and (iv) €491 million in power distribution networks. The latter two categories of investments include expenditures for rehabilitation and new construction.

[39] EPCG 2007–11 investments include €138 million in generation investments, €85 million in transmission investments, €108 million in distribution investments, and €3.6 million in supply investments.

[40] EPCG financial review was based on a draft financial model prepared by EPCG and on other sources of information obtained from EPCG and discussions with EPCG staff.

legal unbundling (and full operational separation) of EPCG's transmission unit. Government is conscious of the fact that further reform steps are needed to (i) complete the full unbundling of EPCG; (ii) continue the process of tariff reforms; and (iii) establish a policy for private-sector participation in the energy sector—a necessary precondition for the financing the long-term investment needs in the energy sector.

Table 3.1 Montenegro: EPCG Operational and Financial Performance Indicators, 2006–11

	2006	2007	2008	2009	2010	2011
Operational indicators						
Installed capacity	868	868	883	883	883	883
Generation, excl. imports, GWh	2,818	2,520	2,903	2,903	2,903	2,903
Imports (PIVA swap), GWh	1,204	1,076	1,076	1,076	1,076	1,076
Imports (others), GWh	1,728	1,966	1,436	1,494	1,546	1,936
EPCG	1,022	1,235	705	462	438	0
KAP	706	731	731	1,032	1,108	1,936
Exports (PIVA swap), GWh	991	762	762	762	762	762
Exports (others), GWh	75	0	0	0	0	336
Gross consumption, GWh	4,684	4,800	4,653	4,711	4,763	4,817
Direct consumer consumption, GWh	2,142	2,153	2,163	2,170	2,170	2,171
35k V and below consumption, GWh	2,386	2,464	2,320	2,371	2,423	2,476
35k V and below net consumption, GWh	1,693	1,930	1,879	1,992	2,084	2,179
Distribution losses, GWh	693	534	441	379	339	297
Transmission losses, GWh	156	183	170	170	170	170
Distribution losses, percent	29	22	19	16	14	12
Transmission losses, percent	3	4	4	4	4	4
Distribution and transmission losses, percent	18	15	13	12	11	10
Financial indicators						
Operating revenue, millions of euro	193.24	243.00	243.50	242.50	247.99	252.10
Expenditure, millions of euro	225.13	254.56	255.62	225.32	223.07	187.23
EBIT, millions of euro	-31.88	-11.56	-12.12	17.18	24.92	64.87
Collections, percent of sales	95	93	95	96	97	98
Self-financing ratio	11	34	33	78	113	183
Net funds, generated internally, millions of euro	4.87	24.20	24.71	55.98	65.42	106.68
Average 3-year Capex, millions of euro	43.79	71.34	75.20	71.77	57.78	58.38

Source: EPCG; and World Bank staff estimates and projections.

3.8 **With the successful implementation of the reform and investment program, and on the basis of the current KAP agreement, EPCG is not expected to have any further operational losses after 2008,** which it had incurred at least since 2001. These losses stemmed from the long-term structural power deficit, production capacity constraints, and low tariff pricing (especially to KAP). A series of operational and strategic changes to EPCG are currently being undertaken to improve the utility's financial performance (Table 3.1):

(i) **The subsidy to the aluminum smelter will be phased out.** After KAP's privatization in 2006, KAP and EPCG signed a multi-year power-purchase agreement (PPA), which provides for a phased tariff increase for electricity supplied by EPCG to the smelter. According to the PPA, EPCG is responsible for supplying KAP with two-thirds of its electricity needs in 2007 and 2008 (at an electricity price that is indexed to the aluminum market price) and one-half of its electricity needs between 2009 and November 2010 (at an electricity price indexed to both the market prices of aluminum and electricity). After

November 2010, KAP is expected to import all needed electricity directly. In 2007, the price of electricity supplied to KAP was about €39 per MWh, compared to €20 per MWh in 2006. Together with KAP's improved payment discipline, the gradual reduction of EPCG's obligation to supply electricity to KAP has begun to show a positive impact on EPCG's financial performance in 2007. The effects will become more apparent in subsequent years.

(ii) **Collections rates will continue to improve and distribution losses decline.** During 2006–07, EPCG's distribution losses remained in the range of 20–30 percent, with negative impacts on EPCG's financial position, while the power utility as able to improve its collection ratio to an average 94 percent for both post-independence years. The latter outcome was party the result of completing a pilot metering program introduced to reduce network losses. The power utility intends to scale up this project, planning to install another 50,000 meters in areas with high network losses. EPCG has set targets for improving its collection ratio from 93 percent in 2007 to 98 percent in 2011, while reducing its losses concomitantly from 22 to 12 percent. To succeed with its ambitious but achievable targets, EPCG needs to implement its 2007–10 metering replacement and network rehabilitation project, at an expected cost of altogether €110 million.

(iii) **EPCG will have to invest in new generation facilities.** For many years, Montenegro has had a power-production deficit, mainly because it could not put into operation new generation facilities. The last such plant was integrated into its grid in 1982. Since then, industrial consumption—specifically for the aluminum and steel plants—and household consumption have increased three-fold. Given increasing supply constraints, this persistent electricity deficit has resulted in increasing imports. With the rehabilitation of the Pljevlja thermo power plant expected to be completed in 2008, an increase in overall production can be expected, implying that total electricity imports should be lower than those in 2007. This reduction in the level of imports can only be achieved if EPCG implements its planned €90 million investment in the rehabilitation and expansion of the Perućica and Piva hydro power plants, while providing €46 million for additional improvements in Pljevlja.

(iv) **EPCG restructuring has to continue.** In December 2006, EPCG's outstanding debt outstanding stood at €114 million. In 2007, Government was able to restructure €92 million of EPCG debt with both London and Paris Club creditors. Government converted remaining debt into additional equity holdings, with the result that its shares increased from 67 to 70 percent. The debt reduction has reduced interest costs. However, the debt deals did not cover the €22 million debt to Russia, the European Investment Bank (EIB), or the IBRD. EPCG's business plan for the period 2007–11 foresees decreased external borrowing, excluding the possibility of new external debt, to be taken of for capital expenditures, as of 2010.

(v) **EPCG staff will need to be cut.** It is foreseen that EPCG will reduce staff by 170 employees (or about 5 percent of its current workforce), increasing its

ability to control personnel costs. Over the 5-year span 2007–11, this objective is to be achieved mainly though planned retirements in its generation and distribution units. This reduction would result in the reduction of annual labor costs by about €0.2 million (net). During the process of restructuring, EPCG needs to define a strategy outlining labor restructuring and skills divestiture to ensure continued (if not increased) operational efficiency.

(vi) **Further tariff reforms are critical to improve the power utility's financial health**—apart from the objective of eliminating high cross subsidies that exist among different consumer groups. Once KAP will be responsible for importing its own electricity, EPCG should be in a position to ensure full cost recovery from all sales of electricity, including the steel plant and the railways. High cross-subsidies exists between other consumers connected to the distribution network (Table 3.2), which includes the level of tariffs for regulated consumers after the regulator's latest tariff revision in July 2008. At the same voltage level, tariffs to households can be a fraction of those for some categories of commercial consumers and small enterprises. To some extent, the July 2008 tariff changes have rectified the situation, but the tariff structure continues to affect the business climate detrimentally. The high cross subsidy between commercial and private EPCG clients does not accurately reflect the underlying cost of supplying these consumers. A tariff path needs to be established that eliminates cross subsidies among consumer groups. This could be achieved over a three- to five- year horizon.

Table 3.2. Montenegro: Electricity Tariffs, 2007–08

Category	Customer	Average tariff (in €/MWh) until June 30, 2008	Average tariff (in €/MWh) as of July 1, 2008	Percentage increase
1	KAP[1]	29.70	33.70	13.5
2	Steel factory	56.80	56.80	0.0
3	Railways	64.40	64.40	0.0
4	35kV	63.40	63.40	0.0
5	10kV	77.20	77.20	0.0
6	Households-two tariff (10pm-6am lower tariff, from 6am to 10pm higher tariff)	66.50	76.60	15.2
7	Households-single tariff (same tariff throughout the day, therefore priced	86.20	91.90	6.6
8	I degree (customers can estimate self peak power)	164.50	152.20	-7.5
9	II degree (no maximum peak provided)	189.70	175.50	-7.5
10	Public lights.	137.98	137.98	0.0
…	Households, weighted average between categories 6 and 7	69.30	78.70	13.6
…	All consumers, weighted average	65.70	71.10	8.2

Sources: Energy regulator; and World Bank staff estimates.

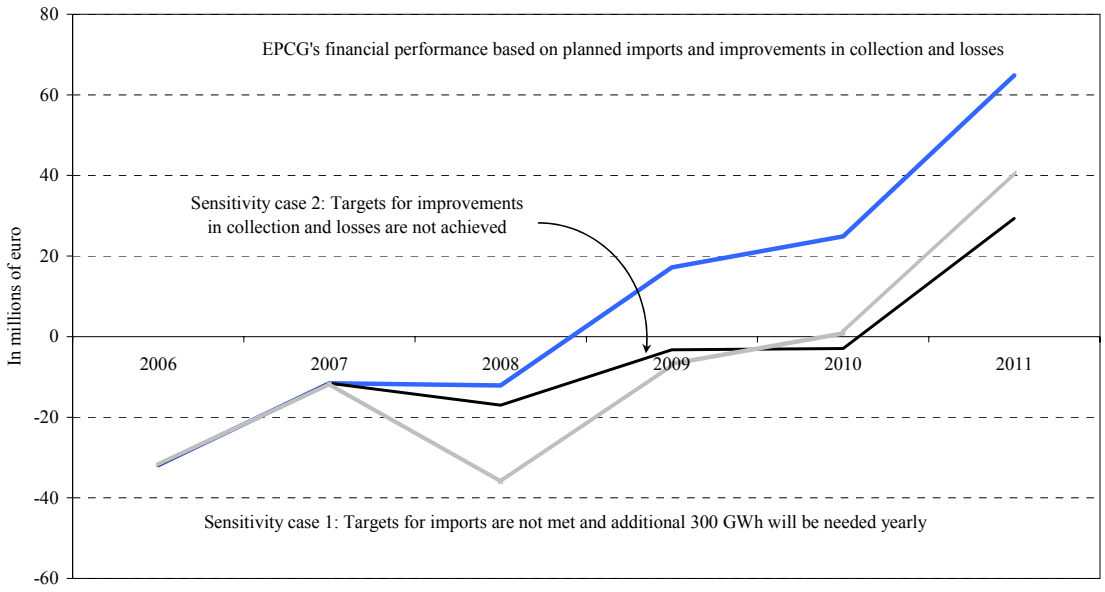
[1] Price according to the KAP-EPCG supply agreement. In addition, KAP imports about 1/3 of its electricity needs from the regional power market at market prices.

3.9 **According to the financial analysis, an improvement in EPCG's position can be expected.** Based on the assumptions and calculations made by EPCG (especially those related to the improvement in collections, the reduction in network losses, and the expected levels of electricity imports), the company's financial position and operating performance should start to improve (Figure 3.1).

3.10 **Imports and collection ratios remain risk factors.** Figure 3.1 summarizes the results of a sensitivity analysis, which shows that EPCG's financial performance will

remain fragile if (i) current forecasts regarding electricity imports are exceeded (one possible reason could be that local generators will not meet their targets for electricity generation); and/or (ii) EPCG proves unable to achieve targets for the improvement in collection ratios and the reduction of network losses. This finding increases the urgency with which EPCG needs to implement its investments plan for 2007–11 and continue to improve its operational performance.

Figure 3.1. Montenegro: EPCG's Net Operating Income, 2006–11



Implied Assumption of Infrastructure Improvements

3.11 **EPCG's development and investment plans amount to a €334 million over the period 2007–11.** The revitalization and modernization of equipment and plants for transmission, generation, and distribution are a prerequisite for improvements in both the production capabilities of local generation plants and the performance of the transmission and distribution networks. Without these investments, EPCG will not be able to meet its targets for electricity supply and network performance. Government and EPCG management place strategic importance to these improvements, motivating the development of a five-year development and investment plan (Table 3.3).

Table 3.3. Montenegro: EPCG Investment Plan, 2007–11

	2007	2008	2009	2010	2011	Total
	(In millions of euro; unless otherwise indicated)					
Total	71.3	89.3	65.0	61.1	47.3	334.0
Generation	26.6	37.7	27.2	27.8	18.4	137.6
Transmission	21.3	26.4	15.8	12.6	8.3	84.5
Distribution (35kV)	14.2	14.9	13.5	12.1	12.1	66.9
Distribution (10 and 0.4kV)	8.3	8.3	8.3	8.3	8.2	41.3
Supply	0.9	2.0	0.2	0.2	0.2	3.6
Base-case assumptions						
Self-financing ratio, in percent	34	33	78	113	183	…
Available own funds	24.3	29.3	50.7	69.1	86.4	…
External funding	47.0	59.9	14.3	0.0	0.0	…

Sources: EPCG; and World Bank estimates and projections.

3.12 **The full financing of these investments is not yet secured.** Of the €334 million in foreseen investments, outside funding of €92 million was identified and has been negotiated in 2007 with bilateral (Norway, France, and Germany) and multilateral (EIB and IBRD) development partners. Additional borrowing of €34 million is expected to meet the investment schedule.[41] As EPCG's financial situation is expected to improve in 2009, according to the assumptions underlying the base-case scenario, additional financing from EPCG's own resources can be expected to become available. However, if EPCG does not meet the targets of network improvement and import levels, significant additional external borrowing will be necessary, which would represent a fiscal burden and, within the constraints of the fiscal rules, crowd out other needed expenditure. Alternatively, additional capital can be raised by privatizing a share of EPCG that exceeds the currently foreseen limit of 45 percent; there are no economic efficiency reasons that would preclude a full privatization of the power utility.

Summary and Conclusions

3.13 **Energy-sector investments are needed to protect Montenegro's growth potential.** Rapid growth rates in economic activities, including the development of a high-end tourism industry, imply high and consistent growth rates in energy demand. With regional supply being limited and the current-account deficit already very high, energy-sector investments into the construction of new power generation facilities represent an important pillar of Montenegro's socio-economic development strategy, which aims at ensuring the sufficient availability of reasonably priced energy. The energy strategy (Ministry of Economic Development, 2007) has outlined measures to achieve this, at costs equivalent to about 70 percent of 2007 GDP.

3.14 **EPCG's poor financial performance in the past led to the negligence in energy infrastructure—necessitating an improvement of the former to address the legacy of the latter.** Since 2002, EPCG has reported annual losses of about 1

[41] The relatively small size of the remaining financing gap brings EPCG—on the assumption that it can successfully implement its reform and investment program—within the range of being able to borrow, akin to the situation of the Port of Bar and the Airport of Montenegro (see below) on its own account and without fiscal implications for the state budget.

percent of GDP. Subsequently, new investments were very limited, and EPCG's assets have deteriorated due to a lack of maintenance and replacements. To improve its physical and financial conditions, EPCG has launched a major reform program aimed at addressing its fragile financial position. To this end, the power utility is embarking on operational improvements, such as meter installations and loss-reduction programs, while introducing measures to improve staff productivity. A strong earnings increase is expected from these actions. However, the improvement in EPCG's financial situation will only be achieved if the power utility is able to (i) maintain electricity production from local generation plants; (ii) improve its collections; and (iii) reduce its losses in line with its targets for 2008–11. As a result, there is a close interrelation between operational improvements and the realization of planned investment projects, particularly those aimed at rehabilitating and expanding existing generation plants. Together with complementary distribution network projects, their implementation should suffice to place EPCG in a financially self-reliant position.

3.15 **In parallel, EPCG's corporate structure will have to be adjusted.** Improvements in EPCG's financial performance will require changes from the traditional form of governance—away from a vertically integrated, state-owned utility towards a commercially oriented company with an unbundled corporate governance structure. This process has started with the *functional* unbundling of EPCG into transmission, distribution, and generation units. Further steps need to be taken to finalize the utility's *legal* unbundling. Government strives towards a complete legal unbundling of EPCG's transmission and market operations into a joint stock company (JSC) by end-2008. The generation, supply, and distribution units will become legally separate JSCs by end-2009. Concomitantly, EPCG needs to develop a strategy for labor restructuring and skills allocation, and divesture to ensure the operational efficiency of the new companies.

3.16 **A partial success in implementing complementary structural reforms will delay the improvement in EPCG's financial situation and might ultimately require the power utility's full privatization.** In the coming 12–18 months, efforts must be focused on improving EPCG's operational and financial performance, while finalizing the legal unbundling of EPCG activities. Progress in these two areas will provide the Government with more favorable conditions for attracting private-sector participation in EPCG. If these targets are achieved, resulting in improved earnings, private-investor interest in EPCG will, in all likelihood, be higher—as will be the receipts from any (partial) sale.

3.17 **Increasing energy generation capacities presuppose the diversification of energy sources and active private-sector participation.** Following the adoption by Government of the long-term energy-sector development strategy in 2007, a total of €1.5 billion will need to be invested until 2025 in new generation capacities (other than existing plants). Investments include the development of wind, small hydro, and solar power plants, as well as the Pljevlja 2 thermal power plant and the construction of new, larger hydro power plants. Over the 17-year time horizon, this averages about €88 million annually, in current prices. Together with €0.3 billion investments required for the rehabilitation and expansion of existing energy infrastructure during 2008–11, this would add another average €67 million to energy-sector investments. These amounts

can be lowered by extending the implementation horizon, downsizing the investment plans, and/or increasing private-sector participation in the energy sector. The trade-off among various sectors will require Government to decide on the cross-sectoral prioritization of conflicting public investment projects, which could be facilitated by a reassessment of the inherent economic benefits and costs of keeping EPCG majority state-owned.

B. The Transport Sector[42]

3.18 **Montenegro has ambitious plans to ensure the integration of the Montenegrin road network with those of neighboring countries.** In particular, two major highway corridors are foreseen—viz., the Bar–Boljare highway (*en route* to Belgrade, Serbia, and the pan-European Corridor 10), and the Adriatic-Ionian highway through Montenegro—as well as several other road projects considered to be of strategic importance. The planned investment for the two main highways is a central component of the transport strategy, with expected costs of at least €2.8 billion (109 percent of 2007 GDP). The scale of these projects underlines the importance, if they are to go forward, that the design and implementation schedules are fully reflective of both current and projected demand and the fiscal envelope available to Government. The sheer scale of these projects poses a serious fiscal challenge to the authorities and necessitates careful study of the associated fiscal risks and liabilities. Even if the implementation is stretched over a decade—considerably longer than currently foreseen—the annual average costs would exceed €320 million in current prices, in addition to about €100 million in annual maintenance costs. This requires a strengthening of the comprehensive fiscal-sectoral strategy, including all available options of private-sector participation, the appropriate sequencing and timing of individual projects, the full reliance of proper tender processes (thereby avoiding the budgetary responsibility for considerable additional cost, as seen by examples of direct procurement elsewhere in the region), and an open mind to reassessing the appropriate scope and size of these projects.

Background

3.19 **The transport system has long been acknowledged to be a necessary component in facilitating economic development and poverty alleviation.** Montenegro's small size, the current narrowness of its economic base, with a strong reliance on tourism and agriculture, highlight the importance of developing an efficient and effective transport system to contribute to the generation of sustainable economic growth and poverty alleviation. In addition, Montenegro's geographical location and terrain—with 55 percent of the country above 1,000 meters—impact on trade, transport costs, and growth, underlining the importance of developing a modern transport system and fully integrating it with those of the neighboring countries in the region.

[42] Prepared by R. Martin Humphreys, Vickram Cuttaree, and Stephen Muzira (all ECSSD).

3.20 **The development of a core regional transport network is recognized as one of the most important objectives for the economic and social development of Southeastern Europe,** which aims at strengthening intra-regional (trade) links and increasing access to the region's more remote areas. The EU has fully supported the core network development through continuous engagement and support, starting with the Transport Infrastructure Regional Study (TIRS) in 2001 and the Regional Balkans Infrastructure Study (REBIS) in 2003. In addition, the EU established in 2005 the South East Europe Transport Observatory[43] (SEETO) in 2005, charged with creating a regional consensus to address existing problems and develop a core transport network in the region. It includes the Trans-European Network (TEN) Corridors in the region as well as other strategic routes connecting national capitals, regional centers, and the main ports and border crossings in a manner consistent with the Common Transport Policy of the European Commission (2001). The SEETO Secretariat, composed of regional experts, is required to produce five-year priority investment plans. The latest, the Multi-Annual Plan 2009–13, is currently under preparation (SEETO, 2007).

3.21 **The SEETO core network amounts to 5,980 kilometers of roads, 4,584 kilometers of railways, 1,185 kilometers of inland waterways, 11 airports, 7 sea ports, and 2 river ports.** Montenegro does not lie on any of the TENs, but it is crossed by two routes of the SEETO core road and rail network, viz., (i) Route 4, which runs from the port of Bar via Belgrade to Vršac on the border with Romania; and (ii) Route 2, which connects Podgorica with the Durrës–Tirana highway in Vorë, Albania. The port of Bar and the Podgorica airport are also defined as being part of the "core" transport network.

