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MONTENEGRO

SELECTED ISSUES

September 2017

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SELECTED ISSUES

August 28, 2017

Approved By
European Department

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ACCOUNTING FOR THE HIGHWAY IN THE MACROECONOMIC FRAMEWORK[1]

The Bar-Boljare Highway is a three-phase project to connect Bar (Montenegro's main southern seaport) to the road network of Serbia in the north. The first phase, to be constructed from 2015 to mid-2019, comprises a 41-kilometer section that is to provide an efficient and safe transport link between Podgorica and the poorest northern region in Montenegro. It runs through the mountainous terrain in the center of the country that is economically undeveloped. Due to its large cost (25 percent of 2017 GDP), the first phase of the highway has used up most of Montenegro's fiscal space and will crowd out other productive spending. For the foreseeable future, the second and third parts of the highway could only be financed with concessional funds, because loans would destabilize the debt sustainability of Montenegro.

A. Introduction

1. **The government's main motivation for this large project is the need to improve connectivity, particularly to Europe through Serbia, boost tourism and trade, improve road safety, and strengthen national security.** The highway is a part of Montenegro's plans to integrate the Montenegrin transport network with those of neighboring countries. The 160-kilometer Bar-Boljare highway would provide a link to Belgrade, Serbia, and the Pan-European Corridor X. Another highway—the Adriatic-Ionian highway—would run through Montenegro to connect to Croatia and Albania. The planned investment in the two main highways is central to the latest transport strategy, with costs estimated in 2007 to be at least €2.8 billion (72 percent of 2017 GDP). In addition, there are plans for a rail connection between the Port of Bar and Belgrade.

2. **The Bar-Boljare Highway is to provide a safer and more efficient transport route especially in the northern part of the country.** The current two-lane road is a curvy and mountainous, and considered dangerous, especially during the winter.[2] The road is under-maintained despite €7 million in maintenance expenditure over the last four years and is frequently shut down in the snowy or rainy weather.

3. **Only the first phase of the highway has been budgeted, contracted, and under implementation since May 2015.** The first phase costs about €1 billion (25 percent of 2017 GDP) and is mostly debt financed. It runs from the outskirts of the capital city, Podgorica, through largely undeveloped areas, to the northern municipality of Kolašin. The map below outlines the highway in red.[3] The current section under construction (Podgorica Smokovac -

[1] Prepared by Mariusz Sumlinski.

[2] Since 2012 there were 580 accidents on the Podgorica-Kolašin section of the existing two-lane road, of which over 200 resulted in death or injury.

[3] Source: Ministry of Environmental Protection and Physical Planning.

Bioče - Pelev Brijeg - Lijeva Rijeka - Veruša – Mateševo) is considered a priority by the government as it would link the capital city Podgorica to northern Montenegro, which is underdeveloped and sparsely populated. The current road link (E65), carved into the Morača canyon, is a bottleneck in the road network. The Podgorica – Mateševo section is 41 kilometers long and starts where the Trans-Adriatic Highway project (in blue) meets the red line and continues North to approximately the sharp right turn on the map.

4. The cost of the highway increased significantly because the loan contract was not hedged. The China Road and Bridge Corporation (CRBC) and China Exim Bank are the contractor and the financier, respectively, of the highway. The highway project was originally costed at €809 million, but due to the fixed exchange rate of $1.37 Euro per dollar agreed for the loan, the project costs around $1.1 billion in dollars, and the current estimated cost is almost €1 billion—an increase of 19 percent (4 percentage points of GDP), which is borne by the government.[4] The contract stipulates completion by mid-2019. Domestic companies are supposed to be subcontractors for 30 percent of the project.[5] China's Exim Bank provides 85 percent of the financing as a 20-year loan, denominated in dollars, with a fixed 2 percent interest rate and a six-year grace period. The loan contract implies about 28 percent concessionality. Interest obligations are paid bi-annually (on January 21 and July 21) based on the amount of the funds outstanding on those dates.

B. Incorporating the Highway into the Macroeconomic Framework

5. The construction of the highway can be expected to generate immediate demand spillovers for local goods and services with a multiplier effect through the economy.[6] Multipliers are usually thought to be between 0 and 1 for emerging economies such as Montenegro. Estimates of fiscal multipliers for Montenegro are not readily available. They are inferred, following Batini, Eyraud, and Weber (2014), by matching the relevant characteristics of economies with estimates of fiscal multipliers with the Montenegrin economy's characteristics.[7]

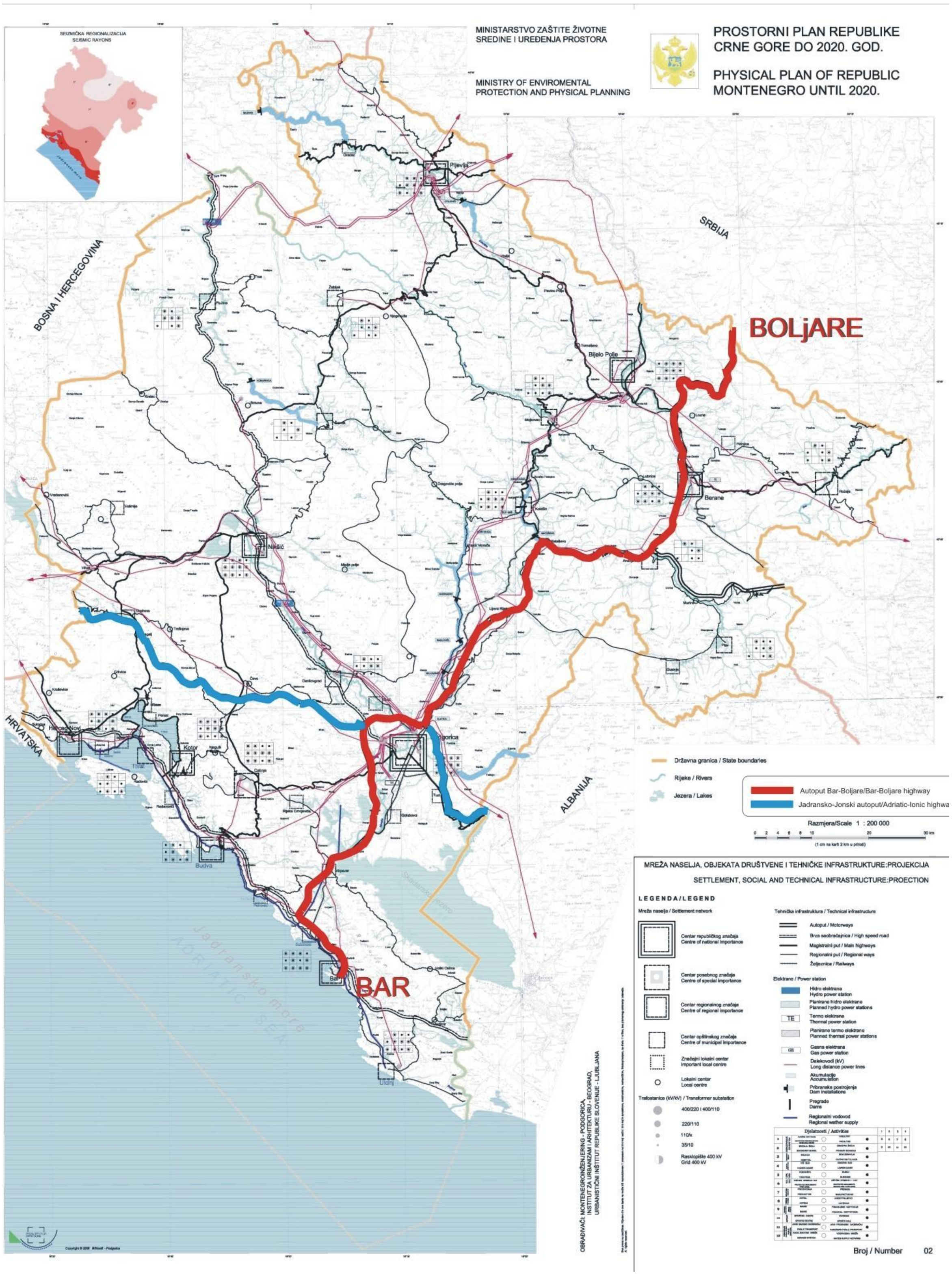
[4] In the fiscal tables in this report, spending on the highway is recorded at the exchange rate, which holds when the spending takes place to reflect the corresponding incurred costs. During the consultations, staff recommend that the authorities adopt the same convention for their fiscal reports to properly reflect the impact of the exchange rate changes on the cost of the highway.

[5] It is estimated that some 4,000 new workers would be employed because of the project, although it is unclear how many would be workers brought in by the company as opposed to local labor.

[6] The reported GDP data might reflect the impact of the highway on growth with a margin of error. The authorities are exploring the ways to refine the GDP recording to increase accuracy of recording of the impact of highway on growth.

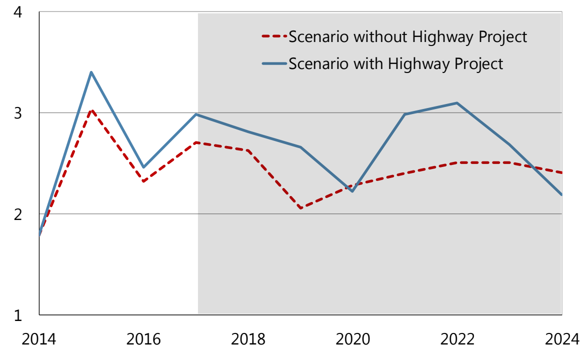
[7] Batini et al, 2014, *A Simple Method to Compute Fiscal Multipliers*.

Planned Route for Bar-Boljare Highway



6. Research suggests that economies with low trade openness, rigid labor markets, share of government expenditure to GDP below 40 percent of GDP, fixed exchange rate regimes, low public debt, and effective PFM systems tend to have higher multipliers.[8] In addition, IMF (SPN 09/11) advocates a rule of thumb using "a multiplier … of 1.5 to 1 for spending multipliers in large countries, 1 to 0.5 for medium sized countries, and 0.5 or less for small open countries … while slightly larger multipliers might be expected from investment spending."[9] Matching the structural characteristics mentioned above with the Montenegrin economy's characteristics and assuming that the 30 percent share of highway spending directed to domestic suppliers will mainly be spent on non-tradable goods, services, and labor, while at least 70 percent leaks out through imports, suggests selection of a low-end instantaneous demand multiplier of 0.2 during the construction phase.[10]

Real GDP Growth
(in percent)



Sources: MONSTAT; and Fund staff projections.

7. The completed highway can be expected to generate positive supply effects, as the improved infrastructure should have a positive effect on the economy's productive potential. To estimate these effects, we use the estimates from the IMF's 2014 October World Economic Outlook (WEO) on the impact of infrastructure investment.[11] They show that investments in infrastructure have positive effects on output ranging from a 0.4 percent increase in the level of output after the first year and up to 1.5 percent after five years. Given the time needed to complete the construction of the highway, the projections assume that the supply effects start in 2019, the year the highway is expected to be completed.

8. As with the demand multipliers, the intensity of the effects will depend on economic circumstances. Most pertinently they are positively correlated with public investment efficiency. IMF researchers constructed a public investment efficiency index which puts overall public investment efficiency for Montenegro in the 2nd bottom quartile of the rated countries—

[8] See: *Montenegro Staff Report for the 2016 Article IV Consultation Appendix I*, February 2016.

[9] Spilimbergo et al, 2011, *Fiscal Multipliers*, page 4.

[10] Staff assumed a standard fiscal multiplier of 0.3 for Montenegro, but since the domestic content of this construction is at most 30 percent compared to probably about 50 percent for the investment projects used for the estimates of multipliers, the final multiplier used is 0.3*0.3/0.5=0.18. The authorities believe that the highway-spending multiplier is somewhat higher at 0.3.

[11] *IMF, October 2014, WEO, Chapter 3: Is It Time for an Infrastructure Push? The Macroeconomic Effects of Public Investment*, Table 3.4.

(continued)

between Ethiopia and Mozambique (Table 1).[12] In addition, a feasibility study for the whole three-phase Bar-Boljare project established its economic rate of return at about 6 percent, which is below the normal benchmark of 12 percent used for World Bank investment projects.[13] The economic return for the first phase is likely to be even lower since the cost is higher per kilometer and the expected traffic is lower.

Table 1. Montenegro: Public Investment Efficiency Index

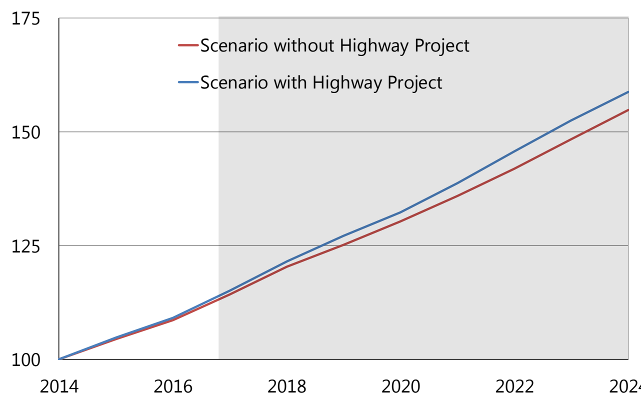
Country	Percentile Rank		All	Appraisal	Selection	Implementation	Evaluation
South Africa	99%	Best	3.5	4.0	4.0	2.8	3.3
Ethiopia	50%		1.7	1.7	1.2	2.4	1.3
Montenegro	47%		1.6	0.8	1.6	2.8	1.3
Mozambique	46%		1.6	0.3	2.0	2.8	1.3
Belize	1%	Worst	0.3	0.0	0.8	0.3	0.0

Source: Dabla-Norris et al. (2011). "Investing in Public Investment: An Index of Public Investment Efficiency."