3.22 **This chapter will review developments since the PEIR-1 in 2006.** It will review actual and planned expenditures by mode, outputs, and financing needs (particularly given the ambitious development plans in this sector), and estimate the potential financing gap. It will also recommend improvements to reduce transaction costs, improve allocative efficiency in the sector, and underline the need for a greater contribution from private financial resources if these plans are to be realized. This will, in turn, require the strengthening of the overarching institutional framework and a careful assessment of the associated fiscal risks.

The Institutional Framework of the Sector

The Road Sector

3.23 **Montenegro has made progress in the past few years in harmonizing the institutional framework for the transport sector with EU norms.** In the road sector, a new law on state roads was adopted in mid-2004, harmonizing the national law with the requirements stemming from the *acquis communautaire*. In this process of approximation, the Directorate of Public Roads (DPR) was established as the body responsible for managing, maintaining, and building state and regional roads. In

[43] On June 11, 2004, the European Commission signed a Memorandum of Understanding with Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, and Serbia and Montenegro on the development of the South East Europe Core Regional Transport Network.

January 2005, when the new law was implemented, the DPR became operational as a line department within the Ministry of Maritime Affairs, Transportation, and Telecommunications (MMATT), which has overall responsibility for the sector.

3.24 **These improvements have not resolved all challenges in the process of strengthening the capacity, administration, and management in the sector**, not least because of the existence of human resource constraints, both in terms of numbers and capacities of the technical staff. For example, the Directorate of Transport is facing difficulty in attracting and retaining qualified engineers. Five of the 13 engineering positions have been vacant for more than a year, ostensibly due to salaries being much lower than those prevailing in the private sector for comparable positions (see also Chapter IV). There is a similar capacity constraint at ministerial level.

3.25 **In addition, planning and budgetary processes are weak—giving resultant investment estimates an indicative character.** Further refinements are urgently needed. The planning and budgetary processes include a number of deficiencies that undermine the efficiency of expenditures, including (i) the absence of robust sector policies and adequate development strategies;[44] (ii) weaknesses in project identification and assessment; (iii) poor budgetary control; (iv) little use of the latest techniques to improve the efficiency of spending (such as performance-based contracting); and (v) little regular monitoring of the condition of the infrastructure assets. With regard to the latest point, there is, for instance, no road and structure inventory database. Only little information is gathered on traffic volumes and axle loads. Thus far, efforts in this regard have lacked a systematic approach and a robust application of methodologies.

3.26 **The devolution of management responsibilities of the local road network to municipalities has proven difficult**. The responsibility for the administration and management of local roads lies with the municipalities. A recent World Bank (2008) study has revealed that the devolution of the responsibility for managing tertiary (local and municipal) roads to local governments undermined the provision of adequate maintenance. Local revenue sources, such as vehicle registration charges, have generally proven insufficient, while transfers from the central Government tended to be inadequate or erratic. On the municipalities' side, administrative costs are frequently too high and managerial capacities weak. Whereas the situation in Montenegro is somewhat better than in some other countries in the region, the survey found that one-half of the sampled local road networks was in poor condition.

3.27 **There are no up-to-date, consistent design and construction standards in use.** The current design standards for the road sector are based on old Yugoslav standards. The new design standards for road and bridge works, harmonized—to the degree possible—with relevant EU requirements and best international practice, await preparation. As a result, works on the road network have not yet achieved uniformity

[44] MMATT (2007) has developed a transport strategy, with support from the European Agency of Reconstruction (EAR), but whilst it provides a good overview of the sector and highlights key priority projects, it includes neither a robust assessment of the institutional framework nor estimates of current and projected demand, all key elements required for determining an action and investment plan that is consistent with the fiscal envelope available to the Government.

in the application and quality to EU standards. This weakness is particularly relevant for the local and municipal roads, for which the disparity between the current use of these roads, earlier standards, and available resources is particularly pronounced.

3.28 **The institutional coordination and management that is necessary to address road-safety problems is currently missing in Montenegro**. The identification of road-safety problems is complex, not least because road-safety responsibilities are spread among various government agencies and shared by businesses and individuals. Reducing road deaths and injuries requires a systematic response that includes a strong focus on results, including interventions that address—and ensure compliance with—safety standards and rules for roads, vehicles, and users. It also requires robust implementation arrangements that include effective leadership, coordination, funding, legislation, promotion, and monitoring and evaluation. Currently, there is no strategy for addressing roads safety, and the coordination among the different stakeholders is weak.

3.29 **In addition, there is no clear policy or set of regulations that would define the scope of private-sector participation**. Although the 2006 "Strategy to Promote Foreign Direct Investment" specifically makes references to the granting of concessions for major infrastructure investments, there is no national PPP policy. The draft Transport Strategy does not present a sector-wide approach to PPPs. In the road sector, a PPIAF-funded study is currently being prepared to assess available options for PPPs in the highway sector (ECORYS, 2008). It is envisaged that this study helps to define a clearer PPP strategy, permitting the authorities to supersede the current case-by-case approach with a more strategic one, taking into consideration all possible PPP options.

3.30 **There is a clear commitment, however, to pursue a strategy aimed at accessing financial resources from the private sector.** Not only does the state law on roads include provisions for the use of PPPs, but also is a new law covering PPPs and concessions is under preparation, aimed at replacing the 2002 law on private-sector participation in public services. Under that law, a Privatization Council had been made responsible for approving proposals for procuring investments with private-sector participation. Although some projects were implemented under the 2002 law, it was not considered appropriate for large road concession projects (ECORYS, 2008). A preliminary review of the draft concession law identified some issues but concluded that it was well drafted overall and a substantial improvement from the previous one. A Concession Commission is expected to be created and play a central role in the approval process for PPP projects. Although the staff of the Commission could use resources from the current Privatization Council, the new entity would have to be staffed quickly with very qualified PPP experts.

3.31 **Capacity building beyond the operational establishment of the Concession Commission is critical for the realization of current development plans.** The draft concession law has not been clear on the relationship between the Concession Commission and the line ministries (in some case there might be some conflicts between institutions on the authority for concessions). In addition, close coordination with the Ministry of Finance will be essential, not only to ensure alignment with the

budget process but also to properly manage the contingent liabilities that are associated with any PPP arrangement. Finally, although current efforts on transport PPPs are concentrated on only a few projects, a PPP capacity building program should be put in place at the level of the MMATT and transport-related public institutions, with a view to supporting a further development of PPP projects.

The Railway Sector

3.32 **With the adoption of a new law in 2005, the regulatory framework for the railway sector is being adjusted.** The new law reflects the relevant EU Directive, mandating the accounting separation between infrastructure and operations and among different lines of business. The law allows for the opening of the railway infrastructure to licensed local and international operators. Therefore, since January 2006, Željeznica Crne Gore (ZCG) has become a holding company with two shareholder companies, one for operations and one for infrastructure. However, the current staffing profile with a skewed age distribution (81 percent of the staff are older than 41 years of age) might prove a constraint to further modernization. Further reform involving accounting separation for each line of business, prior to organization separation and privatization, would be a logical next step.

3.33 **The proposed regulatory body for the railway sector has yet to be created**. At the ministerial level, the Department for Railway Transport within the Directorate of Transport has been endowed with the responsibility of regulating the sector, including the establishment of an access charge regime and the definition of a common network statement. However, it has not yet developed the necessary capacity or been given required resources to undertake these tasks successfully.

The Aviation and Maritime Sector

3.34 **The national airports are formally managed by Airports of Montenegro, a state-owned company created in 1999**. Government purchased Podgorica and Tivat airports from JAT Airlines in 2003, through Airports of Montenegro. In November 2003, 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 the airports in Podgorica and Tivat. However, this body is not fully functional, and there is an urgent need to restructure the administrative responsibilities and increase the effectiveness of the organizations. Analogous to the railway sector, this can be done most effectively by separating infrastructure and commercial operations, while continuing to prepare for the restructuring and privatization of the state-owned enterprises.

3.35 **Currently, Montenegro Airlines is the only national carrier.** It has been created by Government in 1994 and made operational since 2000. It flies five airplanes on regular routes to European destinations in Belgrade, Budapest, Frankfurt, Ljubljana, Paris, Rome, Skopje, Vienna, and Zürich. The current dominant position of Montenegro Airlines 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 state treasury.

3.36 **In the maritime sector, the separation of operational management and planning from regulatory functions is also at the center of efforts to modernize its institutional framework.** This includes the splitting of the port administration to two port director offices.[45] The broader reform process requires the enactment of the new Port Law, which would turn Bar into a landlord port with a separate Port Authority and Port Operator Company, managed under a concession agreement. Notwithstanding some progress with the approval of the port master plan, delays in enacting the Port Law could lead to a delay in the reform process.

3.37 **The port director offices are regional organizations under the MMATT, performing inspection and administrative duties and state control functions.** These duties cover the construction, installation and maintenance of maritime lighting on maritime routes, technical examination of navigable and floating objects. The dedicated department within the MMATT comprises (i) the technical inspection of vessels and implementation of international regulation; (ii) safe navigation; and (iii) general affairs and administration. The Law on Port Operation, which is expected to be enacted soon, will create a new port administration and separate the functions of operations and planning from regulation.

Expenditures in the Sector

The Road Sector

3.38 **Recurrent expenditure—following years of nominal cuts—has seen a moderate trend increase since 2005**. Between 2005 and 2008, recurrent expenditure in the road sector increased by an average of 71 percent. Although the growth in the last two years is lower than in capital expenditure, there seem to be an increasing importance put on allocating more resources to maintenance activities.

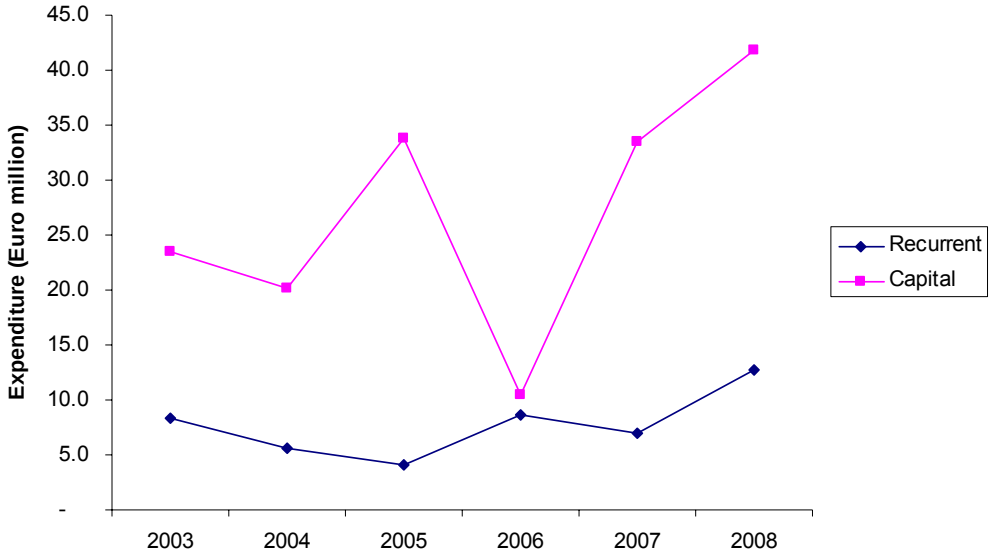
3.39 **The recent increase in budget allocations for recurrent expenses is now ensuring that more resources are being allocated to routine maintenance.** Historically, the maintenance budget was too low to cover the whole network.[46] During 2001–05, an annual average of only about €5 million was allocated to recurrent expenses needed for the routine maintenance of roads. The central Government's 2008 budget foresees about €12.8 million, with €10 million being allocated to routine maintenance. This amount is expected to increase to €16 million, equivalent to about €9,000 per kilometer in maintenance, which is reasonable by international standards and very close to the needs of €18 million estimated by the Directorate for Transport.

[45] One office covers the fjord (Boka Kotorska) with a head office in Kotor (and branch offices in Herceg-Novi, Zelenika, and Tivat) and the other one the Adriatic coastline and the Skadar Lake, located in Bar (with branch offices in Budva, Ulcinj/Ulqin, and Virpazar).

[46] In 2004, the financial resources allocated to road routine maintenance was estimated to cover about 44 percent of needed maintenance and 18 percent of needed improvements.

3.40 **The budget for investments in rehabilitation and reconstruction has been significantly increased,** with additional funds being provided by IFIs. Between 2001 and 2007, the total investment envelope for rehabilitation, reconstruction, and new roads has increased by a factor of three, from €10.4 million to €33.5 million.[47] However, investments from the budget have also increased significantly, by €7.9 million in 2007 and €13.8 million in 2008. Most of the investments in 2006–08 have been directed towards the rehabilitation of existing assets (such as roads or tunnels). Financing sources have become more diversified, with IFIs playing a bigger role in the financing of road infrastructure. The review of the 2008 budget shows that the implemented road works basically covered the upgrading of main roads, with a view to meeting EU standards, including the construction of by-passes and climbing lanes (ECORYS, 2008).

Figure 3.2**:** Capital and Recurrent Expenditure in the Road Sector, 2005–08



Source: Directorate of Transport; and World Bank staff estimates.

3.41 **A positive but limited step to improving expenditure efficiency was taken three years ago with the subcontracting of maintenance works.** Since 2005, following a competitive tender, Crnagoraput (now owned by Strabag) has been made responsible for the maintenance of the entire road network. Not sufficient emphasis has been placed, though, on applying performance-based contract principles.[48] At the time of the tender, Crnagoraput submitted lower proposals for each region, but only two compliant proposals from domestic firms had been received. While the subcontracting of maintenance activities to a firm selected through competitive bidding is a very positive step, it should be ensured that future tenders for this service receive more interest from (foreign) firms so as to allow for potentially cheaper maintenance costs per kilometer of road network. The current contract expires in 2010.

[47] Between 2006 and 2007, the investment budget increased by 25 percent.
[48] See also www.worldbank.org/transport/roads/resource-guide/index.html.

3.42 **Montenegro has made first, preliminary experiences with private-sector participations in the financing of infrastructure investments.** Montenegro has started to engage in PPP-type arrangements. The Sozina Tunnel between Podgorica and Bar was constructed and is maintained by Monteput, a JSC with the state as its main shareholder. In return, the company is allowed to levy tolls for a restricted period of time. A road BOT PPP was recently granted by the Municipality of Herzeg-Novi for a contract to rehabilitate a 12.5-kilometer road segment and extend an existing road by 5.2 kilometers. The project was prepared with the involvement of the Privatization Agency under the Agency of Montenegro for Economic Restructuring and Foreign Investment.

3.43 **Budgetary obligations for the road sector will remain very high in the coming years**, notwithstanding MMATT's efforts in assessing the economic and financial viability of private-sector participation in key road projects. Two road projects, for which Government expressed highest priority, are the Bar–Boljare and the Adriatic-Ionian Highway projects, estimated to cost €2.0 and €0.8 billion, respectively. For these two motorways alone, the costs represent about 109 percent of 2007 GDP.[49] Although the feasibility and the PPIAF-funded ECYROS (2008) studies are not yet completed, the Bar-Boljare highway has become the Government's "signature project", receiving political support at the highest level. The International Finance Corporation (IFC) has, in the meantime, been contracted as a lead advisor for the planned PPP arrangement. International experience has shown that highway concession projects are rarely implemented without public contributions. In addition, the concessionaire often asks for either minimum revenue guarantee (with the inherent risks of compensation payments representing possibly considerable contingent liabilities for the budget).

Railways and Ports

3.44 **Like the other railways in the Western Balkans, the Montenegro railway company is not financially profitable and depends on Government subsidies.** The railway has not been able to generate any positive net income in the last five years. Total aggregate operating losses from 2002 to 2007 stood at about €77 million. In 2007, net losses were around €7.6 million, with an operating ratio of 2.0 without subsidies. This performance places Montenegro at the same level as—or

Table 3.4. Montenegro: Railway Income Statements, 2006–07
(In millions of euro)

	2006	2007
Revenue	25.733	24.609
Operating revenue	13.143	14.850
Subsidies	9.250	7.252
Other revenue	3.340	2.507
Total expenses	33.754	32.181
Operating expenses	29.135	29.681
Materials, fuel, spare parts	4.226	3.150
Electricity	2.009	2.314
Subsistence resources	0.665	0.692
Amortization	4.822	4.900
Salary, wages, and personnel expenses	12.949	15.696
Other costs	4.464	2.929
Additional expenses	4.619	2.500
Operating losses	-3.402	-5.072
Net losses	-8.021	-7.572

Source: Montenegrin Railways (ZCG).

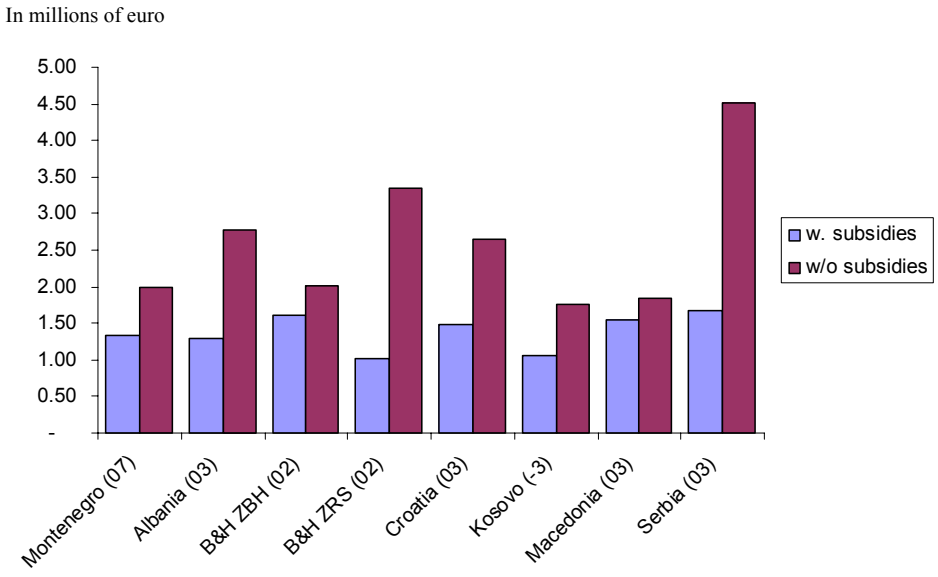
[49] The high costs for the 180-kilometer highway project between Bar and Boljare reflects the difficult terrain, necessitating the construction of at least 42 tunnels and 92 bridges.

only slightly better than—the railways of the neighboring countries (Figure 3.3). However, these railways are all loss-making entities, depending heavily on Government subsidies.

3.45 **Although there is some capital investment in the railway sector, partly through IFI financing, the level of investment remains lower than in the road sector.** Between 2004 and 2007, total investment in railway infrastructure has been €7.25 million, or €29,000 per kilometer of tracks. This figure is considerably lower than the €37,900 per kilometer of roads in the main network. Since 2003, the railway company started taking loans from IFIs to ensure investment in infrastructure. A €15 million loan was contracted with EIB to upgrade rail infrastructure and equipment. Another €15 million loan was signed with EBRD in 2007 to improve track safety and efficiency as well as a labor severance program. Additional financing is expected from EIB (€34 million) and EAR (€3 million).

3.46 **Labor and low operating revenue remain a major constraint to profitability**. The high operating ratio reflects a low revenue base for given expenses (Table 3.4). With 53 percent of operating expenses, costs for salaries and wages represent a very high share. In fact, total labor expenses, having increased by 20 percent from the previous year, exceeded total operating revenue. Although a reform program is being prepared, including with plans for private-sector participation, the financial performance of the railway will hinge on the success in rationalizing railway lines and reducing labor costs.

Figure 3.3: Railway of Montenegro Income Statement Summary



Sources: Montenegrin Railways (ZCG); World Bank (2005).
Note: Total Revenue include capital grant ("sustaining program of railway infrastructure")

3.47 **Budgetary allocations to the port and airport sectors are limited.** Both sectors have their own revenue streams. Public investment in the port sector represents less than 5 percent of total transport budget; the ports largely rely on port dues for the

financing of their activities. Private-sector participation is expected for the port of Bar, to be made possible by the new law on port operations. Future investments in the port of Bar of about €35 million are expected to be financed directly through private-sector investment and via port revenues (that is, mainly port dues and concession payments). Since 2004, airports became self-sufficient through the introduction of user charges; they do not need any state support in addition to guarantees for loans contracted with IFIs (including the €11 million and €11.5 million loans in 2003 from EBRD and EIB, respectively, needed to complete the Podgorica airport modernization plans).

Outputs in the Sectors

The Road Sector

3.48 **The overall scale and scope of the road network appear adequate, but statistics can mislead.** Montenegro has a road network totaling approximately 7,000 kilometers—with 884 kilometers of main and primary roads, 964 kilometers of regional and secondary roads, and around 5,000 kilometers of local roads. This is equivalent to a road network density of 500 kilometers per 1,000 square kilometers. This figure is broadly consistent with the density of regional comparators in Southeastern Europe (with an average of about 555 kilometers per 1,000 square kilometers of territory) but below the levels in the new EU member states (NMS) or the older EU countries (Table 3.5). Other factors, such as the size of the country, the distribution and density of the population, and the country's geography play a very considerable role in determining a country's road network. These effects become evident when making the comparison on a different measure of road density—viz., road kilometers per 1,000 people. With this measure, Montenegro is ahead of most of its regional comparators. With more than 11 kilometers of road per 1,000 inhabitants, Montenegro's figures are comparable to those of the NMS. As this reflects average density, and given the country's lower population, this figure as well explains as much as it obscures important elements in the marked disparity in road density and, equally importantly, the availability and accessibility of roads between the coastal and mountainous areas.