9. The project is disadvantaged by the very high construction cost arising from the rough terrain through which it passes and by the unanticipated cost increase due to euro depreciation. This section is by far the most expensive section of the motorway, with a cost per kilometer of motorway of about €25 million. There are no settlements of significance between Podgorica (population 195,524) where the current section starts and Mateševo (population 68), a village in the Kolašin Municipality (population 7,678), where the current section ends. In view of these considerations, staff assumes the productive boost upon completion of the first segment of the highway is likely to be 1/3 of the output effects

Gross Domestic Product

(Index, in percent; 2014=100)



Sources: MONSTAT; and Fund staff projections.

[12] *Investing in Public Investment: An Index of Public Investment Efficiency* Era Dabla-Norris, Jim Brumby, Annette Kyobe, Zac Mills, and Chris Papageorgiou, IMF WP 11/37. The authorities noted that this assessment needs to be treated with caution given the vintage of the paper and the data used for its conclusion.

[13] Report No.73826-ME, *Montenegro: Preparing for Prosperity Ensuring Sustainability, Connectivity, and Flexibility for Dynamic Growth*, Country Economic Memorandum, December 21, 2012, World Bank, page 48.

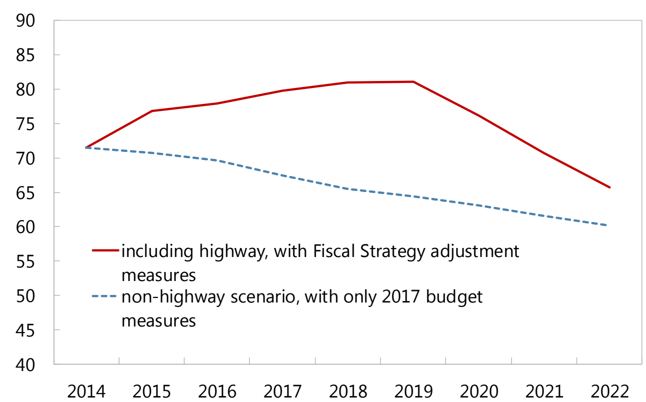
estimated in the 2014 WEO chapter with a total supply multiplier of 0.5 spread over five years.[14] Total GDP including the highway in 2023—the year with the largest difference—would be about 4¼ percentage points of 2014 GDP higher than without it. Growth thereafter would be slightly lower in the scenario with the highway because the higher capital stock would imply larger depreciation. In the very long run, GDP would be the same in the two scenarios.

10. The construction of a highway leading from Belgrade to Montenegro by Serbia would improve the medium-term outlook and economic viability. On May 15, 2017, the Serbian infrastructure ministry signed in Beijing a memorandum of understanding with CRBC for the construction of a motorway, which will connect Belgrade to the border with Montenegro. The works are expected to start in 2018. The CRBC has also expressed interest in constructing a highway to connect the currently built section to the Serbian border, but funds have not been identified. The connection to Belgrade would increase the prospects for economic return of the Montenegrin portion of the highway and improve the macroeconomic outlook for both countries.

C. The Highway's Impact on Debt

11. Montenegro's debt without the highway would have been sustainable, and the authorities would not have had to undertake such significant fiscal adjustment. Based on policies announced in the original 2017 budget and no further adjustment thereafter, debt would have increased to some 93 percent of GDP in 2019. Most of the increase would have been due to the highway as debt would have been 28 percent of GDP lower without the highway. Moreover, debt would have been on a declining path and the fiscal responsibility law targets would not have been breached. With the implementation of the announced fiscal adjustment strategy, debt should remain sustainable over the medium-term and should decline to 66 percent of GDP by 2022.

General Government Debt with Guarantees
(Percent of GDP)

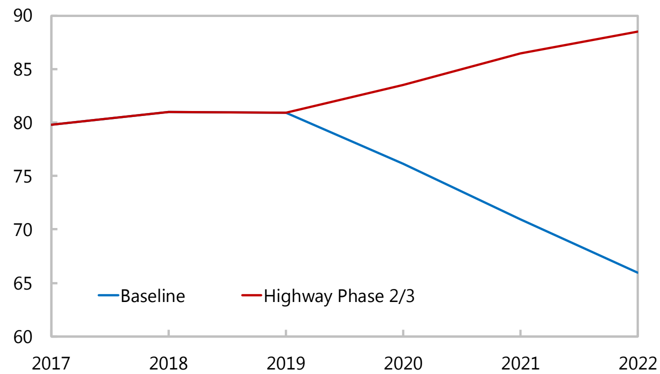


Sources: Montenegrin authorities and staff calculations

[14] The 2014 WEO estimates the investment multiplier at 1.5 after four years for advanced economies. With the project estimated return by the World Bank at half's its estimated value and an investment multiplier of 1 for emerging economies, the estimated efficiency rating for this project is 0.33 = 0.5/1.5.

12. Montenegro can likely not afford to complete the remaining sections of the highway in the foreseeable future. The cost for the two remaining sections is estimated at around €1.2 billion (30 percent of 2017 GDP). Given the high cost and low economic return, the remaining two sections should only be considered if grant financing becomes available. If the country decided to complete the highway with debt financing between 2019-2022, debt would increase to 88 percent of GDP, 22 percent of GDP more than under the baseline. Moreover, fiscal gross financing requirements in 2022 would increase from 11 percent of GDP to 22 percent of GDP. Completing the highway would only be feasible if the authorities could secure mostly concessional financing for the project (over 70 percent) because the estimated return on the investment is so low. This also suggests that Montenegro should focus its attention on other high-return investment projects where the growth effects would be larger and debt sustainability concerns reduced. Better public investment selection and management processes would be important in this respect.

Gross Nominal Public Debt
(in percent of GDP)



Source: IMF staff calculations

FISCAL ADJUSTMENT AND SPENDING REFORMS

With general government debt nearing 80 percent of GDP and large market refinancing needs looming, Montenegro needs significant fiscal adjustment. Appropriately, the authorities began the process of adjustment with the 2017 budget and subsequently have begun to implement a medium-term fiscal consolidation plan, which should address debt sustainability concerns. The authorities should also reform government expenditures and local government finances. This chapter address these issues in four parts. In the first section, we dive into government expenditures, benchmarking Montenegro's level of current expenditures against other country groups. In the second section, we explore the rationale for fiscal adjustment, assess the authorities' fiscal adjustment measures, and explore how further fiscal reform could improve macroeconomic outcomes. In the third and fourth sections, we present specific recommendations to improve the sustainability of the pension system and local government finances, respectively.

A. Public Expenditure Diagnostic[1]

Fiscal consolidation needs to advance in the short and medium term not only to ensure sustainable fiscal and debt positions, but also to meet Montenegro's development needs. Over the last ten years, despite the government's efforts, progress with fiscal consolidation has been marginal, and most recent developments suggest that consolidation commitments are too often difficult to implement owing to political and social pressures. Comparing Montenegro's fiscal outcomes with benchmark country groups suggests that decisive consolidation of current expenditure is needed, including for wages, social, health and pension expenditures. Also, there is a need to rebalance current and development expenditure.