Table 3.5. Central and Eastern Europe: Road Infrastructure Coverage
(In millions of euro)

	Road density	
	km of roads per 1,000 km^2	km of roads per 1,000 people
Montenegro	500	11.1
Southeastern Europe, including Montenegro	555	5.9
Albania	657	3.5
Bosnia and Herzegovina	427	5.6
Croatia	506	6.4
Kosovo	780	3.3
Macedonia, FYR	513	6.4
Serbia	500	5.2
Select new EU member states (NMS)	1,427	19.9
Czech Republic	1,646	12.5
Estonia	1,320	41.2
Hungary	1,733	15.7
Slovenia	1,007	10.2
Regional averages		
Europe and central Asia	580	8.6
Upper middle-income countries	1,076	9.2
Lower middle-income countries	328	4.9
High-income countries (OECD)	1,340	17.3

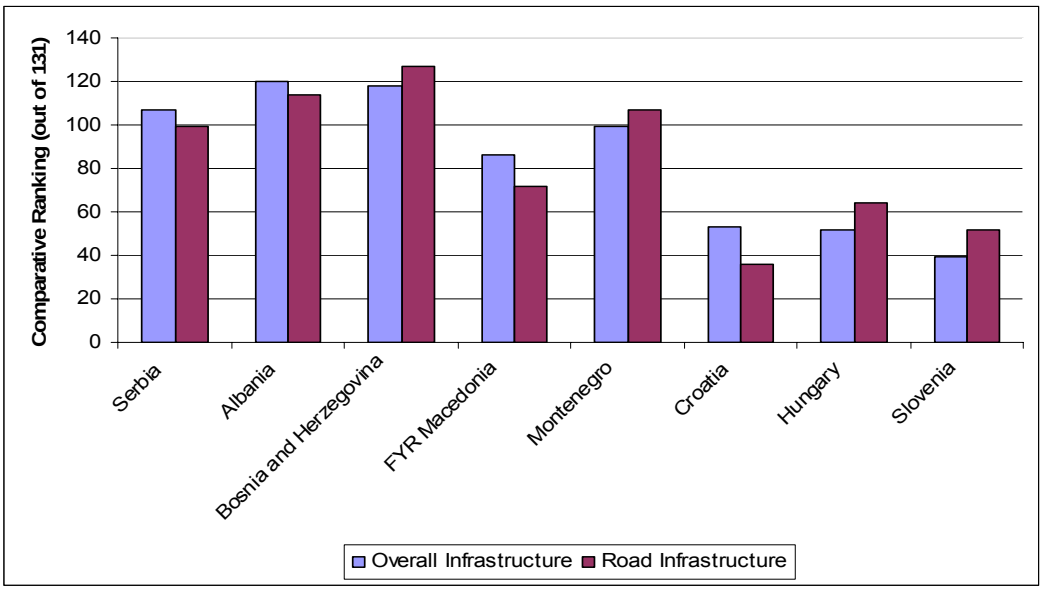
Source: World Bank, WDI indicators and study data.

3.49 **The overall road network infrastructure needs urgent maintenance investments;** see below. Nearly one-half (47 percent) of the entire road network is in poor or very poor condition, reflecting

inadequate maintenance.[50] A vast majority of the network is exhibiting widespread signs of pavement distress and failures.[51] The many instances of patching also confirm the assessment of a weakened pavement that is in need of increased periodic maintenance interventions. These figures imply that the road quality in Montenegro slightly worse than in Croatia and considerably better than in Bosnia and Herzegovina.[52] A recent survey undertaken by the World Bank (2008) revealed that tertiary roads in Montenegro are in a similar condition, with 50 percent of the sampled roads being found to be in poor condition.

3.50 **The problem of poor public infrastructure—and especially road infrastructure—has been widely recognized**. In the recent Global Competitiveness Survey (World Economic Forum, 2008), Montenegro ranked a relatively high 82nd of 131 countries surveyed[53]—but only 99th for the quality of its overall infrastructure and 107th for the quality of its road infrastructure. For the latter sub-indicator, only Albania and Bosnia and Herzegovina scored lower among the countries in Southeastern Europe (Figure 3.4).

Figure 3.4. Southeastern Europe: Comparative Ranking of Infrastructure and Roads As Critical Element in Determining Regional Competitiveness, 2007



Source: World Economic Forum (2008).

3.51 **Inadequate maintenance increases the rate of network deterioration, creating considerable contingent liabilities (in terms of future rehabilitation costs)**

[50] The full breakdown of the main road network is 15 percent good, 39 percent fair, 37 percent poor and 10 percent very poor.

[51] These include including longitudinal joint cracking, longitudinal wheel path-cracking, and ravelling, rutting, and low-to-high undulations and distortions.

[52] The comparative figures for Croatia respectively are 32 percent poor and 22 percent very poor and for Bosnia and Herzegovina 43 percent poor and 22 percent very poor.

[53] This result makes Montenegro the most competitive country in the Western Balkans. Serbia was ranked 91st, Macedonia 94th, Bosnia and Herzegovina 106th, and Albania 109th.

and economic costs (as a result of increased user costs). 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. Heggie and Vickers (1998) report that rehabilitating a paved road, in current terms, is three times more expensive than maintaining it. Expressing this relationship in net present value terms, reconstruction exceeds consistent maintenance by about 35 percent. In addition, failing to maintain a paved road has been estimated to increase user costs by a factor of three—mainly for reasons of additional time, fuel, and vehicular wear and tear. Already, vehicle operating costs are high in Montenegro, given the fact that the network's design characteristics, in terms of speed and axle loads, are below European standards, affecting road safety and competitiveness.

3.52 **Unresolved road-safety challenges have become an increasingly serious socio-economic problem in Montenegro.** Provisional accident data were collected for this report (see Appendix), revealing that road safety has become a serious and increasing economic and social problem in Montenegro, comparable to those in Albania and Bosnia and Herzegovina (Figure 3.5). More than 2,000 people are being injured or killed every year in road traffic crashes. From 2004 to 2006, the number of injured or killed has increased by almost 30 percent, from 1,841 to 2,347. While the number of fatalities had remained broadly unchanged, at approximately 90 deaths per year, it increased sharply in 2007, in which year 122 people were killed on Montenegrin roads (Figure 3.6). Remaining challenges are considerable, amplified by Montenegro's mountainous terrain: the fatality rate of 7.3 per 10,000 vehicles is nearly seven times the rate of the "safest"—but flat—EU member countries.

Figure 3.5. Select European Countries: Fatalities per One Million Inhabitants, 2007

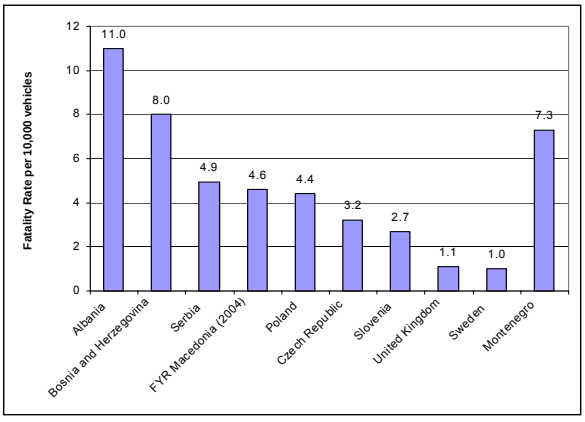
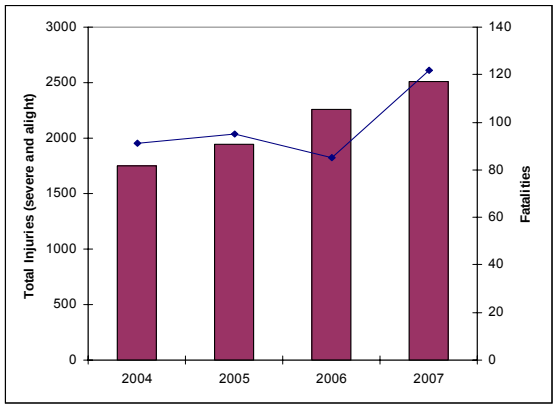


Figure 3.6. Montenegro: Fatalities and Injuries in Montenegro, 2004–07



3.53 **The economic cost of traffic accidents is likely to exceed 2 percent of GDP,** largely as a result of the risen number of registered vehicles. It has grown by more than 50 percent during 2004–07, contributing to the increase in the number of accidents and personal damages by more than 40 percent during the same period of time. As the number of vehicles is expected to grow even further, it can be deducted that, under *ceteris paribus* conditions, the number of traffic accidents and, with it, injuries and

fatalities will continue to grow as well. Already, the socio-economic costs of traffic accidents are very high, with the large amount of accidents and fatalities presenting a growing burden for the health sector. With estimated economic costs exceeding 2 percent of GDP, the situation is worse than the typical situation for middle-income countries, where the costs of road crashes averages about 1.5 percent of GDP (Peden et al., 2004).

The Railway and Maritime Sectors

3.54 **Montenegrin Railways (ZCG) has a small network with rolling stock and tracks in poor condition.** The railway company operates 330 kilometers of track, with a 167-kilometer main line connecting the port of Bar with Podgorica and the border with Serbia. In addition, ZCG maintains an 83-kilometer send line connection between Nikšić, Podgorica, and the Albanian border. During 2005–07, the number of carried passengers has been about 1 million, with a regular yearly average decrease in passenger transport for the last 17 years. Freight has seen a continuous increase since 2003, but the level is still one-third of the volume of operations prior to the dissolution of SFR Yugoslavia. Speed is often below 50 kilometers per hour on key routes, largely due to the poor state of rail infrastructure and safety concerns. About one-half of the total number of vehicles (locomotives and trains) is not in working condition, and defective cars are used for spare parts.

3.55 **Increased competition from the road sector, paired with unresolved safety concerns, constrain growth in railroad traffic**, as reflected in the low (and uncompetitive) speed made necessary by safety concerns and the poor state of tracks and rolling-stock. The country's worst train accident in 2006 resulted in 45 deaths and 184 injured, further reducing the railway's attractiveness to passengers. With the majority of the passenger traffic occurring on the main north-south corridor, the construction of the Bar–Boljare highway will be to the detriment of ZCG.

3.56 **The port sector (especially Bar) is in a better situation, as traffic and the potential for private-sector participation increases**. The port of Bar, carrying about 95 percent of all harbor activities in Montenegro, is in the process of increasing private-sector participation as a way to improve its efficiency and performance. The port of Bar is well located in the Southern Adriatic Sea and has sufficient depth (12 meters) to be an attractive port destination. It has at its disposal a generally good infrastructure, which can accommodate additional traffic without major investments. Current trends are very encouraging: container traffic, for instance, has increased by more than 50 percent between 2006 and 2007, partly reflecting the large increase in imports.

Expenditure Needs

3.57 **The financing requirements of the sector are restricted to the road and rail sector,** including four broad categories of need for future expenditures:

(i) *standard maintenance*: recurrent expenditures for routine, winter, and scheduled periodic maintenance, which are necessary to ensure that the overall

infrastructure does not further deteriorate and that recovered road network can be maintained;

(ii) *maintenance backlog*: capital expenditures required to clear the current maintenance backlog and return the road network to good condition;

(iii) *safety-related investments*: capital expenditure required to improve the safety of road and rail network and align infrastructure with relevant European standards; and

(iv) *new infrastructure*: capital expenditure required to meet the development needs of the network, reflecting demand projections and integration objectives in the transport networks.

3.58 **Routine, periodic, and backlog maintenance costs alone are estimated to exceed €0.5 billion during 2008–12** (see Table 3.6). Adjusted for inflation, the level of expenditure (other than recurrent expenditure) required to address backlog maintenance during 2008–12 is estimated to exceed €280 million, slightly more than that for routine, winter, and periodic maintenance (€256 million). These estimates are based on the current road classification, implying that the updating of the current classification would likely lead to a reduction in both backlog and normal maintenance. However, these estimates include neither expenses for the maintenance of bridges and tunnels nor those for new construction or modernization.[54]

Table 3.6. Indicative Maintenance Cost Projections for Road Network, 2008–12
(In millions of inflation-adjusted euro)

	2008–12	
	Annual average	Total
Road network	107.4	537.0
Maintenance backlog	56.3	281.5
Routine and winter maintenance	21.9	109.5
Periodic maintenance	29.2	146.0
Main roads	43.5	217.5
Maintenance backlog	24.9	124.5
Routine and winter maintenance	5.7	28.5
Periodic maintenance	12.9	64.5
Secondary roads	23.0	115.0
Maintenance backlog	11.8	59.0
Routine and winter maintenance	3.4	17.0
Periodic maintenance	7.8	39.0
Local roads	40.9	204.5
Maintenance backlog	19.6	98.0
Routine and winter maintenance	12.8	64.0
Periodic maintenance	8.5	42.5

Source: World Bank staff estimates.

3.59 **The level of expenditure needed for recurrent maintenance of the road network is higher than the amount historically allocated for this purpose.** The level of estimated recurrent expenditure required to ensure that the main and secondary road network remains in a "steady state" condition amounts to €30 million per year, about 60 percent more than is spent at this time. This estimate includes approximately €10 million for routine and winter maintenance and €20 million for periodic maintenance. These sums do not include the €21 million necessary for the recurrent maintenance of the local road network—a sum far in excess of what has been spent for this purpose thus far.

[54] By international standards, these costs are relatively high. They reflect (i) decades of negligence; (ii) a current use of the road network by heavy-weight lorries not foreseen at the time of construction; and (iii) the difficult topological conditions.

3.60 **In addition, significant investments are required to reduce road-safety risks on the most dangerous sections of the road network.** The main recommendations of the survey included the installation of guard rails in strategic locations, improving junctions, introducing speed reducing measures in towns and facilities for pedestrians, pre-warning, and local speed limits in sharp curves. Based on the sample of roads surveyed, it was estimated that a budget of altogether €105–138 million would be needed over a medium-term horizon to improve the road-safety situation on the entire main network of 1,848 kilometers.

Transport Sector Development Plans

3.61 **Government foresees €3.2 billion in road-sector investments.** These include the two major highway corridors, with estimated coasts of €2 billion for the Bar–Boljare highway and €0.8 billion for the Adriatic-Ionian highway. In addition, the Draft Transport Development Strategy lists 13 road projects with a total cost estimate of €588 million for the period 2008–15 (Table 3.7), including the reconstruction of the road between Nikšić and the border with Bosnia and Herzegovina.

Table 3.7. Montenegro: Strategically Important Road Infrastructure Projects

	Projected time of construction (years)	Preliminary cost estimates		
		in billions of euro	in percent of 2007 GDP	Implied annual average
Strategic road projects	…	3.358	132.0	…
Of which: covered by main road backlog	…	0.125	4.9	…
Strategic road projects, net of backlog	…	3.234	127.1	…
Construction of highway between Bar and Boljare (border with Serbia)	5	2.000	78.6	0.400
Construction of Adriatic-Ionian highway (between Croatian and Albanian borders)	6	0.770	30.3	0.128
Construction of mini by-pass in Podgorica	2	0.025	1.0	0.013
Reconstruction of coastal road from Podgorica to the border with Croatia	3	0.035	1.4	0.012
Construction of by-pass in Bijelo Polje	3	0.012	0.5	0.004
Reconstruction of road between Nikšić and border with Bosnia-Herzegovina	9	0.093	3.6	0.010
Construction of road between Risan and Žabljak	9	0.093	3.6	0.010
Construction of road between Gusinje-Plav and Veruša	4	0.035	1.4	0.009
Construction of road between Cetinje and Nikšić	5	0.085	3.3	0.017
Construction of by-pass in Rožaje	2	0.014	0.5	0.007
(Re)construction of road Hercog-Novi–Trebinje (section Meljine–Petijevici)	3	0.014	0.5	0.005
Construction of Verige bridge over Boka Kotorska bay	2.5	0.087	3.4	0.035
Reconstruction of Adriatic road	5	0.059	2.3	0.012
Reconstruction, modernization of road Podgorica–Nikšić–Trebinje (border with Bił	3	0.018	0.7	0.006
Construction of by-pass Golubovci	2	0.010	0.4	0.005
Upgrading of transport connectivity with Šavnik and Žabljak with arterial network	2	0.009	0.4	0.005

Source: Draft Transport Development Strategy, and MMATT.

3.62 **In the railway sector, the priority remains to improve the speed and safety on the main corridors and to implement the restructuring plan.** One priority is to allow an increase of speed, which would require substantial investments in the reconstruction of tunnels and slopes. Although the railway network is relatively small, with only 250 kilometers of tracks, infrastructure assets are valued at €2.2 billion. Still, it remains one of the most expensive railways in Europe in terms of the unit costs of maintenance, which is mainly due to the country's mountainousness. As a result, maintenance costs are at about €70,000 per kilometer and year. For the main corridor Bar–Vrbnica, this means maintenance costs of about €11.8 million, significantly

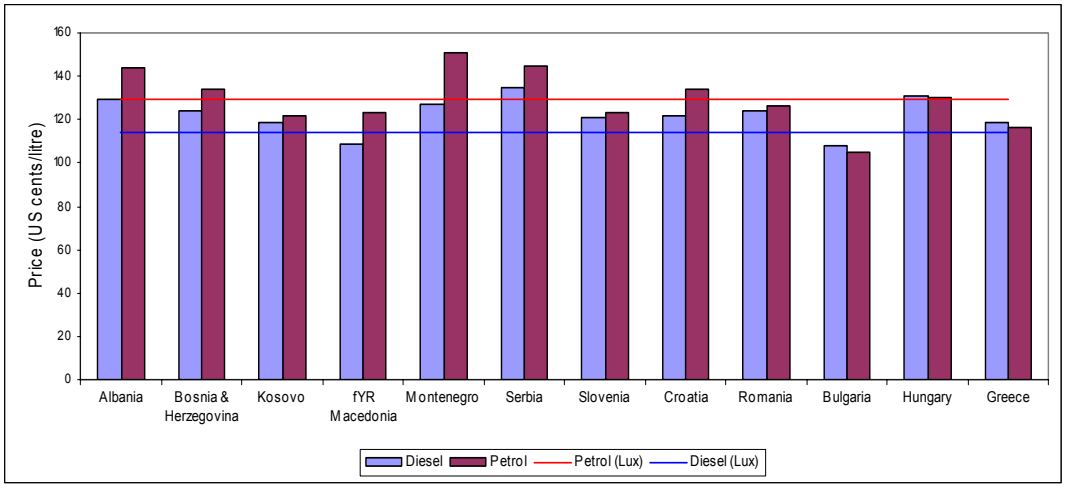
exceeding the total railway maintenance expenditures of €3–7 million in past years (MMATT, 2007). In addition, the 2006 railway accident made safety considerations a strategic priority, requiring investment in infrastructure as well as the rehabilitation of trains. Finally, an important objective of the railways company remains the implementation of its restructuring plan, which should not only improves its financial performance but also allow private participation in the operating company. For the port and airport sectors, financing needs are important but—as discussed above—will not require significant public contribution.

Revenues from the Road Sector

3.63 **The road sector has been a net contributor to the central budget.**[55] The total revenue from road user taxes is estimated at €165 million (or 6.5 percent of GDP)—this is three times as much as the expenditures on roads. In this, Montenegro is not different from its neighbors in the Western Balkans, or indeed elsewhere in Europe. However, the relative importance of the fuel tax as a source of revenue is particular. As a share of tax revenues, fuel taxes amount to 21 percent. This figure contrasts to less than 10 percent in Albania, Kosovo, and the average in EU countries. An additional €6 million comes from a road tax, which is equivalent to a vignette for the use of roads.

3.64 **Fuel is already taxed at high rates**. According to GtZ (2007), on the basis of November 2006 fuel prices, only FYR Macedonia could sensibly consider an increase in taxation for both diesel and petrol products.[56] For Montenegro, together with Albania, Bosnia and Herzegovina, and Serbia, prices for these products are already at or above EU levels, and any further increases would need to be considered carefully, also for reasons of affordability and social and regional cohesion.

Figure 3.7. Fuel Price Comparisons in (South) East Europe, November 2006



[55] It is standard practice not to establish a direct link between transport-sector receipts, which represent budgetary revenues, and the sources of financing, which follow budget allocations to the sector.

[56] Under the "user pays" principle, there is an issue with increasing taxes on diesel not used for motor vehicle purposes that would need to be addressed.

Source: GTZ (2007).

3.65 **In the railway sector, operating revenue is insufficient to cover operating expenses.** Like several railways in the region, the Montenegrin railways company is a loss-making entity, unable to operate without subsidies. Given the increasing competition from the road sector, it is unlikely for the revenue base to be increased. Without further reforms, ZCG cannot bring revenues at par with operating costs. As discussed above, the implementation of reforms, combined with a reduction in loss-making activities, could help to bring into balance costs and revenues. Additional investments would be required to improve the performance and safety of the railways.

Key Recommendations

Strengthening the Institutional Framework

3.66 **In recent years, the funding provided to the road and railway sectors have been insufficient to clear backlog maintenance and perform routine and periodic maintenance.** This resulted in delays in implementing some priority constructions. If Government decided to realize existing expenditure plans, as discussed above, it would have to provide the fiscal space necessary for significant increases in the allocation from the budget, together with additional contributions from multilateral or bilateral development partners. The alternative is, of course, to radically revise the proposed implementation schedule for capital projects.

3.67 **Given very high socio-economic costs, a coherent safety strategy for all modes of transportation should be made a high priority,** implying that sufficient resources be allocated so as to ensure that the necessary measures and reforms can be implemented. A clear transport investment plan is important to prioritize and sequence expenditures for backlog maintenance, to address challenges in recurrent and periodic maintenance, to upgrade the network and (re)construct road segments of strategic importance. It is thus crucial to base decisions on robust estimates of current and projected demand, specifying a multi-annual financing framework for corresponding expenditures.

3.68 **A detailed medium-term budgetary program can develop into an important planning tool for prioritizing and sequencing public investments.** As such, it places fiscal constraints over the transport strategy, requiring the development of criteria according to which decisions on the identification of projects are made and available alternatives to public investments assessed. This requires a careful weighing of costs and benefits, including their broader socio-economic impacts. Sound feasibility studies represent an important tool for this task, while careful project designs which integrate measures aimed at increasing safety features and decreasing maintenance requirements can reduce future rehabilitation or safety improvement works. Detailed designs of road projects should only be initiated *after* the corresponding feasibility studies were completed and budgetary resources been made available in the context of a medium-term expenditure framework.

3.69 **There needs to be a clear delineation between the roles of Government and those of the institution responsible for managing the road network.** Government should restrict itself to setting the policy agenda and promoting the necessary reforms and legislative actions. Management functions should rest with "company-like" bodies with competent staff and a clear mandate of strong performance. The management bodies should be given autonomy to manage their tasks independently, without undue interference from Government.

3.70 **There is a need for significant efforts in institutional strengthening and capacity building in various institutions in the transport sector.** The reforms being implemented will create a high demand on the staff of existing and newly created institution to perform their new functions. With the increase of budget in the road sector, the DPR would need additional resources for planning and supervising more works. An increased role of the private sector means that specific skills will have to be attracted and retain to design, procure and monitor PPP projects. Staff with the require expertise should be recruited and retained. The reforms in railways to make the railway company a more commercial entity and to regulate the sector would also require more modern techniques and skills less available in the public sector (such as experts in the finance, legal, and regulatory fields).

Improving Management Structures

3.71 **To improve performance, the DPR's management structure needs to be modernized.** Steps in this direction would include (i) a clearer delineation of responsibilities within the DPR; (ii) the definition of clear goals and targets, in close cooperation with the MMATT (possibly through the signing of a bilateral performance agreement); and (iii) human resource actions aimed at retaining and attracting a sufficient numbers of highly qualified staff (which probably need to be paid at wage levels equivalent to the private sector); and (iv) the provision of training programs, with a view to ensuring that the organization is up-to-date regarding latest developments and best practice in road management, planning, and prioritization, as well as methods to ensure efficient spending.

3.72 **There should be an up-to-date road inventory database that covers all the classes of roads under the agency's control,** which should include details on the surface type, condition, drainage structures and usage (volume and type of traffic) on individual roads. It is important to standardize the road inventory and keep it as simple as possible so as to avoid incurring extra costs on collecting large pieces of information that may not be useful. The road inventory would serve as an important instrument to review and update the functional classification system (accompanied, where necessary, by the strengthening of the overarching legal framework). The laws should be explicit in referring to the criteria for each class of road—that is, main, secondary and local roads—and in describing the procedures under which transfers from one category to another or those governing the designation for new roads. Responsible agencies for each class of roads should be mentioned, including clear chains of command, responsibility, and funding. Any changes to the road network, at any level, would need to be clearly reflected in the ownership record.

3.73 **An asset management system should be maintained and updated.** Data should be continuously collected on road inventory and basic traffic counts. Pavement conditions should be monitored on a rolling basis, as should be the revolving functional importance of different roads within the network. This would aid in the definition of network-wide maintenance priorities. The Asset Management System should support the preparation of both annual and multiannual plans for maintaining the road network taking into account the condition, function, available funding and prioritization. The use of economic decision models like the Highway Design and Management (HDM-4) model would be instrumental in assisting effective prioritization processes.

3.74 **Good management practices require increased accountability,** transcending the term's narrow definition, which restricted companies to simply justify the use of the funds received. The concept needs to be looked at more broadly, with road users as one principal target audience. This would require the agency to have (i) established good financial management systems and auditing processes; (ii) assessed the needs of road users (including through user satisfaction surveys); (iii) evaluated the performance of the agency against pre-determined performance criteria; and (iv) prepared annual reports that discuss the aforementioned elements.

Recommended measures

3.75 **The private sector can play a more active role in the maintenance of the road network, resulting in possibly significant cost savings.** This could be done through the widespread introduction of output- and performance-based (OPRC) maintenance contracts, defining a "final product". The work selection, design, and product delivery —including underlying decisions on the methods used—would be entirely the contractors' responsibility. Relative to traditional contract arrangements, OPRCs allocate a higher risk to the contractor. But this is intended, as they create incentives to improve efficiencies in the process and a higher degree of effectiveness in the design, technology, and management (as the contractor seeks to minimize cost for achieving a given output). Other innovations in the management and maintenance of the road network should be explored for the applicability to the Montenegrin situation, ranging from experiences made elsewhere with concession and maintenance contracts, management area contracts (used, e.g., by the UK Highways Agency), while applying stricter quality control to improve allocative efficiency.

3.76 **Current investment needs, notwithstanding the recent budget increase and possible private-sector participation, will require a significant increase in public funds relative to previous years.** Public funds are roughly adequate to ensure proper routine and periodic maintenance, leaving unfunded both backlog maintenance and plans for the construction of new highways. International experience shows that PPP arrangements for the construction of motorways require a significant participation from the public sector to make the project financially and economically viable—and this is more likely the case in a small, mountainous country like Montenegro. The already high level of user charges reduces the potential for further increases, while there has been only limited experience of toll roads in Montenegro. Such

considerations suggest that a significant budget allocation is likely to be required in the coming years to implement the planned investment program.

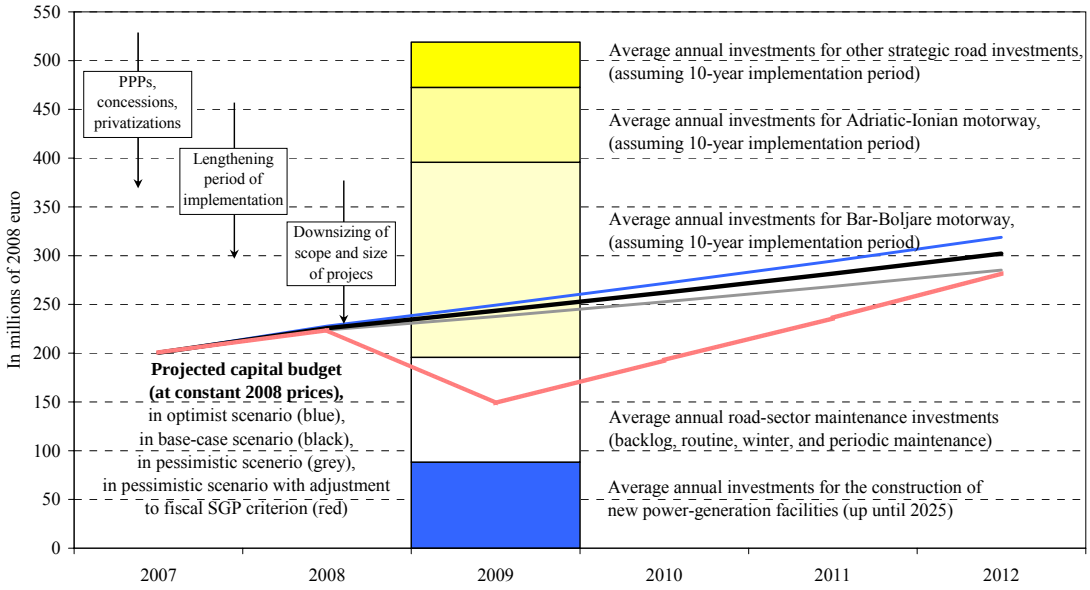
3.77 **Montenegro needs a concession law that draws from best international practice.** International experience has shown that successfully PPP projects benefitted from an overarching legal, regulatory, and policy framework that is consistent in itself. Montenegro is taking concrete steps towards increasing private-sector participation, not only in the transport sector. However, international investors are likely to be more attracted to a pipeline of PPPs as it allows the costs associated with preparing a proposal across several projects. Moreover, smaller projects—certainly when viewed from an international perspective—would result in lower financing capacity thresholds required from potential bidders. Government could thus receive more proposals from local and regional investors. However, as the country's PPP program strengthens, the role for the strong legal, regulatory and institutional framework, including on the management of related contingent liabilities, is also becoming a priority. The merits of establishing a specialist PPP unit should be considered.

3.78 **The definition of a PPP agenda for the broad transport sector and the individual projects' scope and size presupposes caution and a sense of realism.** Experience of PPPs has shown that projects that require investments at the level foreseen for the Bar–Boljare project will only attract a handful of bidders that will have the required expertise and financial strength. The level of borrowing required and the limited reliability of traffic forecasts make these projects very risky for lenders. One way to reduce this risk is to simply reduce the scope of the project, or implement it in phases (such as the initial construction a two-lane highway, which is to be extended to four lanes at a later point in time). In addition, the structuring and procurement of a complex PPP project requires time. This means that the invitation to bidders to submit proposals should start only when most of the concerns expressed by them have been addressed. Not doing so would likely reduce a project's attractiveness, limiting the number of bidders, and the value of the PPP option for Government.

C. Concluding Remarks

3.79 **The public investment program outlined in the Chapter will be implemented during in a phase of the business cycle that will be less benign than during 2006–07.** The international environment has deteriorated considerably, while endogenous and exogenous factors that have fueled the boom during the immediate post-independence period are beginning to dissipate. As a result, tax revenues—as a share of GDP—will decline. To protect the capital budget from the fluctuations in the overall business environment, and to be able to gradually increase public investments, very considerable efforts will have to be made, as discussed in the next Chapter, to contain recurrent expenditure obligations. Under the constraints and economic assumptions discussed in Chapter II, the capital budget could increase, at 2008 prices, by about 30–40 percent between 2008 and 2012. However, the aforementioned investment plans in the two priority sectors energy and transport alone exceed the fiscal space by a considerable margin (see Figure 3.8).

Figure 3.8. Montenegro: Public Investments and Fiscal Constraints



3.80 **The realization of the Government's investment plans thus requires utmost care and caution.** For every project, policymakers need to carefully assess the degree to which the private-sector might find it economically profitable to (co-)finance these projects—whether in the form of PPPs, concessions, or outright privatizations. However, in order to be able to negotiate any form of private-sector participation, Montenegro needs to urgently adopt a concession law that draws from best international practice. Some reforms and projects—for instance, those related to EPCG—open themselves to the option of full privatization, while others are more effectively be realized by carefully negotiated PPPs or concession arrangements. It is critical that (i) feasibility studies address risks and costs as frankly as inherent potentials and benefits; (ii) possible contingent liabilities are carefully assessed; and (iii) proper procedures of tendering are applied and "shortcuts" avoided. Government has to have the courage to reject those projects that—even after considerable "political capital" has been invested—proves economically not viable and would, consequently, present an undue burden to subsequent budgets. Concomitantly, policymakers need to carefully assess whether the implementation period of a given project could be usefully expanded. For the two motorways, a lengthening of expected construction period—partly for the reasons mentioned in Box 2.1—would bring the timeline closer to the experiences with similar investments elsewhere. In addition, Government needs to strengthen its cross-sectoral development strategy, define criteria of prioritization, and reassess the scope and size of projects currently foreseen. All of these measures, as summarized in Figure 3.8, could help to bring annual costs for public investments closer to the available fiscal envelope. And lastly, without strict control over the recurrent budget, these investments would soon be out of reach entirely.

APPENDIX

Beyond Prestige Objects: Challenges of Road Safety[57]

A3.1 **Long periods of negligence incur large social and economic costs,** necessitating Government to undertake considerable investments for the existing road network as well. With large growth rates in (i) international trade; (ii) tourism; and (iii) domestic car ownership, existing roads have not been constructed for the demand for road infrastructure. The result are economic costs in terms of time foregone (traffic jams) and, particularly, the social and economic costs of car accidents. The following section, by means of example, highlights the challenges and recommends policies to remedy this situation.

A3.2 **The road safety situation in Montenegro is very poor,** compared to both the EU average and neighbors in the region. The fatality rate on Montenegro's roads—measured as deaths per capita—is 50 percent higher than that of EU average. Taking into account that car ownership in Montenegro is still considerably lower than the European Union average, this situation will deteriorate even further if no actions are taken. Traffic accidents entail considerable economic losses, adding a development problem to human tragedy. In Montenegro, as well as in the other countries in the Balkans and the EU, efforts have been made in recent years to address this problem, but reforms were insufficient and inadequate—partly because addressing the situation properly requires considerable investments.

A3.3 **Even within a regional context, Montenegro has a very high fatality rate.** The collected accident data show that road safety is a big—and increasing—problem, with more than 2,000 killed or injured every year. During 2004–07, the number of killed and injured has increased by an average 12.6 percent annually, from 1,841 in 2004 to 2,628 in 2007 (Table 3.8). Comparing Montenegro's figures, expressed in fatalities per one million inhabitants, to those of other European countries (see Figure 3.9) shows that Montenegro is ranking not only significantly higher than the 15 "old" EU countries but also higher than the 10 "new" EU countries. In Montenegro, 143 fatalities were registered per 1,000,000 inhabitants (average 2005/2006), while the EU-25 average in 2005 was 91 fatalities per 1,000,000 inhabitants (82 for EU-15 and 136 for EU-10)[58]. Montenegro has also a higher fatality rate from road accidents than some of the neighboring countries, such as Serbia (117), Bulgaria (124)[59], and Slovenia (129). Whereas the trend in EU is towards a decline in number of fatalities and injuries, Montenegro's figures point in the opposite direction. Montenegro's fatality rate, between 7 and 8 per 10,000 vehicles, is more than 5 times higher than some of the best performing countries in EU, and higher than that of most of its neighbors.

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[57] Prepared by Jesper Mertner, Senior Road Safety Expert, COWIS A/S. For the full report, see COWIS A/S (2008).

[58] CARE database EU.

[59] Data collected during several studies in the region.

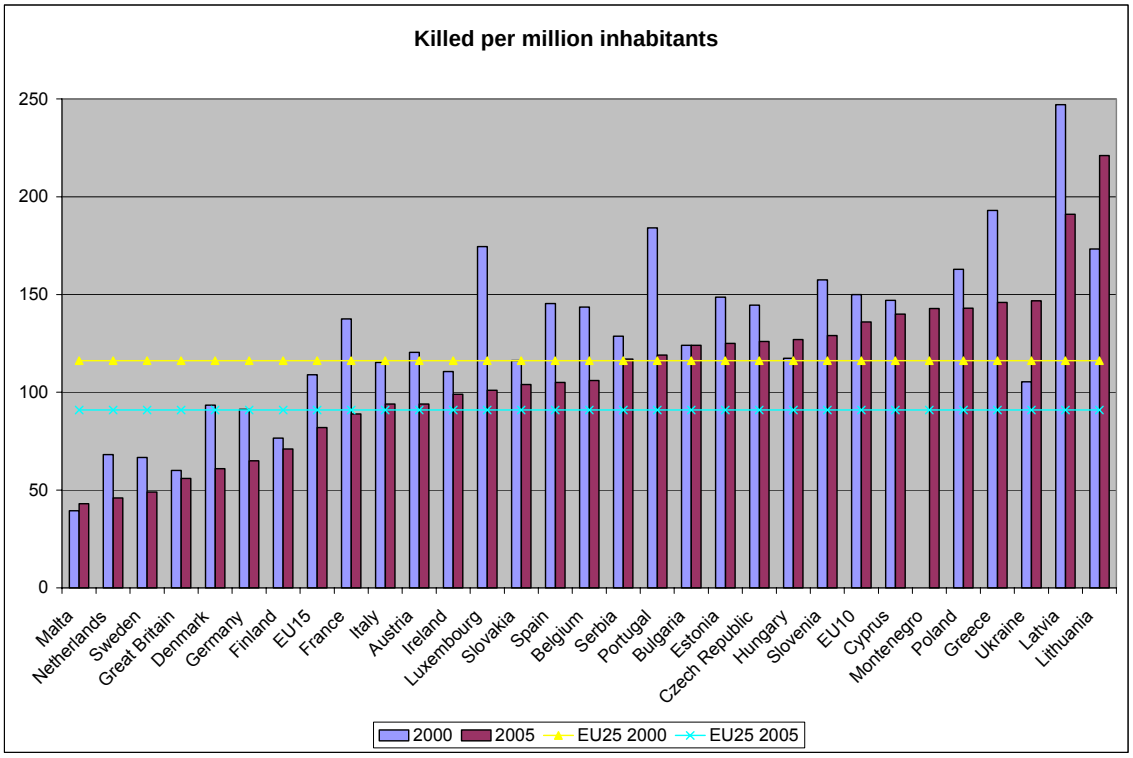
Table 3.8 Montenegro: Car Accidents, Injuries, and Casualties, 2004–07

	2004[1]	2005[1]	2006[1]	2007[2]
Total accidents	5,377	6,192	7,185	8,760
Damage only	4,157	4,845	5,631	7,008
With personal damages	1,220	1,347	1,554	1,752
Casualties[3]	1,841	2,037	2,342	2,628
Fatalities	91	95	85	122
Injuries (light and severe)[3]	1,750	1,942	2,257	2,506

Sources: [1] Louis Berger SAS, *Road Accident Reduction Benefits* , Technical Memorandum No. 12; [2] Policy Directorate.

[3] consultant's estimates, based on other data sources, for 2007.

Figure 3.9. Fatalities Per One Million Inhabitants, 2000, 2005



A3.4 **The economic cost of traffic accidents is estimated to exceed 2 percent of GDP.** The number of registered vehicles has grown by more than 50 percent during 2004–07, while the number of accidents and personal damages has increased by more than 40 percent. As the number of vehicles will grow further, it is likely that, under *ceteris paribus* conditions, the number of traffic accidents and injuries will continue to

grow. Already, the socio-economic costs of traffic accidents are very high, with the large amount of accidents and fatalities presenting a growing burden for the health sector; see Peden et al. (2004). They report that, in many low- and middle-income countries, the burden of traffic-related injuries is such that they represent between 30 and 86 percent of all trauma admissions. Traffic accidents are very costly for a society, posing a development problem as much as they represent human tragedies. As reported in Louis Berger SAS (2008), apart from human suffering and the loss of life, accidents result in losses to the economy of at least €38 million a year (based on 2006 data), and these losses could well be in excess of €50 millions per year, depending on unit prices used. This is equivalent to at least 2 percent of GDP—a high figure when compared to the typical situation for middle-income countries, where costs of road crashes averages at about 1.5 percent of GDP (Peden et al., 2004).

A3.5 **Actions to improve road safety therefore need to be taken urgently.** During the period 2004–07, there have been almost 400 deaths and over 8,000 injuries in road accidents, resulting in estimated economic losses to the Montenegrin economy of over €150 million. Unless urgent and effective action is taken to reduce the annual toll of deaths and injuries, such human and economic losses will continue into the future. No country however developed can afford to sustain such losses year after year so Montenegro must address this growing problem by taking the necessary actions to improve road safety. Recurring and growing losses of this magnitude are undoubtedly inhibiting economic development and Government needs to recognize that failure to invest in road safety will result in such losses continuing year after year.

Road Safety Inspection

A3.6 **For this PEIR, a EuroRAP-style road safety assessment was undertaken** on a sample of the main and regional road network, providing also general impressions of problems and recommendations. A number of sample roads were selected for assessment of the road safety condition of the roads. The total length of roads inspected for road safety condition was 550 kilometers, accounting for more than 60 percent of highways (885 kilometers) or 30 percent of regional roads and highways (1848 kilometers).

- 136 kilometers on route M2: Podgorica—Mioska—Kolašin—Ribarevina—Bijele Polje—Border with Serbia (136 km);
- 137 kilometers on route M18: Podgorica—Nikšić—Plužine—Border to Bosnia-Herzegovina;
- 37 kilometers on route M6: Nikšić—Border to Bosnia-Herzegovina;
- 58 kilometers on route M2.3: Podgorica—Cetinje—Budva;
- 26 kilometers on route M2: Border to Croatia—Igalo—Kameneri;
- 40 kilometers on route M2.1: Kamenari—Risan—Kotor;
- 35 kilometers on route M2: Kotor—Radanovići—Budva—Petrovac;
- 47 kilometers on route M2.4: Petrovac—Bar—Ulcinj/Ulqin;
- 27 kilometers on route M2: Virpazar – Podgorica;
- 13 kilometers on New Tunnel road: Sutomore—Virpazar.