Introduction

1. A deterioration in fiscal performance has been present since 2004 (Figure 1). Montenegro is a young sovereign state having separated from Serbia in 2006. The country experienced rapid growth in 2006–08 that supported buoyant revenues and allowed for a reversal from the small pre-independence deficits to sizable surpluses in 2006–07. In 2008, with the onset of the global financial crisis (GFC), the budget posted a small deficit. As the economy shrank in 2009 by more than 5 percent, the deficit increased and has not reversed since then. Since 2004, spending in Montenegro has outpaced GDP growth. Spending grew 154 percent, while GDP grew 117 percent, and revenues 136 percent. For current and capital expenditures that translates into an overall 23 percentage points of GDP increase in spending. Current spending increased from 20 percent of GDP in 2004 to 41 percent of GDP in 2015. Capital expenditure increased from 3 percent of GDP in 2004 to 6 percent of GDP in 2015. Spending grew at a much

[1] This section was prepared by Mariusz Sumlinski. The analysis is based on the data and aggregations provided via IMF FAD Expenditure Assessment Tool. Special thanks to Mercedes Garcia-Escribano and Candice Yue Liu, who provided data and guidance through their paper: *Expenditure Assessment Tool (EAT)*, October 2016, IMF FAD.

slower pace in most comparators. It averaged 1.1 percentage points of GDP in Emerging Europe countries, 5.3 percentage points of GDP in EMs, and about 1.9 percentage points of GDP in the OECD countries.

2. General government expenditure in Montenegro is significantly above the regional comparators and EMs averages, and is heavily tilted towards current expenditures. The latter feature is somewhat consistent with the trend in the regional comparators. However, it exceeds the EMs average which is equal to about ¾ of Montenegro's current spending. In 2015, Montenegro's government spent nearly 47 percent of GDP, 6 percentage points of GDP more than the EM Europe average. When assessing the composition, current spending represents nearly 90 percent of the budget. This heavy tilt towards current spending is reflected in spending growth primarily driven by current spending, which grew about 3.5 times since 2004.

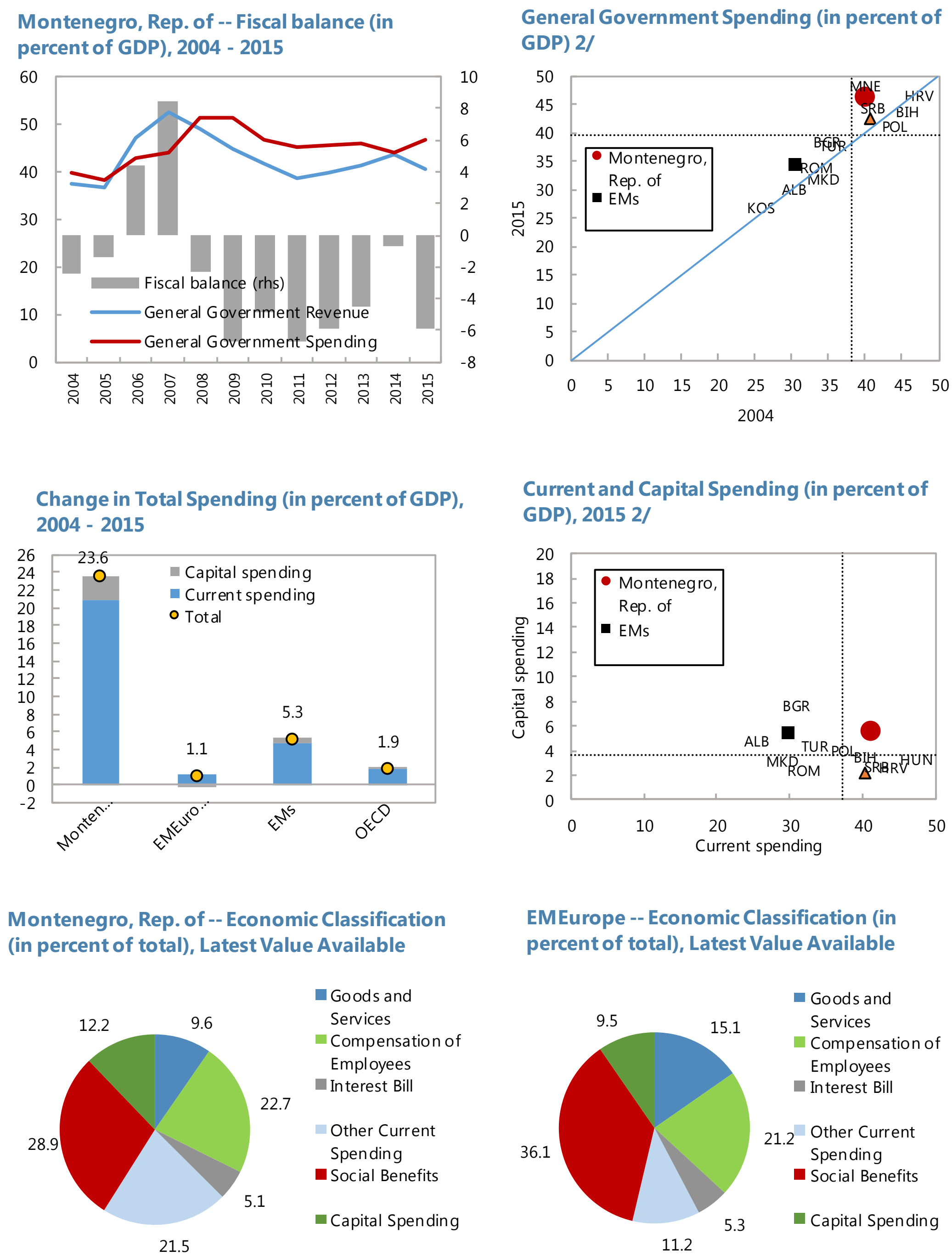
Current Spending

3. Current spending is high for most economic categories, but especially for the compensation of employees, social benefits, and the other current spending. Together, these three categories amount to nearly 75 percent of spending. Compensation of employees is broadly as in the EM Europe comparators as a percentage of spending, but social spending is 7 percent lower, and other current spending is some 10 percent above the comparators. The high share of other current spending should be reviewed to see if there is room for savings, as it is high compared to others. Capital spending, while somewhat above the comparators in 2015, should increase further given the infrastructure, maintenance, and other investment needs (including EU-mandated).

4. Montenegro's wage bill has not changed significantly over the last ten years (Figure 2). As a share of GDP, it has declined marginally since its peak in 2012, but was still 11 percent in 2015, which is broadly equivalent to the 2004 level. The wage bill declined briefly to below 9 percent of GDP in 2008 reflecting rapid economic growth over 2006-08 and declining public sector employment owing to increased employment opportunities in the private sector. However, this decline did not last and the wage bill recovered to previous levels. The share of public sector employment has been broadly unchanged since 2011.