The EuroRAP methodology is based on three protocols (see EuroRAP, 2006, and Lynam et al., 2007) that can be applied in any country assuming accident data are

available, viz., (i) risk rate mapping; (ii) performance tracking; and (iii) road protection score:

- ***Risk mapping*** is the preparation of colored maps showing the risk of deaths and injured that road users face, divided into individual risk and community risk. The individual risk is based on registered accidents and traffic. The accident rate (for instance, killed and serious injured per year per million vehicle kilometers) is calculated and typically illustrated on maps. By presenting the accident rate, the risk compared to the traffic may be assessed. The community risk is more targeted towards the road authorities and these maps will typically show the density of accidents (for instance, fatalities and serious inured per kilometer). Other maps could be comparison with similar roads and the potential for accident reduction. Only limited accident data by road section were made available; however, for route M2, some accidents have been collected for a 1½-year period as part of the feasibility study for M2; see Louis Berger SAS (2008b).. Thus risk mapping may be illustrated for parts of M2 for the rather short period.

- ***Performance tracking*** is a way to for instance evaluate benefits of safety schemes by identifying the development of killed and serious injured on road sections over time. Typically, road sections which have shown a reduction in the number of accidents over time are identified as well as those with little or no changes. The data are checked for consistency. The measures applied on the road (remedial, enforcement, and education) that may explain the change are indicated. Until now, only Britain has presented results on performance tracking and road improvements, but work is also ongoing as part of national programs in Austria, Ireland, Italy, and Spain. There were insufficient data to allow for performance tracking in Montenegro.

- ***Road protection score*** is based on the EuroRAP-style assessment of the roads. It is focused on addressing four types of accidents generally accounting for more than 80 percent of fatalities on non-urban roads—viz., head-on collisions, single-vehicle accidents, intersection collisions; and accidents involving vulnerable road users. Roads are assessed according to (i) how well the medians are treated (separation of directions); (ii) the design standard and frequency of intersections; (iii) how well the road sides are protected and how the edge of the carriageway is treated; and (iv) the availability of facilities for pedestrians and cyclists. The road is given a score between 1 (lowest) and 4 (highest score) for each of the four elements, and the scores are aggregated to produce a "risk rating" for the roads. If data are available, the four elements are weighted according to the distribution of fatalities on rural roads among the four elements.

    - ***Median treatment.*** To obtain 4 points on median treatment, the road should be divided by a wide median, while 1 point is given for typical undivided single carriageways as most of the Montenegrin roads. Thus, almost all rural roads in Montenegro would presently be assessed to 1 with regard to the median treatment.

- ***Edge-of-road protection.*** To obtain 4 points on edge-of-road protection, there should be at least 3.5 meters hard shoulders, continuous safety barriers, or a 10-meter safety zone. In addition, the section should be rather straight and flat. Most of the inspected roads have no or only narrow shoulders, only barriers on most severe sites and are running through mountainous terrain with generally high frequency for sharp bends and crests and dips. Thus the Montenegrin roads were generally given a score of 1–2 points.

- ***Intersections.*** With regard to intersections, 4 points can be given if major intersections are out of level (merging traffic only) and the frequency of minor intersections are low, thus no 4-leg junctions and less than 1 T-junctions per kilometer. In Montenegro, most major intersections in the rural area are a T-level priority junctions, thus scoring 1 point while on most roads there is a rather low frequency of minor junctions thus scoring 2–4 points, thus the score for intersections will typical be between 1.5 and 2.5 points.

- ***Facilities for non-motorized traffic.*** Roads should to obtain a rating 4 for the provision of facilities for non-motorized traffic. This could be provided with protected crossings where traffic moves slowly, and be provided with segregated footways and cycle-ways. If there is no provision the rating is 1. In the rural areas there are generally no facilities for non-motorized traffic, thus the score is generally close to 1.

- ***Build up areas.*** In addition to the EuroRAP assessment, the survey also registered facilities that were used in linear villages, towns, and other build-up areas. Apart from a few footways, unprotected pedestrian crossings, and a very limited number of humps, there are generally no measures used in the build-up areas to support the lower speed limit.

Road Safety Inspection

A3.7 **The survey estimated a fatality accident rate of 0.06 per one million vehicle kilometers on the main M2 north-south route through Podgorica.** This figure is three to eight times higher than in many other European countries. For single carriageways, such as the M2, fatality rates are between 0.008 (Sweden), 0.01 (UK and Ireland) and 0.02 (Spain). In general, single carriageways tend to have the highest fatal rates (compared to motorways and dual carriageways). There are generally large variations in risk rates among countries, but also between single carriageway roads in a country. The same is the case on M2 in Montenegro. Average fatality rates vary from 0.00 to 0.19 fatal accidents per one million vehicle kilometers, with the highest fatality rate found between Podgorica and Bioče; see Tables 3.8–3.9.

A3.8 **The average fatality density on M2 in Montengro is 0.13 fatal accidents per kilometer per year,** varying from 0 to 0.38 fatal accidents per kilometer per year. The highest density of fatalities is found, again, between Podgorica and Bioče; see Table 3.13. The data appear imply that the seriousness of the accidents tends to be highest in

the mountainous areas to the North of Podgorica, where—on some sections—more than 50 percent of the accidents involve fatalities and/or injuries. The underlying reasons appear to be a combination of two reasons, viz., (i) the traffic level near Podgorica is higher, resulting in lower average speed; and (ii) in the mountainous areas, an accident will not be as forgiving, leading to a higher number of fatalities and injuries per accident.

Table 3.9 Montenegro. Accidents on Route M2, 2006–2007-S1

From	To	km	traffic	Accidents per year (2006 and first half 2007)			
				fatalities	injuries	damages	all
Barski most	Bijelo Polje	13.0	5,518	0.7	18.0	32.0	50.7
Bijelo Polje	Ribarevina	5.6	5,518	0.0	14.7	26.0	40.7
Ribarevina	Slijepac most	6.0	5,052	0.0	7.3	7.3	14.6
Slijepac most	Mojkovac	17.0	5,832	4.7	24.0	23.3	52.0
Mojkovac	Kolasin	20.2	6,552	2.7	20.0	32.0	54.7
Kolasin	Mioska	17.1	4,325	2.0	24.7	21.3	48.0
Mioska	Man. Moraca	7.2	4,485	0.0	4.0	16.0	20.0
Man. Moraca	Bioce	32.0	4,485	4.7	24.7	46.0	75.4
Bioce	Podgorica	7.1	5,380	2.7	18.7	54.0	75.4
Podgorica	Golubovci	6.5	6,875	0.7	46.0	93.3	140.0
Golubovci	Virpazar	20.1	6,875	1.3	12.0	42.0	55.3
Total		**151.8**	**5,503**	**19.5**	**214.1**	**393.2**	**626.8**

Source: COWIS (2008).

Table 3.10 Montenegro. Accident Rates on Route M2, 2006–2007-S1

From	To	km	traffic	Accidents rates per million vehicle kilometers			
				fatalities	injuries	damages	all
Barski most	Bijelo Polje	13.0	5,518	0.03	0.69	1.22	1.94
Bijelo Polje	Ribarevina	5.6	5,518	0.00	1.30	2.31	3.61
Ribarevina	Slijepac most	6.0	5,052	0.00	0.66	0.67	1.33
Slijepac most	Mojkovac	17.0	5,832	0.13	0.66	0.64	1.43
Mojkovac	Kolasin	20.2	6,552	0.06	0.41	0.66	1.13
Kolasin	Mioska	17.1	4,325	0.07	0.91	0.79	1.77
Mioska	Man. Moraca	7.2	4,485	0.00	0.34	1.36	1.70
Man. Moraca	Bioce	32.0	4,485	0.09	0.47	0.88	1.44
Bioce	Podgorica	7.1	5,380	0.19	1.34	3.87	5.40
Podgorica	Golubovci	6.5	6,875	0.04	2.82	5.72	8.58
Golubovci	Virpazar	20.1	6,875	0.03	0.24	0.83	1.10
Total		**151.8**	**5,503**	**0.06**	**0.70**	**1.29**	**2.06**

Source: COWIS (2008).

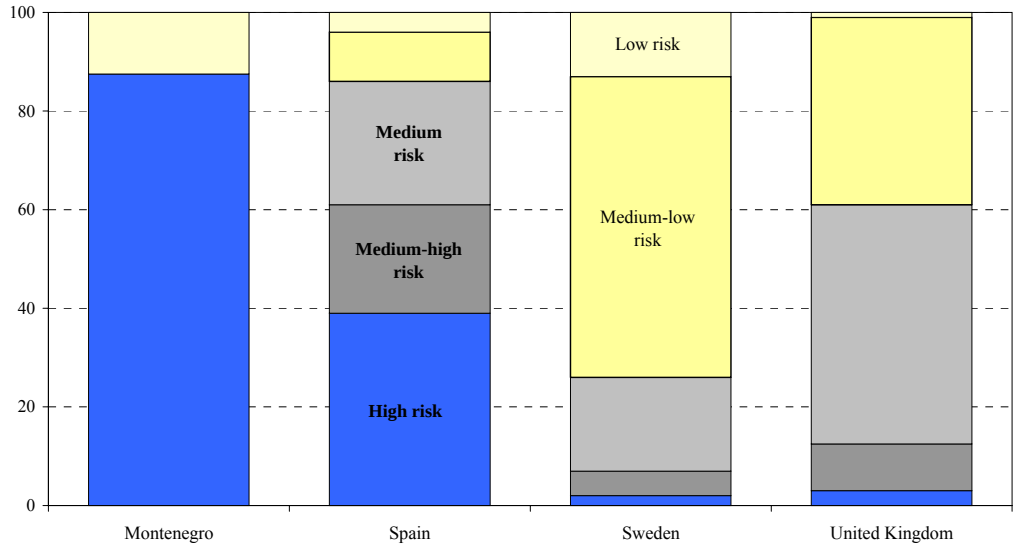
Table 3.11 Montenegro. Accident Density on Route M2, 2006–2007-S1

From	To	km	traffic	Accidents per kilometer per year			
				fatalities	injuries	damages	all
Barski most	Bijelo Polje	13.0	5,518	0.05	1.38	2.46	3.90
Bijelo Polje	Ribarevina	5.6	5,518	0.00	2.63	4.64	7.27
Ribarevina	Slijepac most	6.0	5,052	0.00	1.22	1.22	2.43
Slijepac most	Mojkovac	17.0	5,832	0.28	1.41	1.37	3.06
Mojkovac	Kolasin	20.2	6,552	0.13	0.99	1.58	2.71
Kolasin	Mioska	17.1	4,325	0.12	1.44	1.25	2.81
Mioska	Man. Moraca	7.2	4,485	0.00	0.56	2.22	2.78
Man. Moraca	Bioce	32.0	4,485	0.15	0.77	1.44	2.36
Bioce	Podgorica	7.1	5,380	0.38	2.63	7.61	10.62
Podgorica	Golubovci	6.5	6,875	0.11	7.08	14.35	21.54
Golubovci	Virpazar	20.1	6,875	0.06	0.60	2.09	2.75
Total		**151.8**	**5,503**	**0.13**	**1.41**	**2.59**	**4.13**

Source: COWIS (2008).

A3.9 **Most of Montenegro's road network is high risk, including those segments with a high traffic volume.** Comparing the distribution of risk rates by length of roads reveals an important difference to many other countries; see Figure 3.11. While most other countries tend to have a large proportion of road sections within the low-medium to medium risk rate, the M2 in Montenegro has almost 90 percent of its sections in the high group. Of the roads surveyed, the high-traffic route between Podgorica and Budva, as well as the roads linking Montenegro to Bosnia-Herzegovina,[60] are among the most dangerous.

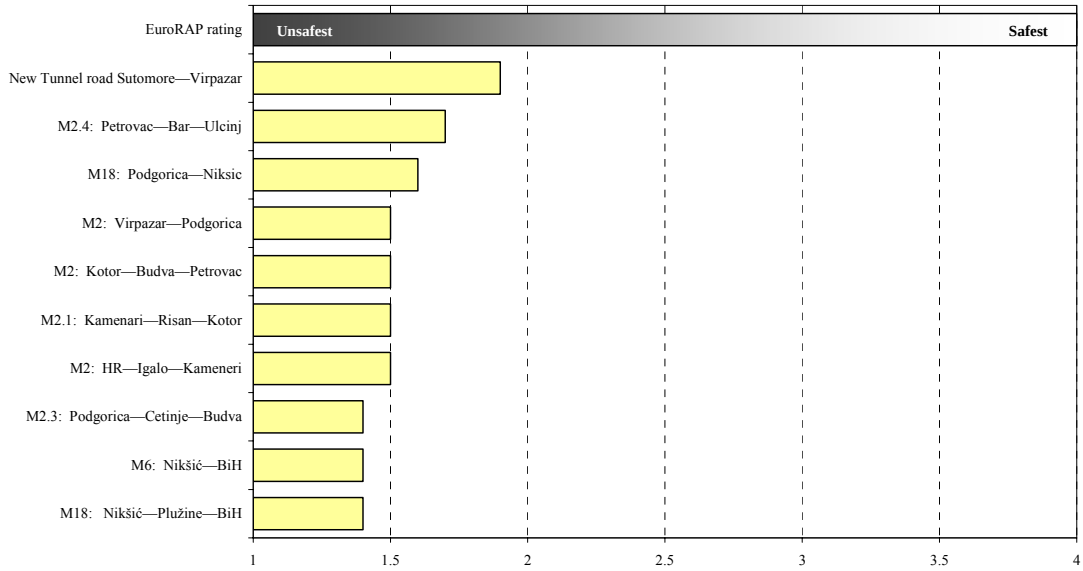
Figure 3.10. Distribution of Fatality Accident Risk Rates



Source: COWIS A/S (2008).

[60] Generally, the road networks tend to deteriorate closer border stations, including Albania.

Figure 3.12. Montenegro: EuroRAP Ratings for Select Roads



Source: COWIS (2008).

A3.10 **Generally, the key problems related to insufficient maintenance.** The survey found that (i) guard rails tended to be missing on inner and outer side of road where there are deep and steep slopes; (ii) existing guard rails were often damaged, too short, in poor condition, with gaps, and mixed with concrete poles; (iii) fixed objects (such as trees, poles, stones, or rigid signs) were posted within safety zone of road; (iv) mountain sides, stones, and concrete were within the road's safety zone; (v) curves were lacking background markings, warnings, and speed limits, (vi) bridges were often missing guard rails on approaches; (vii) tunnel entrances were obstructed by fixed objects; (viii) longer tunnels were missing light and guiding; (ix) tunnel road surface and tunnel walls were in poor condition; (x) stones were falling on the road from mountain sides on many sections; (xi) the use of signs was often lacking (local speed limits were not consistently used and the ending of local speed limits rarely indicated); (xii) warning signs for curves and steep gradients were not used consistently; (xiii) junctions were often designed too dynamic, often with very fast right turns; (xiv) the few pedestrian crossings were not always located properly and not clearly marked or protected; (xv) road markings were worn or missing; (xvi) there were no measures to motivate or force drivers to respect speed limits in build-up areas and in towns with speed limits; and (xvii) there were few or no facilities for pedestrians, forcing pedestrians onto the road. Road user conduct—with respect to speed, reckless overtaking, high speed in curves and build up areas—represents an additional risk element.

A3.11 **To remedy the aforementioned problems, based on the experience from similar roads in, for instance, Southern Serbia, the estimated cost per kilometer on the typical mountainous roads is estimated at around €60–80,000 per kilometer,** only for road safety improvements. On the flatter segments, the costs may be in the order of €45–55,000 per kilometer. The assessed costs are generally based on

the findings of the Feasibility study of the road between Belgrade and Montenegro; see COWIS (2007, 2008). The costs are mainly used to ensure the safety zone by guardrails, improvement of junctions, improvement of tunnels and improvement in built-up areas. This means that, only for the 550 kilometers on the road network sampled in this survey, the cost of applying the safety measures on the entire length would be in the magnitude of €35–45 million. Based on the available accident data from the M2 road, the cost assessments described above, the social costs of accidents used in the feasibility study in Serbia, and assuming an effect of 40 percent if all above described measures are applied will lead to economic benefits as shown in Table 3.12.

Table 3.12 Montenegro.Economic Benefit of Investment by Section (M2), 2006–2007-S1

From	To	Accident reductions per year				Benefits	Costs	Benefit/
		fatalities	injuries		damages			
			serious	light		(per year, in euro)		cost ratio
Barski most	Bijelo Polje	0.27	1.44	5.76	12.8	159,893	910,000	17.6
Bijelo Polje	Ribarevina	0	1.17	4.69	10.4	67,893	392,000	17.3
Ribarevina	Slijepac most	0	0.59	2.35	2.93	31,680	420,000	7.5
Slijepac most	Mojkovac	1.87	1.92	7.68	9.33	639,147	1,190,000	53.7
Mojkovac	Kolasin	1.07	1.6	6.4	12.8	397,333	1,414,000	28.1
Kolasin	Mioska	0.8	1.97	7.89	8.53	334,827	1,197,000	28.0
Mioska	Man. Moraca	0	0.32	1.28	6.4	22,080	504,000	4.4
Man. Moraca	Bioce	1.87	1.97	7.89	18.4	650,827	2,240,000	29.1
Bioce	Podgorica	1.07	1.49	5.97	21.6	400,907	355,000	112.9
Podgorica	Golubovci	0.27	3.68	14.72	37.33	294,187	325,000	90.5
Golubovci	Virpazar	0.53	0.96	3.84	16.8	216,907	1,005,000	21.6
Total		**8**	**17**	**68**	**157**	**3,215,680**	**9,952,000**	**32.3**

Source: COWIS (2008).

A3.12 **To improve the road safety situation on the entire main network of 1,848 kilometers costs an estimated €105–138 million.** The remaining roads are not expected to be in better road safety condition than the sample roads inspected, and may even be in worse condition than the sample roads, partly because the latter include the most frequently traveled roads in Montenegro. However, assuming that the remaining roads are in similar condition and that 80 percent are in mountainous areas would mean that, to improve all roads, the total costs would be in the range of €55–72 million on regional roads and another €50–66 million on highways.

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IV. PUBLIC ADMINISTRATION: EMPLOYMENT AND WAGES[61]

The wage bill—comprising more than one-fourth of all government expenditure—faces conflicting pressures. A set of policy measures will have to be implemented that can achieve the following objectives concomitantly, viz., to (i) increase effectiveness and professionalism of the public administration in key areas critical for achieving the EU integration objective; (ii) prevent a "brain drain" towards the private sector among the high-skilled; and (iii) contain the overall expenses for public-sector employees to a level that is consistent with the realization of the Government's broader fiscal policy priorities. This chapter discusses policy measures that could foster public-administration development. Much progress has been made over recent years, but the reform process will have to continue. The assessment of current challenges within the public administration have revealed that overall effectiveness could be increased by linking more closely pay and performance, defining job requirements and performance indicators, making recruitment more competitive, continuing the process of aligning priorities with staff, and outsourcing non-core functions to the private sector.

A. Background

4.1. **Montenegro has made considerable progress towards creating a more efficient public sector, including by readjusting the composition of public-sector employment towards priority sectors.** The reform process remains, however, work-in-progress; the relatively large public administration continues to be constrained by high costs and low effectiveness. The underlying problem transcends purely fiscal challenges. The large size of Government—due to the frequent existence of (i) overlapping functions; (ii) insufficient coordination; and (iii) ill-defined lines of accountability among ministries, agencies and other state subordinate entities—hampers decision-making processes and reduces the quality of service delivery. There has been a proliferation of agencies and subordinate entities enjoying operational autonomy and, in many instances, revenue-raising capabilities. Government thus faces a double challenge. On the one hand, for reasons of fiscal sustainability, the overall wage bill needs to be contained,[62] while, on the other one, an unreformed public administration risks to hamper policy-making and implementation, impacting value-for-money considerations and the quality of service delivery.

4.2. **Major elements of the 2003–09 Strategy for Public Administration Reform have already been implemented.** The public-administration reform has aimed at bringing public administration closer to EU standards and international best practices. The modernization program has included measures to increase overall efficiency in the delivery of public services—principally by (i) pursuing further decentralization; (ii) improving public service delivery quality; (iii) establishing competitive structures; (iv) creating a client-oriented public service; (v) accelerating administrative modernization, including through the increasing provision of e-government options; (vi) ensuring continued deregulation; and (vii) strengthening management and monitoring. The adoption of the public administration reform strategy, together with a clearly defined

[61] Prepared by Sanja Madžarević-Šujster, Danijela Vukajlović-Grba, and Danijel Nestić (all ECSPE).

[62] Chapter II recommends a policy that aims at keeping the wage bill constant in real terms.

action plan, represented an important step towards the modernization of Montenegro's public administration. This becomes particularly evident when comparing the experience in Montenegro to that of some of its Southeastern European neighbors.

4.3. **The legal foundation for the reform process has been laid.** In 2004, Parliament adopted the *Law on the Civil Service and Employees*, which addressed deficiencies that had previously existed in the legal definition of civil servants and state employees. Other changes affected, most notably, the de-politicization of the public administration (up to the level of state secretaries). Government introduced additional changes that strengthened rules for recruitment, promotion, and training, while regulating possible conflicts of interest. It streamlined the number of ministries,[63] established and strengthened regulatory bodies, and made initial strides towards reforming the salary system and introducing a merit-based pay system.

4.4. **The (sub-)legal framework for an efficient and effective public administration has been established.**[64] In particular, the relevant laws that regulate salaries and compensations for civil servants, state employees, state officials, and employees in the judiciary have been adopted since PEIR-1 (World Bank, 2006), while implementing regulations that (i) increased the decompression of wage rates (from 36 to 38 classes); (ii) set the basic salary; (iii) defined fixed and variable portions of salaries for state officials, civil servants, and state employees; and (iv) introduced a performance appraisal system. A significant portion of the legislation was adopted or amended during 2007 and became effective in 2008. It is still too early to assess the overall impact of the recent reforms. Some clauses have already been challenged in the administrative and constitutional courts, typically for reasons that gave ministers too much discretion over individual salaries or the establishment of "specialized" positions (including extra bonuses), thereby diluting the underlying "equal pay for equal work" principle. For a summary of post-PEIR-1 reforms, see Table 4.1.

4.5. **Still, further progress is required to ensure convergence with EU standards.** While the EU Progress Report (European Union, 2007) recognized the progress made towards a professional, efficient, accountable, transparent, and independent public administration, it refers to a number of existing weaknesses and inefficiencies. Additional efforts are needed to meet 1995 Madrid criteria[65] and be able

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[63] The new Government formed in 2006 has been smaller than the preceding one. Four deputy prime ministers and 15 ministers were replaced by two deputy prime ministers and 13 ministers. It has been proposed recently, however, to re-introduce a third Deputy Prime Minister.

[64] Government introduced additional changes to the organization and work of public administration. It closed the Agency for Public Administration, established the Human Resource Management Authority (HRMA), charged with the task of maintaining the human resource (HR) registry, including salary information, and provided policy support to Government in horizontal HR management issues.

[65] Together with the Copenhagen criteria, the ones adopted at the Madrid European Council are so-called accession criteria. In 1993, at the Copenhagen European Council, the EU agreed that the associated countries in Central and Eastern Europe that so desire should have the right to become EU members. Concerning the timing, it was stated that accession would take place as soon as an associated country was able to assume the obligations of membership by satisfying certain economic and political conditions, the Copenhagen criteria. Membership also required that the candidate country had to have created conditions for its integration through the adjustment of its administrative structures, as

to implement and enforce the *acquis communautaire*. Government has worked closely with the EU to meet the requirements inherent in the integration process into the European Administrative Space[66].

Table 4.1. PEIR-1 Recommendations and Policy Reforms, 2007–08

PEIR-1 Recommendations	Policy Reforms
To develop a medium-term civil-service pay strategy that will lead to a 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.	***Largely fulfilled.*** Government adopted changes of the Law on Civil Servants and Public Employees, resulting in a moderate decompression in salaries, but insufficient to accurately reflect underlying demand for skills and expertise.
To reduce the impact of seniority-based allowances on total civil-servant pay and restructure the collective-bargaining process to facilitate future policy reforms.	***Largely unfulfilled.*** Seniority-based allowances have not been removed from the new wage bill and the Law on Civil Servants and State Employees; collective bargaining process was not restructured.
To enhance the capacity of the Civil Servie Administration (CSA) by implementing a credible performance-appraisal system and following through on other outstanding civil-service reforms within a realistic timetable.	***Considerable improvement.*** The CSA became a part of the Ministry for Interior and was replaced by the Human Resources Agency (HRA). The HRA improved significantly the process of selecting candidates within public administration, of training public-sector employees, of creating the data base, and of adopting a regulation with which extraordinary performance can be rewarded. There are still considerable implementation problems with these reforms.
To strengthen the institutional arrangements for overseeing and managing the. implementation of the public administration reform, including by developing a sequence action plan with resource implications.	***Not accepted,*** but public administration reform become a part of agenda for EU integration, with management of that reform being communicated to individual administrations rather than one administrative unit.
To develop a consolidated human-resource data base for planning and managing the entire public service.	***Not fulfilled.*** Data base has not yet been compiled and does not contain data on all public employees and/or their employment and working history.
To plan and undertake a horizontal review of government functions and activities with the aim of abolishing "left-over" structures from the previous system and strengthen capacities in areas most needed to support effective EU integration.	***Largely unfulfilled.*** Reviews have not been carried-out in the major sectors, while some additional administrations were established, increasing administrative staff.
To plan vertical functional reviews of three to four major sectors or functions in order to reduce inefficiencies and identify potential savings.	***Partially fulfilled*** **.** Most of administrative units have prepared the systematization of postions, but without the significant cuts of their number, reflecting a certain unwillingness lay off staff and reduce inefficiencies.
To carry out a comparative assessment of how the EU integration process has been managed in countries of similar size (e.g., Lithuania or Estonia).	***Fulfilled.*** Comparative assessment was completed and presented in National Program for Integration (Government, 2008).

4.6. **In parallel, the wage bill will have to be brought to a sustainable level,** notwithstanding additional demands placed on the public administration in the context of meeting the challenges in the EU accession process (which entail increasingly complex policy coordination requirements and particular expertise). As discussed, the broader fiscal-policy objectives require this. The experience of EU-8[67] suggests that this will be a long haul-effort (World Bank, 2007). More than two years after accession, it became clear that the harmonization with the *acquis communautaire*—

underlined by the Madrid European Council of end-1995. According to the Madrid criteria, (i) EU legislation had to be transposed into national legislation; and (ii) the legislation had to be implemented effectively through appropriate administrative and judicial structures. The latter requirement was viewed as a prerequisite of the mutual trust required by EU membership; for details, see http://ue.eu.int/ueDocs/cms_Data/docs/pressdata/en/ec/00400-C.EN5.htm.

[66] During the 8th meeting of EU Ministers of Interior Affairs in Strasbourg on November 7, 2000, participating delegates defined European Administrative Space as the "environment in which the national administrations are called upon to assure homogeneous levels of service efficiency and quality."

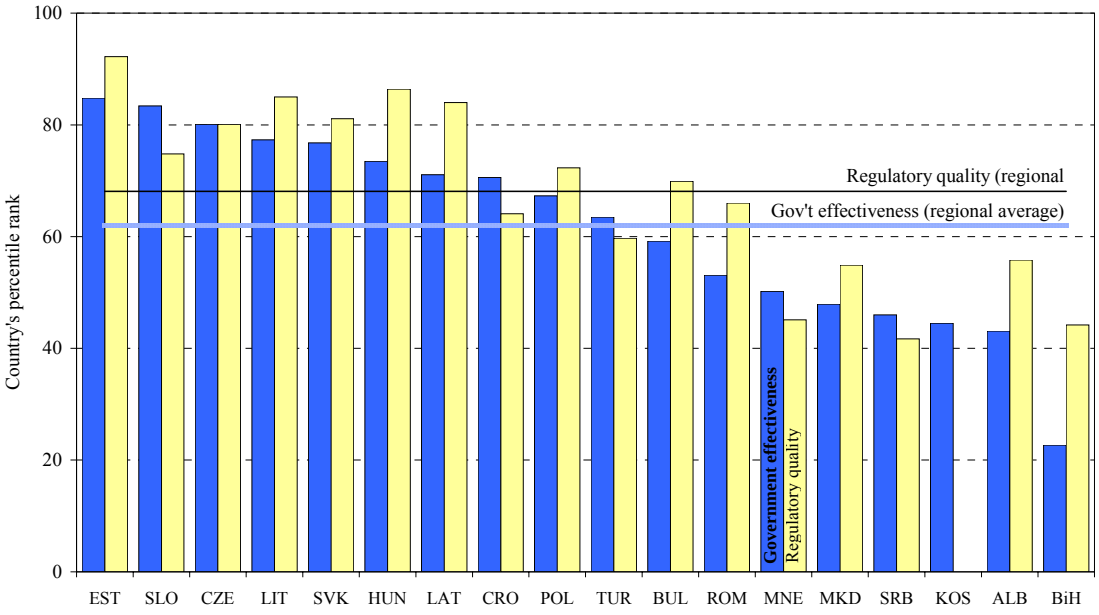
[67] EU-8 refers to eight, formerly Communist countries that joined the EU in the 2004 enlargement, viz., Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia. Cyprus and Malta, which joined the EU at the same time, are not included in this aggregation.

rather than being a "one-off" effort—needed to be supported by soundly performing systems across the whole government, with a professional and independent civil service in place, motivated by a merit-based remuneration and promotion systems.

B. Effectiveness of Public Administration

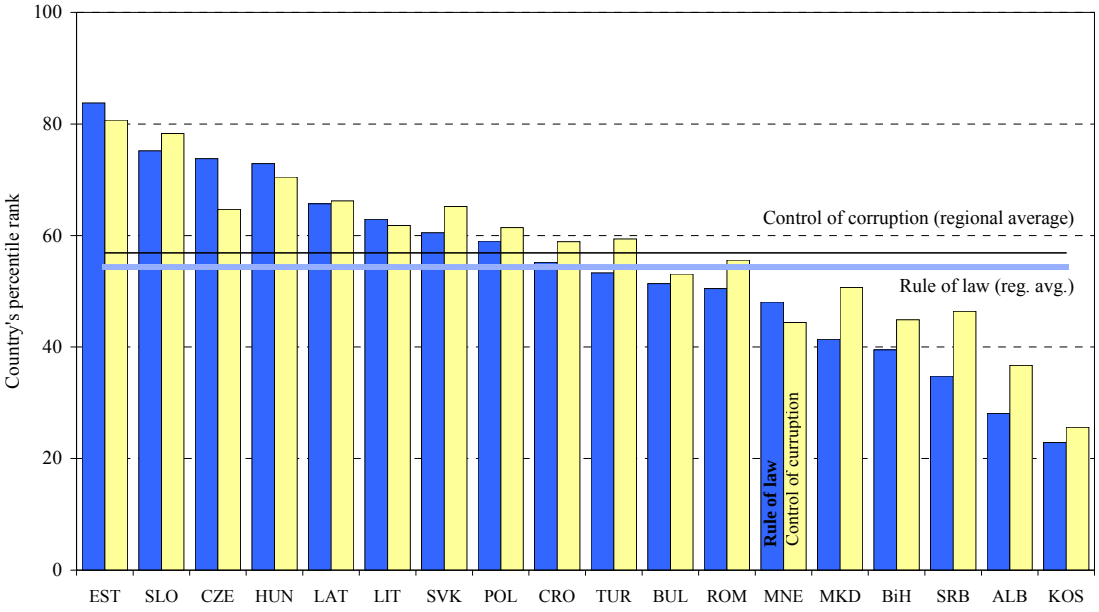
4.7. **Government effectiveness in Montenegro is still lower than among Eastern European and Baltic countries—but it is improving at a considerably faster rate.** The World Bank, with its governance indicators, has sought to capture the quality of public administration worldwide (see, e.g., Anderson and Gray, 2006). Comparing Montenegro's results to other countries in the region highlights remaining weaknesses in terms of corruption, rule of law, regulatory quality, and government effectiveness. It is probably not surprising that Montenegro lags behind the pre-2004 accession EU members (EU-15) between 57 percentage points (control of corruption) and 39 percentage points (government effectiveness). Although Montenegro compares well with other countries in the South and Eastern Europe, government effectiveness indicators still lag behind the ex-Communist EU members (EU-8+2); see Figures 4.1a. Among the five Western Balkan countries, Montenegro ranks only third with respect to control of corruption (Figure 4.1b). The underlying trends, however, point in the right direction for all four indicators (Figure 4.1c).

Figure 4.1a. Government Effectiveness and Regulatory Quality, 2007



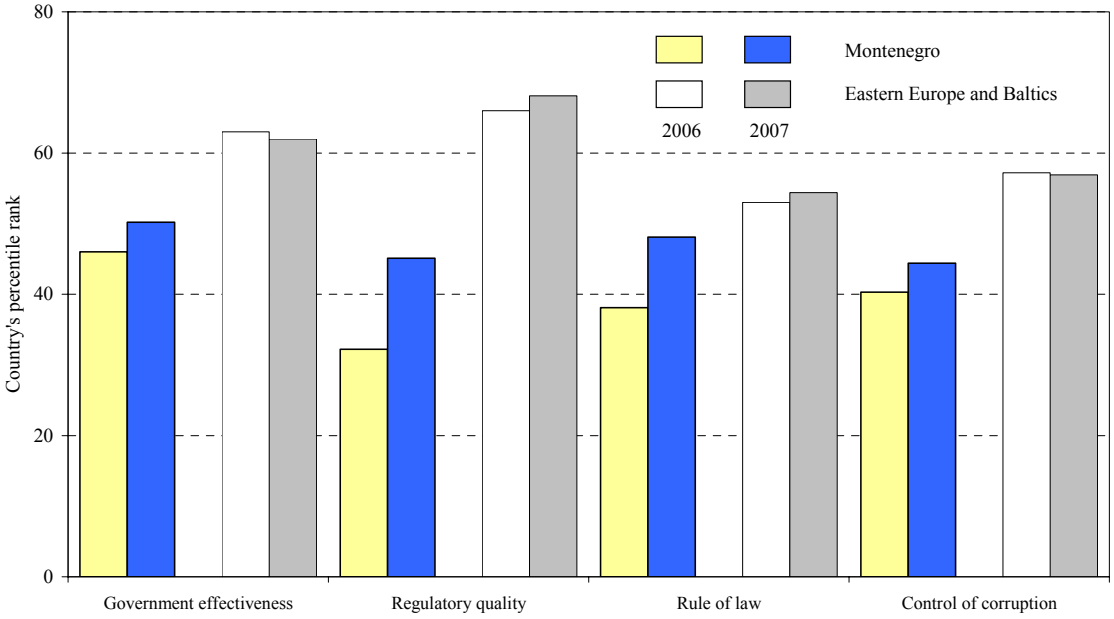
Sources: World Bank Governance Indicators.

Figure 4.1b. Rule of Law and Control of Corruption, 2007



Sources: World Bank Governance Indicators.

Figure 4.1c. Governance Indicators, 2006–07



Sources: World Bank Governance Indicators.

4.8. **Selected *Doing Business* indicators (World Bank, 2008) as well show the need for Montenegro to close remaining gaps with OECD countries in the areas of administrative and judicial processes.** Transaction costs of obtaining building licenses have represented a particular challenge, as do those on the time required for

registering property, starting businesses, or paying taxes (Table 4.1).[68] Some improvements have been observed in various areas, and further improvements should be expected in the coming years, with the strengthening of regulatory agencies, the resolution of significant backlog of court cases and first successes of the land registry reform.

Table 4.1. Selected Doing Business Indicators, 2008

	No. of procedures per payment		Duration (in days*, in hours†)		Cost to total tax rate	
	MNE	OECD	MNE	OECD	MNE	OECD
Starting business	15	6	24*	15*	6.2	5.1
Dealing with business licenses	19	14	185*	153*	559.6	62.2
Paying taxes	88	15	372†	183†	31.6	46.2
Registering property	8	5	86*	28*	4.6	2.4
Enforcing contracts	49	31	443*	545*	25.7	17.7

Source: Doing Business (2008).

4.9. **Problems are well recognized within the country, but relevant institutions are severely understaffed.** The *Strategy for Public Administration Reform for 2003–09* recognized the urgent need for reform, not only to increase the efficiency of the public administration and but also to strengthen the country's overall competitiveness. Together with tax rates and other more easily quantifiable indicators, the provision of effective public services represents a critical element to investors' ultimate decision regarding their preferred site of production. The Government rightly points out in its strategy that a competent, efficient, and motivated public administration, simpler and cheaper operating procedures, and an efficient and independent judicial system are basic institutional determinants that lead to a favorable business and investment environment.

Efficiency Considerations

4.10. **Public administration in Montenegro consists of five layers of organizational structure,** viz., Government ministries (13); central state administrative offices (2); secretariats and commissions (4); public sector funds, agencies and institutes (27), and local self governments (21). While Montenegro's legislation consolidates public-administration employees into only four separate categories (civil servants, state employees, state officials and judicial employees), subordinate legislation (decrees and rulebooks) *de facto* differentiates public administration into six categories. These are (i) civil servants and state employees (including employees of local government units); (ii) public servants (including employees in health, education, and social welfare); (iii) judiciary; (iv) uniformed services (police, defense, and intelligence); (v) regulatory agencies and state fund employees and (vi) state officials. There is a vast set of legislation that regulates the

[68] To address those challenges, Government has requested World Bank assistance on addressing these type of challenges in the context of a project aimed at strengthening land administration and management issues The project is in its final stages of preparation.

employees in each of these categories which would require another consolidation attempt beyond recent 2007 measures (Box 4.1).

Box 4.1 Public Sector Remuneration Policies in Montenegro

Montenegro consolidated the rules for wage determination across the civil service through the amendments to the Law on Salaries of Civil Servants and State Employees, but there are over 60 legislative pieces on employment rights and obligations of the public administration in Montenegro. Only in the last two years, some 30 new pieces of legislation, including decrees and agreements, have been adopted, not necessarily contributing in an effective manner to the objective of increasing the transparency of remuneration within public administration.

Collective agreements for civil servants. The 2004 Law on Civil Servants and State Employees (LCSSE) and the 2007 amendments regulate the rights, obligations, and responsibilities of civil servants, while defining their salaries as well as those of other state employees in the central government's administration and other bodies that had been established to provide civil service. This generic law, covering public servants in health, education, culture, and social welfare, provides for the establishment of salary levels through collective agreements. However, different wage coefficients and bonuses for similar posts can be applied across the civil service.

***De facto* autonomy for local governments.** Staff in local authorities is partially covered by the Law on Civil Servants and State Employees, but also through the Law on Local Self-Government (2003). While they are supposed to follow the same job classification as per the LCSE, the local governments preserve the autonomy in setting their own coefficients for different posts, different basic salary, and bonuses. Municipal administration officials in Podgorica are covered by a separate decree adopted in 2006, defining its own coefficients (see paragraph below).

Special salaries and supplements to political appointees. The Law on Salaries and Other Compensations of State Officials (2007) and the 2008 decrees regulate the coefficients and bonuses for political appointees, including top ranked civil servants. They determine their basic salary (36 percent higher than comparable remunerations for civil servants). In additions, the Decree on the Compensation for Participation of Deputies in Parliament (2008) defines a 20-percent deputy supplement for members of parliament.

Special laws for judicial-sector employees. The Law on Salaries and Other Compensations of Constitutional-Judicial Functions, adopted in 2007, regulates the coefficients, compensations and bonuses (such as the winter and housing bonuses and a 30 percent supplement) only applied to judicial staff.

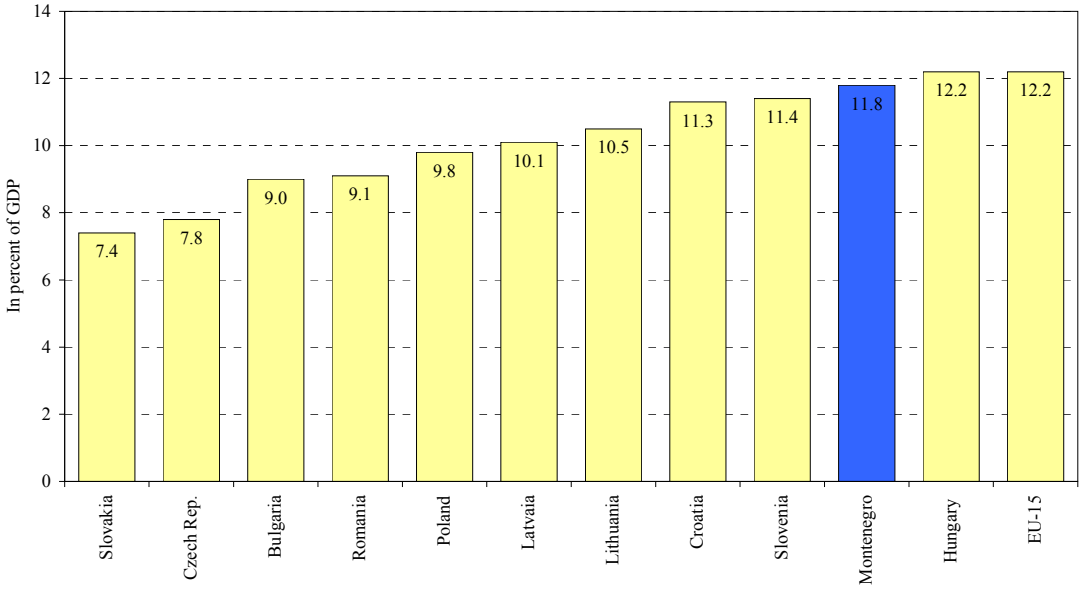
Separate laws for police and the military. Police and army personnel are covered by the Law on Police (2005) and the Law on the Army of Montenegro (2007), together with subordinated decrees from 2008, which determine the coefficients and bonuses (up to 30 percent for all police personnel relative to state administration employees), with army personnel having an entirely separate salary system.

Special salaries for employees in state funds and specialized agencies. State funds (Development, Employment, Pension and Disability, Restitution, and Health Funds) and agencies (for National Security, Telecommunications, Energy, Radio-Diffusion, Tobacco, and Insurance) have separate salary systems, which are defined through organic laws, statutes, and rulebooks.