5. Montenegro's wage bill as a share of GDP is slightly elevated compared to emerging markets and regional comparators. The average wage spending for the income based benchmark (emerging markets and middle-income countries) is around 9 percent of GDP compared to 11 percent in Montenegro. However, at 12 percent of the labor force, government employment is much higher than the income based comparator's average of 8 percent, and also larger than regional comparators or OECD countries. A more disaggregated comparison with the regional peers shows that Montenegro's wage bill as a share of total spending is the highest among the regional peers and equivalent to the EM's average value, but below the income based benchmark. The public wage premium is not available for Montenegro, but the average

Figure 1. Government Spending and Economic Classification 1/

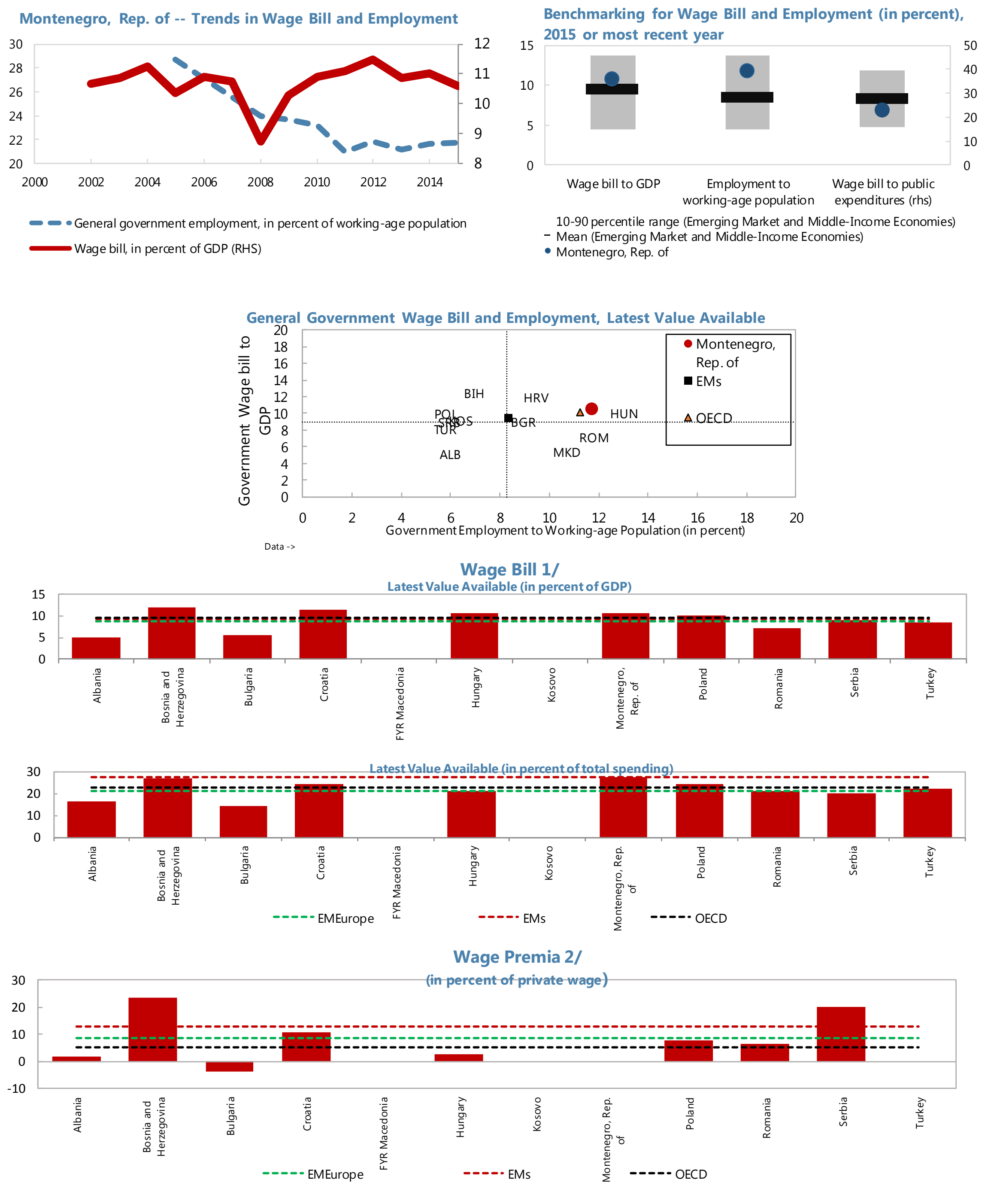


Source: IMF FAD Expenditure Assessment Tool (EAT), World Economic Outlook.

1/ Coverage refers to general government as per World Economic Outlook metadata.

2/ Dashlines are the average of EM Europe.

Figure 2. Government Wage Bill



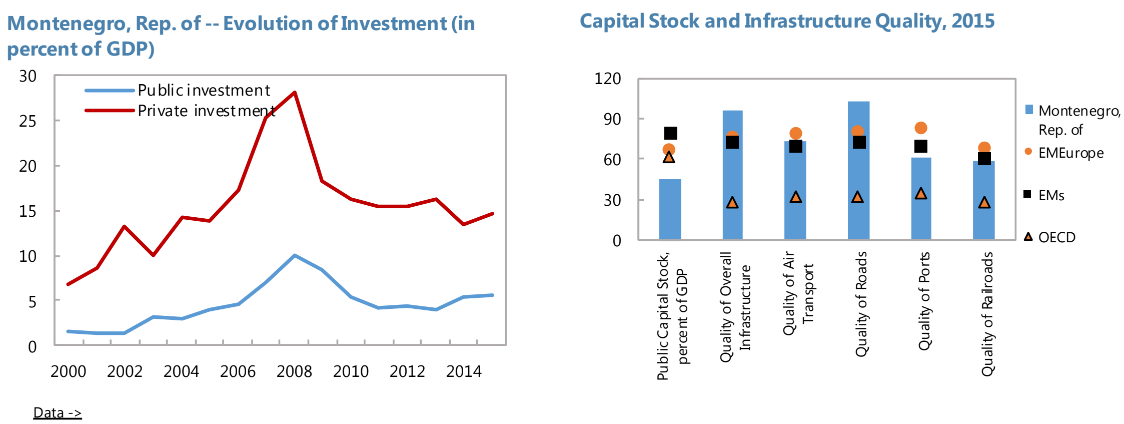
Source: IMF FAD Expenditure Assessment Tool (EAT), IMF FAD Government Wage Bill and Employment Dataset.
1/ Dash lines are the average for countries in the regional benchmark group.
2/ Public-private wage differential (as a percent of private wage): based on a review of regression-based studies that control for skill differentials between the public and private sector. Numbers are calculated by taking the within-country average over time. Form MNE not available.

government wage is higher than the average private sector wage. However, it seems reasonable to assume that the wage premium is less of a problem than excessive public employment. The reforms aimed at rationalization of the wage bill should probably concentrate on employment in a context of a comprehensive civil service reform. The wage structure should be adjusted to make it fiscally affordable while assuring efficient delivery of public services and attracting the appropriate job skills.

Capital Spending

6. Montenegro's public capital stock is much lower than that of the comparators (Figure 3). It is the result of the relatively low public capital spending over the past decade and a half. Since 2010, public capital spending as a share of GDP has stabilized at about 4-5 percent of GDP after expanding to about 10 percent of GDP in 2008 in the context of the run-up to the GFC. For 2017-19 public capital expenditures are expected to average 10 percent of GDP due to the Bar-Boljare highway construction, however at a cost of increasing public debt and endangered fiscal sustainability (see discussion in the Staff Report and Chapter I).

Figure 3. Investment and Infrastructure



Sources: IMF FAD Expenditure Assessment Tool (EAT), IMF Investment and Capital Stock Dataset, and World Economic Forum.

7. The quality of infrastructure is below regional and emerging markets comparators. The quality of air transport and railroads is on par with the EMs and the European EMs. The quality of ports appears to be even better than the comparators. However, the quality of roads seems much worse than the comparators. Catching up will require increased public investments, as most infrastructure is in public hands and private investors are unlikely to shoulder these projects.

8. An increase in investment is needed to address infrastructure gaps. Priority should be given to increasing the public stock of capital. This should happen alongside ensuring proper maintenance of the current capital stock. Montenegro has pressing needs for additional high-quality investment to fill the infrastructure gap. Additional investments in the environmental sphere are demanded by the EU standards. It is important that Montenegro develops strong capacity in project appraisal and implementation, which would help avoid an investment boom-bust cycle like the one observed in the last decade.

Energy Subsidies

9. Energy subsidies in Montenegro in 2015 amounted to around 15 percent of GDP (Figure 4). They comprised about 1 percent of GDP of subsidies to petroleum and about 14 percent of GDP subsidies to coal. This is much lower than the subsidies in some of the regional comparators—most notably Serbia, Kosovo, Bosnia and Herzegovina, but also much higher than in the European EMs. It is slightly above the EM Europe average, but a multiple of the OECD or the EM averages.

10. The negative externalities derived from the coal subsidies in Montenegro at about 17 percent of GDP are as large as the subsidies. They are at the level of European EM average, but again a multiple of the OECD or the EM averages. Montenegro can ill afford those significant subsidies as well as the externalities that impose a substantial cost on the population in terms of diminished life expectancy and disease. The social, economic, and political importance of the coal and energy industry make it difficult to implement decisive actions that would eliminate the subsides. However, the careful cost benefit analysis of the subsidies and their detrimental unintended effects would clearly show that their removal is in the best interests of the country's economy as well as current and future generations who will bear the costs of diminished life expectancy and preventable diseases.

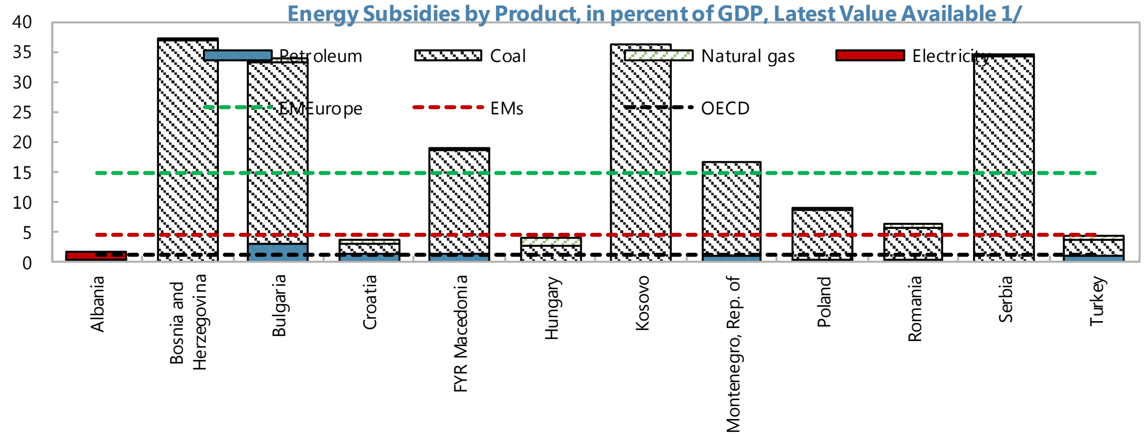
Health and Education Spending

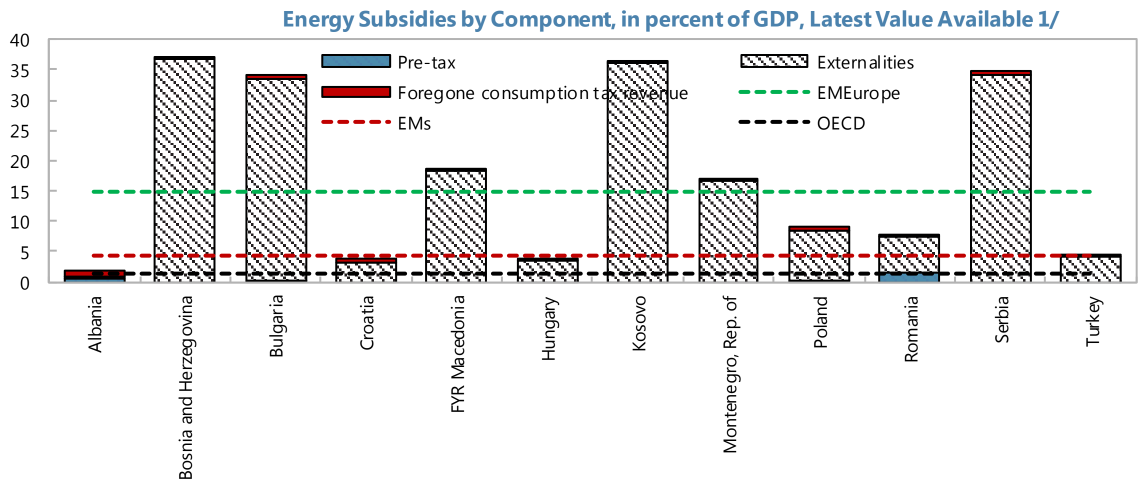
11. Health outcomes are impressive in Montenegro (Figure 5). Health outputs, such as number of infant deaths and life expectancy at birth are better or equal to comparators. The inputs—hospital beds, numbers of medical personnel, and number of physicians are more favorable in Montenegro than in comparators. Montenegro places close to the healthy efficiency frontier (HALE) indicating that health-system inefficiencies are small and below the EM average.[2] HALE adjusts standard life-expectancy measures for severity of illnesses and quality of life factors.

[2] The efficiency frontier is calculated using Data Envelopment Analysis (DEA) technique, which provides efficiency scores based on the input and output variables. DEA involves an application of linear programming methods where the frontier is built by connecting the bundles of units (countries) for which no other unit (country) produces the same or more output with a certain amount of input. The DEA frontier is the line that connects those bundles and is convex. The health efficiency frontier allows to examine the scope for improvements in health spending effectiveness. The chart plots Healthy Life Expectancy (HALE) as output on the vertical axis and

(continued)

Figure 4. Energy Subsidies





Source: IMF FAD Expenditure Assessment Tool (EAT), IMF Energy Subsidy Estimates.
1/ Dashlines are the median for countries in the region.

total health expenditure per capita on the horizontal axis. The distance to the efficiency frontier, which is a best practice frontier, provides information on the loss in HALE due to health system inefficiencies. The distance to the frontier also informs on potential savings without compromising health outcomes. The bigger the distance to the efficiency frontier, the more inefficient a country is in providing health services. HALE adjusts standard life-expectancy measures for severity of illnesses and quality of life factors. Factors such as the quality of health care environment are not considered. HALE is calculated by subtracting the years of ill health (weighted per severity) from overall life expectancy. See Mercedes Garcia-Escribano and Candice Yue Liu, *Expenditure Assessment Tool (EAT)*, October 2016, IMF FAD, p. 14.