Spending Efficiency

4.11. **The wage bill of the general government is high**. At 11.8 percent of GDP in 2006 (and 12.7 percent in 2007), the general government's wage bill is higher than that of most new EU member states (Figure 4.2). It is close to the average for the EU-15, countries, even though the quality of services remains much lower.[69] The EU accession process—as well as aspirations for further decentralization—will result in additional pressures on the wage bill. The EU integration process implies increased specialized services within Government. The transfer of responsibilities to the municipalities requires new regulatory institutions. An additional source of pressure comes from the increasing need to compete with the private sector over highly qualified staff. Enterprises are able to pay significantly higher salaries for highly qualified staff. Government will thus have to either agree to higher decompression in salaries (raising wage rates at the highest spectrum of skills and qualifications) or accepting an accelerating rate of "brain drain" from the public administration to the private sector, ultimately leaving the Government ill-equipped to address the considerable challenges it will face over the medium- to longer-term horizon.

Figure 4.2. General Government Wage Bill, 2006



Sources: Ministry of Finance; Eurostat; and World Bank staff calculations.

4.12. **While still high, the wage bill has been gradually declining over the last three years as a share of the general government spending.** More than one-fourth of general government spending remains spent on wages and other compensations to public administration (Figure 4.3). There are pressures mounting on both factors:

(i) **Large across-the-board wage increases limit the ability to decompress the wage scale**. Partly in reaction to increasing (food and electricity) prices,

[69] In addition, the tax rates, especially for corporate and personal income taxes, are much lower than in the EU-15 countries, limiting the Government's ability to fund a large wage bill and an ambitious public infrastructure program.

Government agreed to a 30-percent increase in public-sector wages in late 2007. The effects of this decision—together with a 10-percent basic salary increase—will only become apparent in 2008 and subsequent years. The acceleration in food and oil price increases during the first semester of 2008, which has already led to strike actions, and politico-economic considerations surrounding the electoral cycle, could easily result in pressure for further across-the-board pay increases over the medium term.

Figure 4.3. General Government Wage Bill, 2002–07

Sources: Ministry of Finance; and World Bank staff calculations.

(ii) **Additional public sector recruitment for reasons of EU integration and decentralization is not compensated by a corresponding decrease in staff elsewhere.** The general government budget in 2007 supported 44,015 employees, or 6.9 percent of the population and 16.3 percent of the labor force. The corresponding numbers for 2006 were 42,873 and 6.8 percent of population (Table 4.2). Comparing four-year averages for 2002–06, Montenegro's ratio of public employees to population (7.4 percent) exceeds the values of relevant comparators by considerable margins. Croatia has a ratio of 6.2 percent, while the EU-8 (EU-15) countries have an average ratio of 5.4 (6.2) percent. About 5.5 percent of population is employed by the civilian public administration, almost double the median value of 3 percent in Europe and Central Asia. To some extent, this is due to the relatively high "fixed cost" proportion of public administration in a small country, which—irrespective of its size—has to provide the same services as large states without being able to exploit economies of scale. To some degree, however, this reflects the fact that increased staff numbers in priority areas are not fully compensated by a reduction elsewhere, leading to a trend reversal in overall public-sector employment, with an increase of 1,142 in 2007 (Table 4.3). Generally, in the structure of public administration, there has been a 30-percent increase in employment at sub-national levels since 2002 and a 40-percent increase in the

judiciary since 2005. Almost one-half of total public sector employment is in the health and education sectors, regardless of unfavorable demography. These increases have been made possible by a significant reduction of army personnel (40 percent), with uniformed services representing a still significant 20 percent of public-sector employment.

Table 4.2. Montenegro: Relative Structure of Public Sector Employment, 2007

	In percent of		
	public sector	population	labor force
Total public sector employment	100.0	6.9	16.3
Civil servants	26.0	1.8	4.2
Central government	20.7	1.4	3.4
Government and ministries	15.8	1.1	2.6
Agencies and extra-budgetary funds	4.5	0.3	0.7
Outside the executive	0.4	0.0	0.1
Other	5.3	0.4	0.9
Public servants	54.3	3.7	8.8
Teachers and other education staff	25.9	1.8	4.2
Employees in the health sector	20.0	1.4	3.3
Employees in the cultural fields	1.4	0.1	0.2
Social workers	1.3	0.1	0.2
Employees in the judiciary	5.6	0.4	0.9
Uniformed services	19.7	1.4	3.2

Sources: Government of Montenegro (Ministry of Finance and other ministries and agencies); MONSTAT; and World Bank staff calculations.

Table 4.3. Montenegro: Relative Structure of Public Sector Employment, 2002–07

	2002	2003	2004	2005	2006	2007
Total public sector employment, by level of Government	48,671	46,870	46,201	44,435	42,873	44,015
Central government	45,227	43,348	42,601	40,757	38,847	39,530
Local self-government	3,444	3,522	3,600	3,678	4,026	4,485
Total public sector employment, by status	48,671	46,870	46,201	44,435	42,873	44,015
Civil servants	10,238	9,655	9,963	10,030	10,802	11,444
Central government	7,614	6,883	7,177	7,706	8,840	9,133
Government and ministries	6,794	6,133	6,363	6,352	6,776	6,959
Agencies and extra-budgetary funds	684	614	678	1,218	1,874	1,992
Outside the executive	136	136	136	136	190	182
Other	2,624	2,772	2,786	2,324	1,962	2,311
Public servants	23,795	23,448	23,295	23,363	23,354	23,895
Teachers and other education staff	12,460	12,111	11,943	11,872	11,270	11,402
Employees in the health sector	8,320	8,410	8,500	8,590	8,790	8,807
Employees in the cultural fields	687	664	612	605	612	612
Social workers	606	545	522	537	543	592
Employees in the judiciary	1,722	1,718	1,718	1,759	2,139	2,482
Uniformed services	14,638	13,767	12,943	11,042	8,717	8,676
Memorandum items:						
Public employment as percent of population	7.9	7.6	7.4	7.1	6.8	6.9
Public employment as percent of labor force	17.5	17.1	17.8	17.3	16.9	16.3

Sources: Government of Montenegro (Ministry of Finance and other ministries and agencies); MONSTAT; and World Bank staff calculations.

4.13. **Therefore, to contain the overall cost while increasing individual pay, Government will need to carefully assess priorities within public administration and downsize staffing overall.** Some of the areas, where staffing numbers could be reduced without affecting much the delivery of public services, seem to include the following:

- **Central and local government administration.** Further decentralization of functions to local government needs to be followed by respective cuts at the central government level, combined with a careful monitoring of local government employment. For the level of decentralized functions (which remains relatively low), local-government employment is high, with continuing pressures for further fragmentation of local self-government.
- **Internal affairs and defense.** The defense sector reform has already resulted in a significant downsizing of military personnel and corresponding spending. However, with over 8,600 employees in internal affairs and defense, uniformed personnel exceeds the number in the central Government and ministries by 25 percent, leaving room for further downsizing of both military personnel and administrative staff in the defense sector.
- **Public service and civilian staff.** Recently, Government initiated reforms in the education and health sectors, where there is a potential for efficiency gains in bringing teacher-to-pupil ratios closer to the OECD average. In addition, there is scope to consider increased private-sector participation in the health sector. Functional reviews would show that there is a large scope for reducing the unnecessary administrative procedures in ministries and agencies, including by an increased reliance on IT technology employed to retrieve and maintain databases.
- **Contracting-out.** Instead of trying to compete with the private sector on wage terms for some highly specialized skills, the government could outsource specialized services. Many staff hours are being spent on auxiliary services across the public administration that could easily be outsourced on the basis of public tenders (such as cleaning, catering, and security). In other countries that have adopted this approach, tendering non-core activities to the private sector has led to significant efficiency gains.

Linking Salaries to Performance

4.14. **The public wage structure is too compressed.** The wage compression ratio in Montenegro's civil service is about 4.95.[70] This is not comparable to the levels prevailing in other countries. In the OECD countries, for example, this ratio falls within the range of 8 to 9 (that is, the difference between the highest and lowest wages is considerably larger). For the majority of employees in Montenegro, the basic salary range is within a narrow band. As a result, public wages for managerial posts are significantly below the private market in Montenegro. Anecdotal evidence suggests that this may be causing difficulties in recruiting and retaining well-qualified staff.

[70] The compression ratio is the ratio of the wage level at the highest grade over that at the lowest grade.

4.15. **Salary levels are primarily determined by "time in service" rather than performance.** The general principles for the compensation of civil servants are provided by the *Law on Civil Servants and State Employees* (2004 and amendments in 2007). According to the law, the salary for civil servants is determined through a formula combining (i) a "task complexity" coefficient (fixed by Government regulation for the various workplaces); (ii) the wage calculation base[71] (established by a collective agreement and a decree); and (iii) a seniority supplement (0.5 percent per year of service up to 10 years, 0.75 percent from 10–20 years, and 1.0 percent per year with 20 years of service and more). Taken together, the years of service are still the dominant determinant for promotion and pay level. The seniority supplement in the wage calculation formula allows for a 32.5 percent wage difference between new entrants into the grade and those with 40 years of service. Such a system makes the public administration less attractive to young qualified job seekers.

4.16. **There are over 15 different supplements and bonuses found in the state administration**, of which only one relates (to some degree) to staff performance. Performance bonus differs from 10 to 30 percent and is provided as a regular part of pay to everybody employed in the judiciary and health sectors as well as in the extra-budgetary funds, without much reference to real staff performance. On the other hand, a performance bonus has yet to be introduced for civil servants. This non-uniform approach across the administration contributes to the upward pressure on effective wages, relating total remuneration to the strength of bargaining power rather than qualifications, merit, or performance.

4.17. **Supplements for work conditions and bonuses create a large share of net civil servants salaries**—but these are not included in the base of taxable income. Over 11 percent of the overall wage bill is left untaxed and provided through discretionary bonuses (Figure 4.4). Except for the seniority supplement (0.5–32.5 percent), additional coefficients for working conditions (30 percent for police, judiciary, inspectors, tax and customs officials, up to 10 percent for class masters), rare skills' supplement[72] (20 percent), overtime (40 percent), Sunday and holiday work and duty roster (10 percent), the rest of the bonuses are left untaxed—notwithstanding the fact that they create a significant portion of individual pay.[73]

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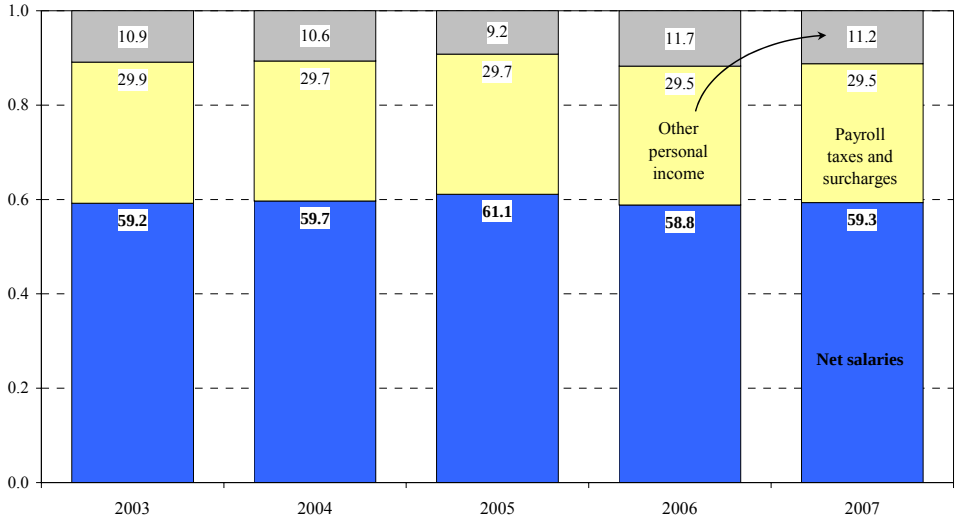
[71] Government had signed the tripartite Agreement on Determining the Lowest Price of Work with the Trade Unions of Montenegro and with the Association of Employees in 2007, setting it at €55 (net). This is different from practices elsewhere and undermines social-insurance benefits that employees are receiving from social contributions paid into the budget. Government agreed as well to gradually lower the rate of obligatory contribution for health to 9 percent, from currently 13.5 percent. Within this Agreement, Government has also expressed an interest in transferring meal and holiday bonuses into the basic salary. However, until the mid-2008 this initiative did not come to realization.

[72] This supplement was temporarily given to IT and cleaning services, until a 2008 Constitutional Court decision reversed this practise.

[73] Examples are meal (€25–27.50), transportation (€22) and holiday bonuses (€150–165) which add €714–759 per year to one's salary (or even over 50 percent to lower grades). A winter bonus, the so-called *zimnica*, is provided by some funds and agencies and amounts to three times the minimum net wage (€165). The housing bonus, which is provided in judiciary and education, allows for covering the rental costs or housing credit cost up to the amount similar of that of other one-off bonuses.

Figure 4.4. Montenegro: General Government Wage Bill Structure, 2003–07



Sources: Ministry of Finance.

4.18. **The performance appraisal system is still in its testing stage.** Notwithstanding stipulations in the *Civil Service Law* that make career advancement a function of professional accomplishments, working capacity, and work quality, promotions to higher grades continue to be mostly based on time lapsed in the administration. The performance appraisal system allows for promotions to higher steps within the same grade for those marked "good" ("excellent") for five (three) consecutive years. However, the appraisal criteria stay undefined and are subject to a discretion and non-transparency[74].

4.19. **The inherent emphasis on seniority precludes sufficient performance incentives and, ultimately, lowers staff morale.** As a result, older employees have even fewer incentives to leave, given that the salary structure rewards them for their seniority. Insufficient data are available on the structure of public administration by age, gender, education, and years of service. An independent survey by the *Institut Alternativa* (2008) tried to fill this gap, and it confirmed results of an internal exercise by the Human Resource Management Authority (HRMA) on a sample of 12,640

[74] The *Decree on More Detailed Criteria and Modes for Determining the Variable Portion of the Salary of Civil Servants and Employees* specifies criteria on the determination of the variable portion of an employee's salary, complementing the Civil Service Law. The law had introduced the variable part of the salary as a way to reward staff based on merits. However, the law only defined in general terms that the salary's variable portion should be granted based on the employee's quality of work. The decree ill-defines the education profile (such as university education) and "independence at work" aspect as merit-reward criteria, while it fails to define upper limits to the variable portion of salaries. While the current appraisal system—in principle—is the key instrument to be used to distribute annual performance bonuses, it is not applied consistently across the administration. In 2006, only 52 percent of institutions performed staff appraisals. According to HRMA figures, "excellent" marks were given to most public-sector employees, thereby defying the purpose of this exercise. As such, current practices contradict OECD standards (Rexed et al., 2007), according to which a good remuneration policy for the public administration should aim at providing equal pay for equal work.

employees in 2006 that suggested that two-thirds of public servants are between 35 and 45 years of age, while another 12 percent of the public sector is older than 45 years.

Administrative Efficiency

4.20. **High public-sector employment is partly the result of a complex government organization,** with the large number of government entities leading to multiple-layer structures, overlapping functions, and competing responsibilities. These create costly inefficiencies. Over the last few years, Government created new layers of regulatory institutions, partly to administer and manage the EU accession process. However, not all of the newly established positions can be explained by the need to establish EU-compatible functions. To assess the efficiency of existing structures, Government might want to undertake further functional reviews across the public sector, at national and local levels, to eliminate any duplications and overlaps. In so doing, Government would determine the potential for further rationalizations of administrative procedures and to employ existing staff more effectively with the Government's strategic objectives in mind.

4.21. **Four years after the adoption of the *Civil Service Law,* not all institutions have completed the process of internal reorganization,** including the (re)classification of individual positions. This stands in some contrast to the fact that the process of internal reorganization and classification had been requested as a precondition for any new employment. Some state institutions, including the Ministry of Justice, have not done this, putting in question the legality of the current employment and salary levels in those organizations.

4.22. **Current public-sector employees have a *de facto* advantage in filling public-sector vacancies,** eroding the formally introduced principle of equal access to public-sector employment and healthy competition among new entrants. The Law on Civil Servants and State Employees had declared equal accessibility to employment in the state administration. This stands in contrast to current practice and supporting legislation, according to which all state organizations are encouraged to first try to fill their vacancies through internal advertisement, before engaging in an open competition.

4.23. **Accepting a severance package does not preclude re-employment in the public sector.** The *Law on Civil Servants and State Employees* stipulates that civil servants and state employees who are laid off in the process of reorganization are entitled to a severance pay from the budget. Anecdotal evidence shows that some employees have used this opportunity to accept severance pay before their re-employment within the public sector. The law should be changed in a way to limit the possibility of re-employment within the administration to instances, in which the termination process has not been concluded and the severance payment not made.

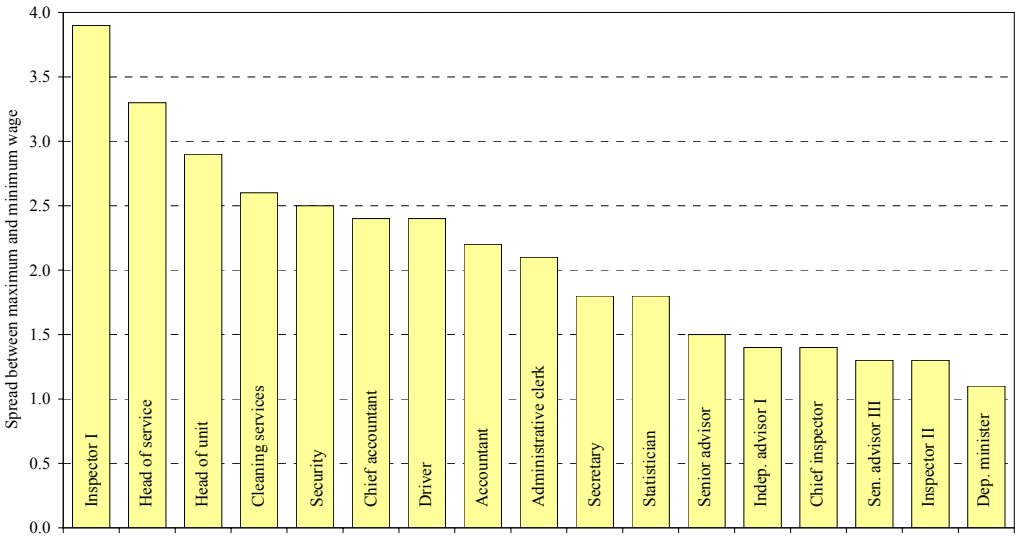
4.24. **The Ministry of Finance and the HRMA should work together on establishing a proper human resource management information system, which links personnel information to payroll payments.** Although the *Law on State Administration* gave the Ministry of Finance the legal right to perform a control over

the payment of salaries, the Ministry does not have the complete information that would be required to exert full control over the state administration's wage bill. Some parts of the state administration are still not sharing with the Ministry of Finance the individual salary levels and the details on underlying factors determining a given wage rate. Instead, only payment request for the overall wage bill are made. However, good progress has been made in creating the central registry for human-resource data, including information on salaries. This is an important step forward. However, without a clear just-in-time link to the Treasury, these efforts of collecting personnel data would become outdated quickly and lose their inherent value for policymakers.

4.25. **The wage negotiation for civil servants in Montenegro is highly fragmented**. While coefficients and bonuses on working conditions, overtime, Sunday and holiday work are from 2007, determined by law, the wage base and supplements, including bonuses, are agreed collectively between public sector entities and labor unions. These agreements are negotiated separately by the state government, local self-governments, and other administrative units. The result of this decentralized negotiation process is a fragmented and inconsistent remuneration structure, resulting in a considerable variability of wage dispersion with the public sector (Figure 4.5).

4.26. **Furthermore, fragmented collective bargaining mechanisms allow the various labor unions to negotiate salary increases outside the control of Finance Ministry and outside the regular budget preparation processes**. Some sectors (like health, judicial, internal affairs, inspectors, and defense) are able to negotiate higher wages, especially through additional bonuses not linked to performance, thereby further eroding the key "equal pay for equal work" principle. This manner of deriving at collective-bargaining agreements reflects inherent weaknesses. Government needs to consider ways to reverse the delinking of the consultations process among social partners with the budget preparation process. Some efforts have been made in that regard, but—to allow for a consistent approach to fiscal policies—the central decision-making power of the Ministry of Finance needs to be further strengthened.

Figure 4.5. Wage Dispersion for Selected General Government Occupations, 2007



Sources: Ministry of Finance; and World Bank staff calculations.

4.27. **The lack of effective data collection and control system on wages and salaries in the public administration further increases the risk of an excessive dispersion of remunerations.** Although there are, in principle, standard civil service rules for salaries' calculations, the fragmentation of government's organization hinders the implementation of effective controls. Agencies directly responsible to the Parliament have their own independent salary system. In addition, local governments units and their agencies are not reporting centrally their wages and salaries.