The chart also suggests that some trade-off between the HALE and the costs of obtaining it is still possible. A detailed analysis of the health system would provide options that could generate savings without adversely affecting health outcomes.[3]

12. Good health outcomes were achieved with lower expenditures than comparators. In addition, total health expenditures including their public share have been declining since 2011. The share of health expenditures in total public expenditures has been broadly stable at about 10 percent since 2010. The efficiency of the health expenditures appears not too far from the efficiency frontier. Both factors would argue for a careful review of the public spending practices that would build on the current synergies to preserve the quality of outcomes while at a minimum retaining the efficiency of their production. The World Bank suggests discovering efficiencies locked in provision of drugs and services and concentration on primary and preventive care. Strict arrears control and prevention through better public financial management would also be helpful with cost control. Tax policies utilizing "sin" taxes and coal/carbon tax to control pollution would also be helpful in making the system less costly and better able to deal with future health care challenges. The authorities are increasing some of these taxes as part of their fiscal strategy.

13. Education outcomes have matched those of comparators (Figure 6). PISA outcomes match those of the EMs, the literacy rate is virtually universal and in line with comparators as is primary enrollment. The challenge going forward is to revamp the educational system to better serve evolving labor market needs, while preserving strong literacy and numeracy accomplishments. The efficiency of education provision could be improved as indicated by the estimated position of indicators for Montenegro vis-a-vis the efficiency frontier with respect to spending and number of teachers.

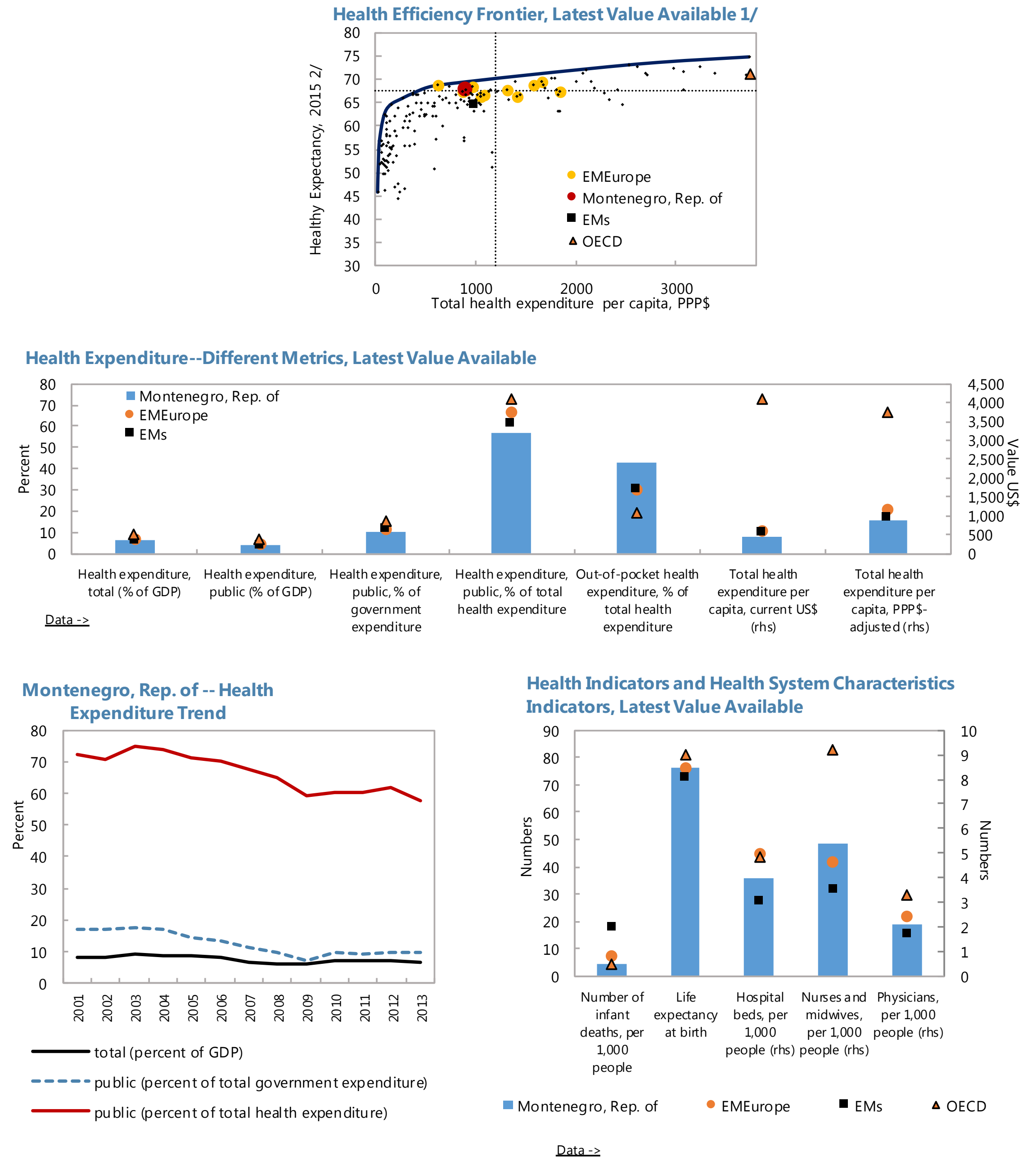
Social Protection Spending

14. The provision of social protection to the vulnerable population presents a major challenge going forward (Figure 7). Social assistance spending is above the EM average.[4] The recently adopted law on benefits to mothers with three or more children had the potential to exhaust fiscal space and threaten fiscal sustainability and fortunately is being revised to improve targeting of social benefits and child support as part of the authorities' fiscal strategy. Meeting the social protection needs will become more challenging in the future given population dynamics facing Montenegro. With near zero population growth, the country faces a future

[3] The authorities are working with the World Bank to generate health sector savings. However, these savings would mostly be used to bring down unfunded expenditure commitments.

[4] Social assistance programs comprise non-contributory transfers in cash or in-kind. The EAT uses the World Bank's ASPIRE project data, which classify social assistance into the following categories: unconditional cash transfers, cash transfers, social pension, food and in-kind transfers, school feeding, public works, fee waivers and other social assistance.

Figure 5. Health Expenditure



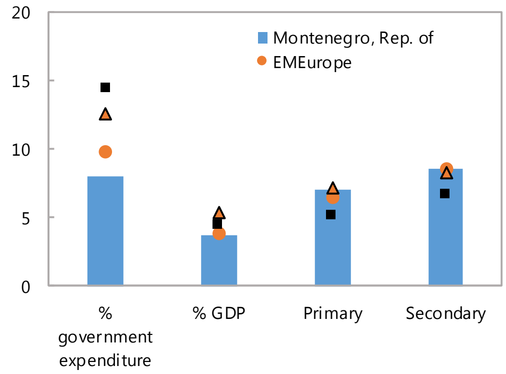
Source: IMF FAD Expenditure Assessment Tool (EAT), World Bank, World Health Organization.