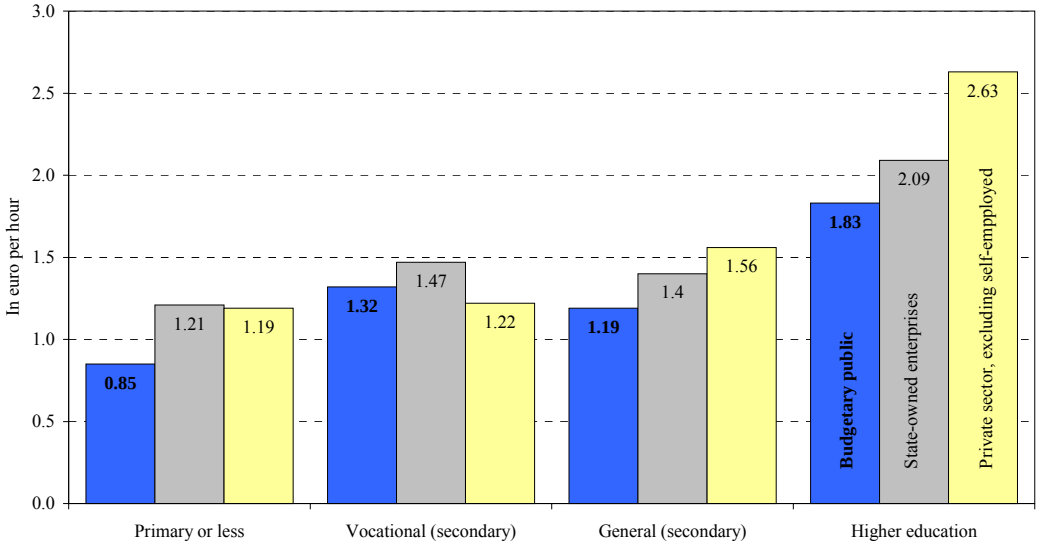
Equity Considerations

4.28. **It is a common phenomenon also seen in other countries that wages in the government sector are lower than those in the private sector, as employees have greater job security and enjoy a number of other pecuniary and non-pecuniary benefits.** This discount has been generally in the range of 10 to 20 percent. However, in Montenegro, the discount seems to be much larger for high-level jobs when correcting for hours worked and other individual characteristics (Figure 4.7).[75] Another symptom is that, while labor turnover within public administrations is generally low, the only segment where mobility occurs is at the top end—as younger and more ambitious public servants leave for employment in the private sector after a few years of broadening experience and acquiring know-how. Past that point, the wage differential with the private sector becomes too high to be compensated by job security.

4.29. **The hourly wage of a worker with higher education in budgetary public sector is on average 30 percent lower than for a comparable worker in the private sector** (€2.09 per hour vs. €2.63 per hour). Compared to state-owned enterprises, this difference is approximately 20 percent. Interestingly, the public sector benefits those with vocational secondary education (1–3 years of secondary school) by providing a higher average wage than the private sector.

[75] The wage disparity between the public and the private sector in Montenegro was analyzed by using the 2006 Labor Force Survey (LFS) data. The LFS is a regular survey conducted by the Statistical Office of Montenegro (MONSTAT) which reaches around 900 households per year. In 2006, there were 3131 individuals covered. We restrict our interest to wage comparisons by sectors, meaning that only employees (over 15 years of age) for whom there were information on their wages and sector of employment are available. Self-employed are excluded from the analyses because their income cannot be treated fully work-related; it also includes remuneration for their entrepreneurial skills. All in all, in 2006 there are 699 observations remained in the sample of wage employees. Distinction between the public and private sector is based on information on ownership of employers, which are provided by the LFS respondents. For analytical purposes, the public sector is sub-divided in two categories: (i) budgetary public sector which covers public sector employees in public administration, education, and health care and social work, and (ii) state-owned enterprises (SOEs) which cover public sector employees in all other activities.

Figure 4.6. Montenegro: Hourly Wage by Sector and Education, 2006



Sources: Authors' estimates, using 2006 LFS (MONSTAT).

4.30. **Wages in the private sector are much more dispersed than wages in the budgetary public sector, and the compression is particularly high at the managerial posts.** The Gini coefficient for wages in the private sector is 0.33, while for wages in budgetary public sector it is around 0.20 (Table 4.3). Percentile ratios indicate that differences in dispersion between sectors are to be found mostly in the upper part of the wage distribution. For example, p10/p50 percentile ratio of 0.6 is observed in the private sector as well as in both parts of the public sector, but the difference is quite obvious at the p90/p50 percentile ratio. In the private sector, wage of a worker at the 90th percentile is approximately 2.4 times the wage of the median worker (50th percentile), while in the budgetary public sector such a ratio stands at 1.5. In other words, compression of wages in the budgetary public sector is much stronger than in the private sector, particularly at the upper part of the distribution. Dispersion of wages in SOEs is somewhere half-way between wage dispersion the private sector and the budgetary public sector.

Table 4.4. Montenegro: Dispersion of Hourly Wages, 2006

	Percentile ratio			Gini coefficient
	p90/p10	p90/p50	p10/p50	
Private sector[1]	3.9	2.4	0.6	0.33
Budgetary public sector	2.6	1.5	0.6	0.20
State-owned enterprises	3.5	2.1	0.6	0.28

Sources: 2006 LFS; MONSTAT; and World Bank staff calculations.

[1] Figures refer to employees only; self-employed are not included.

4.31. **Women earn substantially less than men in all sectors**, but the dispersion of female wages is somewhat lower across sectors. In private sector, average female wage is 21 percent lower than average male wage, while in the budgetary public sector the gender gap is 14 percent (Table 4.4). In SOEs, women earn some 22 percent less than men, and 8 percent less than women in private sector. In the budgetary public sector, women constitute slightly more than half of all employees, while in SOEs the share of female employment is below 40 percent.

Table 4.4. Montenegro: Hourly Wage by Sector and Gender, 2006

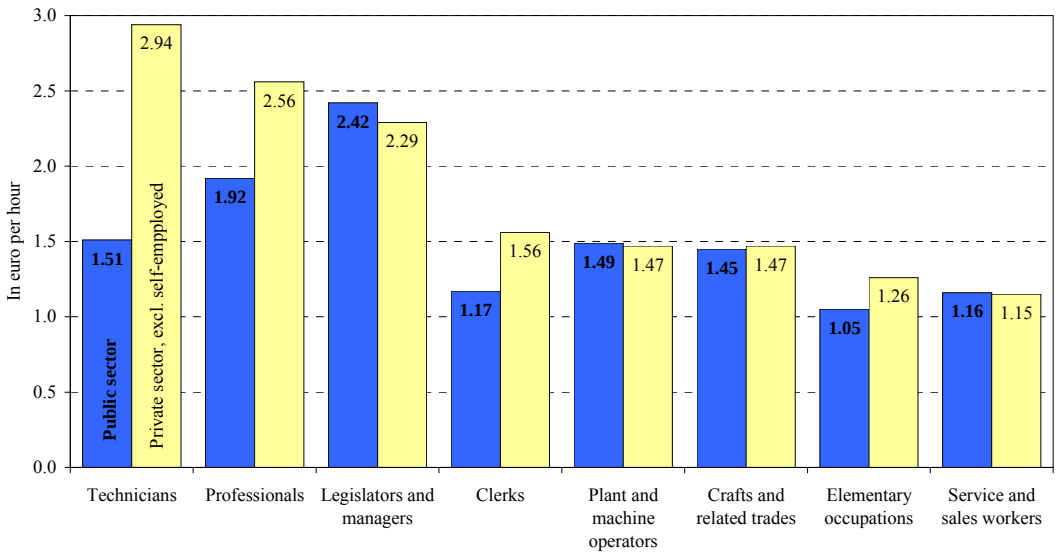
	Hourly wages (in euro)		Relative wage (private = 1)		Female wage	Fraction of
	male	female	male	female	(male wage = 1)	female employees
Private sector[1]	1.78	1.41	1.00	1.00	0.79	0.46
Budgetary public sector	1.58	1.36	0.89	0.96	0.86	0.53
State-owned enterprises	1.67	1.30	0.94	0.92	0.78	0.39

Sources: 2006 LFS; MONSTAT; and World Bank staff calculations.

[1] Figures refer to employees only; self-employed are not included.

4.32. **High-skilled white-collar workers are disadvantaged in terms of wages by working in the public sector.** Figure 4.8 shows rather wide wage gap between the private and the public sector for professionals and technicians, where the public sector wage "penalty" is around 25 and 50 percent, respectively.[76] A relatively large gap is found for clerks, too. One would expect to find a notable gap for high-ranked government officials (legislators) as compared to managers in the private sector. Presumably, underreporting in this case does not allow a reliable comparison; private-sector managers might receive only a part of remuneration in form of wage, while other part consist of bonuses and company shares that are not covered in the LFS data.

Figure 4.7. Montenegro: Hourly Wage by Sector and Major Occupation Groups, 2006



Sources: Authors' estimates, using 2006 LFS (MONSTAT).

[76] The low number of observations by occupation groups permits only for as distinction between wages between the private and overall public sectors (that is, the budgetary public sector and SOEs).

Table 4.5. Montenegro: Hourly Wage by Sector and Occupation, 2006

OSCO code	Description	Hourly wage (in euro)		Relative wage (private = 1)
		public sector	private sector[1]	
24	Business and administration professionals (economists, sales and marketing professionals)	1.81	2.68	0.68
31	Science and engineering associate professionals (technicians, controllers, supervisors)	1.82	4.69	0.39
41	Administrative clerks (general office clerks, secretaries, bookkeepers)	1.13	1.65	0.68
42	Counter clerks (customer service clerks, client information workers	1.24	1.46	0.85
51	Personal service workers (cooks, waiters, personal care workers)	1.21	1.19	1.02
52	Service and sales workers (sales persons, cashiers, ticket clerks)	0.94	1.12	0.84
92	Simple professions in trade and services (cleaners and helpers, maids, garbage collectors)	0.89	1.09	0.82

Sources: 2006 LFS; MONSTAT; and World Bank staff calculations.

[1] Figures refer to employees only; self-employed are not included.

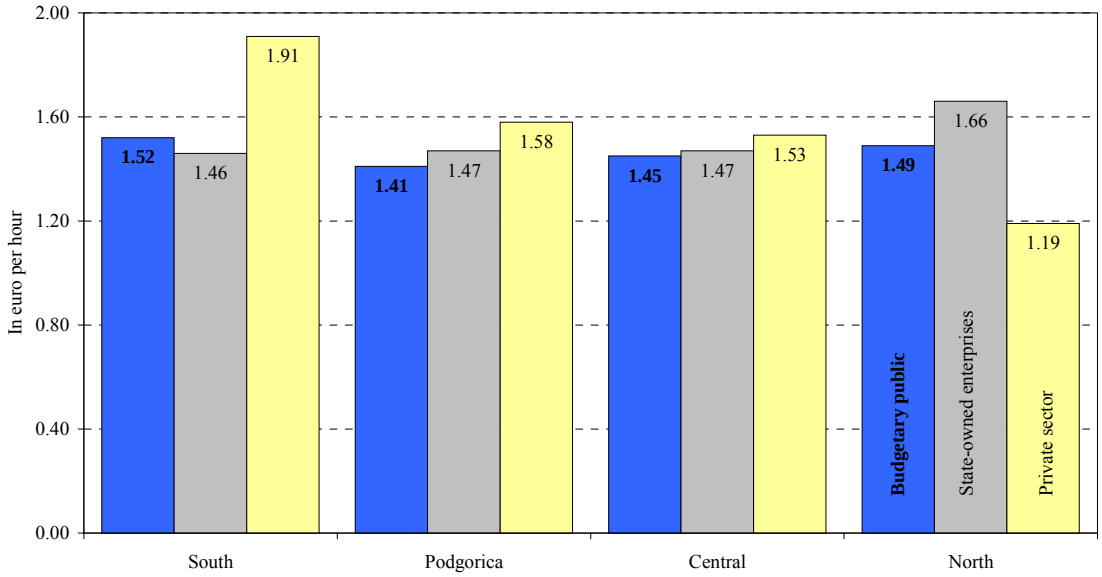
4.33. **The difference in public-private wages varies widely across professions.** Business and administration professionals, science and engineering associate professionals, as well as administrative clerks earn substantially lower wages in the public sector compared to the private sector. Table 4.5 compares the average wage for various occupations that are common in both the public and the private sector. For elementary occupations such as cleaners and helpers, the public sector offers some 18 percent lower wages than the private sector.

4.34. **Salary levels differ among local authorities, and they are often higher than at the state level.** While wages are calculated according to the same formula for the state government and the local administration, the basic wage is negotiated separately. The provisions of the *Law on Local Self Government* enable the municipalities to (i) collect incomes from sources other than the state budget; and (ii) determine independently specific posts' coefficients and base salaries (which range from €55 in the North to €100 in the Southern municipalities). Wealthier municipalities have used this method to provide for salaries that exceed those at the central level. The law also allows for different basic requirements applied to the promotion to certain grades (years-in-grade requirements tend to be lower in municipalities than in the ministries). These differences complicate horizontal and vertical mobility and undermine equity principles within the public administration.

4.35. **Budgetary public-sector wages are more comparable across regions.** This uniformity stands in contrast to the salaries paid by firms. While state-owned enterprises pay implicit hardship bonuses to employees in the North, private-sector

wages reflect local wealth and purchasing power (Figure 4.9)**.** In all regions (except in the North), average wages in the private sector[77] are above those in the public sector.

Figure 4.8. Montenegro: Hourly Wage by Sector and Region, 2006



Sources: Authors' estimates, using 2006 LFS (MONSTAT).

4.36. **The existence of "opportunity costs" to working in the public sector is confirmed by the results of a wage regression.** The average wage for employees of the budgetary public sector is about 13.2 percent lower than for employees in the private sector, controlling for observable individual and regional characteristics[78] (Table 4.6). Age and marital status are not significant explanatory variables for variations in individual wages. However, as discussed above, gender is an important correlate to the wage level; the average hourly wage for female employees is about 18 percent lower than for male employees with comparable labor market characteristics. A third major determinant of wage levels—maybe not surprisingly—is schooling and training. Returns on education are progressively increasing with educational levels. After controlling for individual workers' characteristics and sector of employment, regional effects on wages are not significant.[79]

[77] The share of private-sector to public-sector employment is much lower in the poorer North (about 33 percent in 2006) than in the more prosperous regions of Podgorica and the South (45 percent).

[78] Apart from looking at the bilateral correlation between the average wage by sector and certain characteristics, a joint influence of individual, regional and sectoral factors on workers' remuneration was analyzed, using the ordinary least square (OLS) estimate of the wage function. The more accurate estimate of the percentage effect is 100*[exp(–0.132)–1]= –14.1 percent.

[79] This phenomenon is possibly the result of different approaches to salary determination applied by Government, state-owned enterprises, and the private sector (as discussed above and summarized in Figure 4.8).

Table 4.6. Montenegro: Determinants of Hourly Wage, 2006

Dependent variable: Natural logarithm of hourly wage	Coefficient	Standard error	Significance
Demographic characteristics			
Age	0.009	0.011	
Age (squared)	-0.008	0.014	
Married	0.035	0.039	
Female	-0.181	0.032	at 1 percent
Education (reference: primary or less)			
Vocational secondary	0.136	0.064	at 5 percent
General secondary	0.251	0.057	at 1 percent
2-year college	0.449	0.089	at 1 percent
University graduate	0.745	0.064	at 1 percent
Region (reference: Podgorica)			
Central	0.019	0.043	
North	-0.052	0.046	
South	0.034	0.045	
Sector (reference: private)			
Budgetary public sector	-0.132	0.039	at 1 percent
State-owned enterprises	-0.073	0.047	
Constant	-0.138	0.231	
Memorandum items:			
Number of observations	699		
R^2	0.252		

Source: Authors' estimates using 2006 LFS.

C. Policy Options

4.37. **Reform options should aim at containing the growth in the wage bill while improving the effectiveness of public administration.** Capacity will need to be built up to manage the process of EU accession and decentralization. The authorities have taken important steps towards reforming public administration through the *Law on the Civil Service* and the implementation of relevant regulations, including on those defining the civil service salary system. But considerable challenges remain to achieve the twin objective of developing a *fiscally sustainable* and *operationally effective* public administration. On the basis of the above assessment, the following list summarizes recommendations of measures that could support policies aimed at achieving the two goals.

4.38. **A strategy aimed at making the public sector more competitive with the private sector, requiring increased decompression in wages, is inconsistent with across-the-board wage increases.** Within this context, the decision taken in late 2007 to increase salaries by a uniform 30 percent has reduced the fiscal space required to advance the agenda of a gradual decompression in wages. Similar decisions should be avoided in the future.

Short-term measures

4.39. **The Human Resource Management Authority (HRMA) needs to play a central role in defining the reform agenda.** The reform management has to be driven by the HRMA. It has to ensure an even closer cooperation with the Finance Ministry to allow for a full alignment of fiscal and HR policies.

4.40. **Government should initiate a pay and grading reform.** The current pay system—based on characteristics of rank, education, and seniority—will need to be replaced by system that links remuneration and performance**.** An EAR-financed review (*Human Dynamics*, 2008) of the existing pay and benefits system, containing options and proposals for a civil and public service pay and grading reform, serves as valuable input for drafting the new legislation. These reforms should aim at decompressing the salary scale and establishing a promotion mechanism that is based on the input from a fair and transparent performance appraisal system. This will require devising a new job classification, wage scales, while introducing a reliable system of performance appraisals. The reforms should seek to harmonize remuneration across the various levels of government. This needs to be accompanied by a fiscal impact assessment of the proposed new salary system.

4.41. **A tighter link between pay and performance needs to be established**. Public sector employees currently receive an automatic annual increase of 0.5 to 1 percent in basic pay for each year of service. Moving towards a merit-based system, the salary formula should include a performance-based supplement, while the seniority supplement should be reduced or eliminated.

4.42. **New job descriptions and performance indicators should be developed as a precondition for the new salary system**. Efforts need to be directed towards developing the performance budgeting together with an associated set of performance appraisal criteria and mechanisms. To accomplish this, the HRMA and Finance Ministry need to develop a jointly operated human resource management information system to be able to link personnel information with payroll payments.

4.43. **Recruitment rules need to be made more competitive to allow for new entrants (and additional skills)**. A termination from a post in the civil service, with the payment of severance pay, has to preclude the re-employment in another state institution.

4.44. **The collective salary bargaining process needs to be streamlined.** It should start earlier each year and be concluded before the regular budget preparation process. It would be advantageous to negotiate the gross rather than net minimal price of work

(basic salary). The calculation formula for calculating gross from net salary payments (using the coefficient 1.67) needs to be corrected, as it reflects the contribution rates from previous years. Adjusting for current social-security contribution rates, the contribution liability for the state on behalf of its staff will be reduced.

4.45. **The personal-income tax base needs to be broadened to cover all bonuses and supplements, while many bonuses should be integrated into the basic salary.** Winter and meal bonuses are an example of archaic practices that have been abandoned almost everywhere else in Europe. While additional coefficients for working conditions need to be reflected in job descriptions and job classifications, the rare skills' supplement should be eliminated, as it is prone to abuse and ill-equipped to increase the attractiveness of high-level public sector jobs with comparable ones in the private sector. Performance bonuses should be the main supplement to the basic salary. They need to be devised in a manner that they are linked to a strengthened appraisal system, while remaining financially controllable.

Medium-Term Measures

4.46. **Reduce public employment in selected areas.** There are areas that have already been diagnosed as being overstaffed. The ongoing education reform efforts could serve as an example of how the process may be managed and designed. Staff reduction could be achieved through a combination of attrition with a partial and selective hiring freeze. Moreover, to accommodate selective increases in wages to decompress the pay scales and hiring of new staff required for tasks related to the EU accession process, voluntary separations could be considered. A non-voluntary separation approach is better from a fiscal point of view, since there would be no additional costs related to severance payments. Assuming an attrition rate in the public sector of 1 to 2 percent per annum, accompanied with a hiring freeze would generate savings of about 0.4 to 0.9 percent of GDP per annum at 2007 wage rates.

4.47. **Rationalize the structure of government operations**. This would require a comprehensive functional review of the size, functions, and staffing of all government organizations. At 13, the number of ministries is not large but these ministries have a large number of subordinate organizations. The government should examine the possibility of eliminating some of these organizations through consolidation and providing better coordinated services to the beneficiaries while simultaneously reducing administrative costs.

4.48. **The functional review process should be designed with the following considerations in mind:**

(i) A vertical functional assessment of sectors should be undertaken to review the mandates, the allocation of functions, and the alignment of resources with those functions within a single sector. The primary purpose should be to identify areas where staff reductions are possible without disrupting service delivery.

(ii) There is a strong case for reviewing all of the institutions individually, to determine whether each one is performing a useful function, to gauge whether

their functions could be transferred to either a ministry or the private sector, and to ensure a clearly defined operational and fiscal responsibility towards one ministry. These reviews should also cover subordinate agencies. Government will need to develop policy criteria to facilitate decision-making on whether or not a given function should be undertaken by central government. With an affirmative response, follow-up considerations would refer to the manner, in which this function should be organized, while in the case of a negative response, the questions arise whether that particular function should be dissolved, devolved to local government, or privatized (on the basis of public tenders).

4.49. **Some non-core functions should be outsourced**. Non-civil servant positions in non-core functions—such as transport, security, mail, cleaning, catering, and maintenance—could be transferred, by public tender, to the private sector. The main source of inherent cost savings would come from the increased efficiency, with which the private sector can perform these tasks. If it were possible to outsource 400 positions in the non-civil servant worker pool, Government could expect to save about 0.15 percent of GDP—under conservative assumptions using 2007 wage rates.[80]

[80] The calculations on the outsourcing of 400 positions to the private sector have been done with the assumption of a cost reduction of 50 percent. This is a conservative estimate of the potential saving; international experience suggests that the private sector can provide outsourced public functions with as little as one-third of the number of public workers that had performed the functions previously.

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