1/ Dashlines are the average of EM Europe.

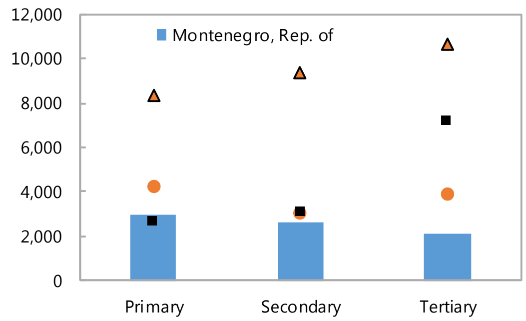
2/ Healthy life expectancy (HALE) is a measure of health expectancy that applies disability weights to health states to compute the equivalent number of years of life expected to be lived in full health.

Figure 6. Government Education Expenditure

Government Education Expenditure, Latest Value Available



Government Education Expenditure per Student, PPP$ adjusted, Latest Value Available



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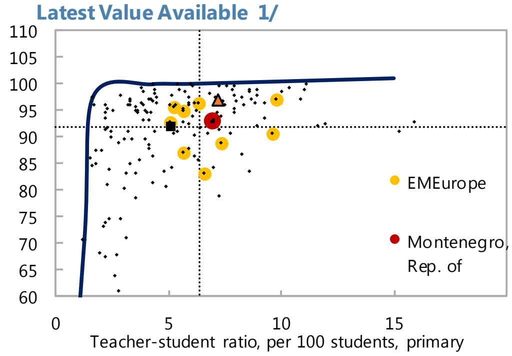
Teachers and Outcome, primary, Latest Value Available 1/



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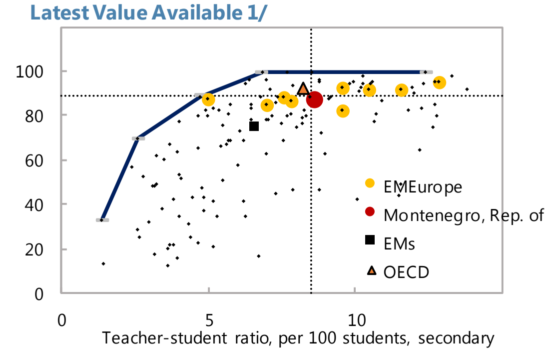

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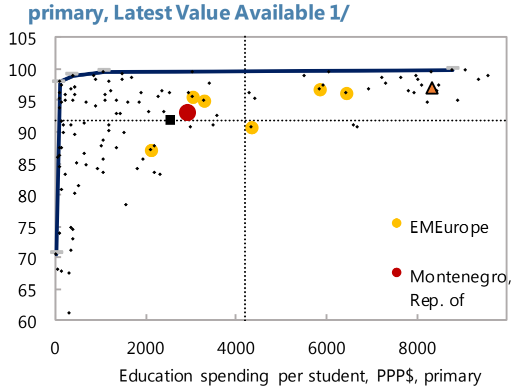
Government Education Spending and Outcome, primary, Latest Value Available 1/



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Government Education Spending and Outcome, secondary, Latest Value Available 1/

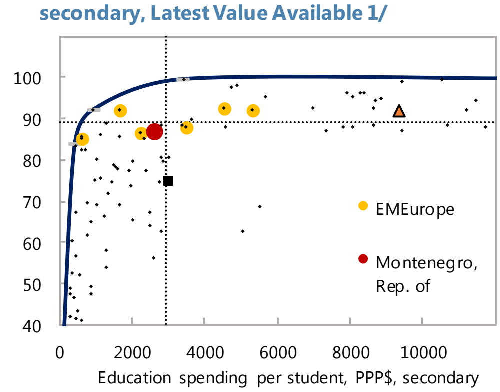

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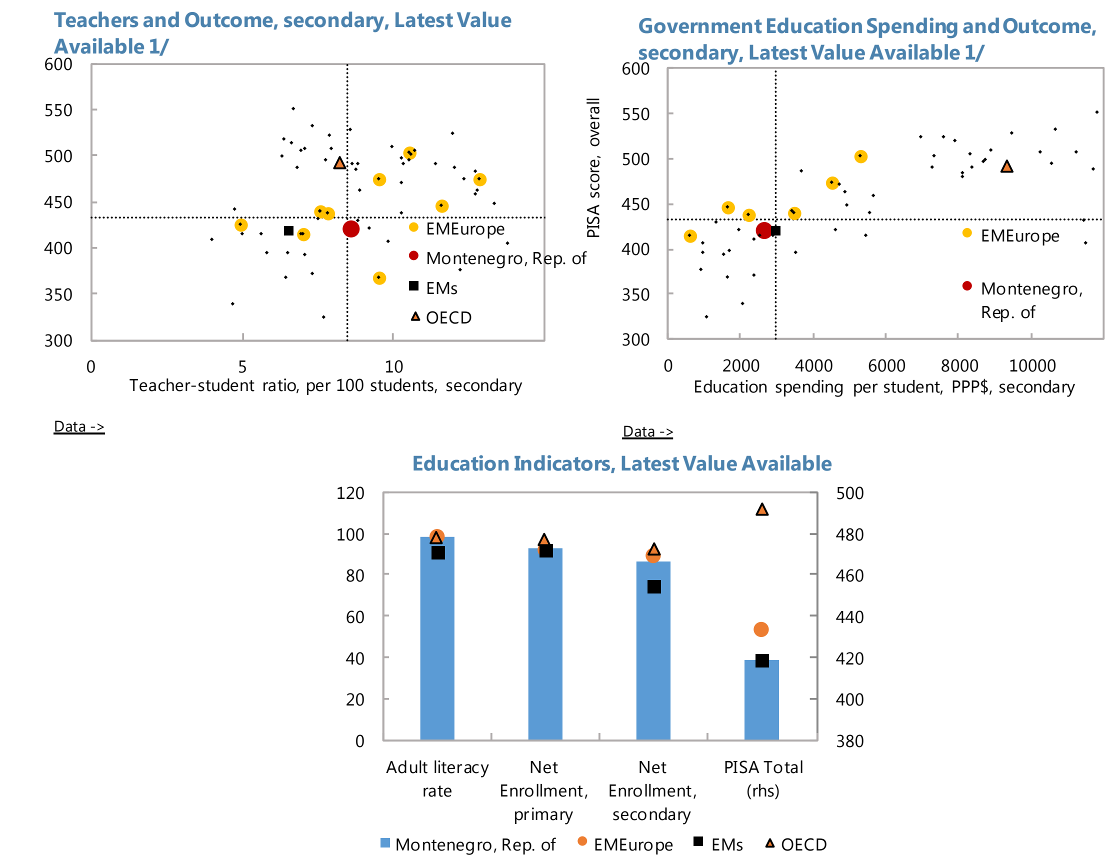
Figure 6. Government Education Expenditure (concluded)



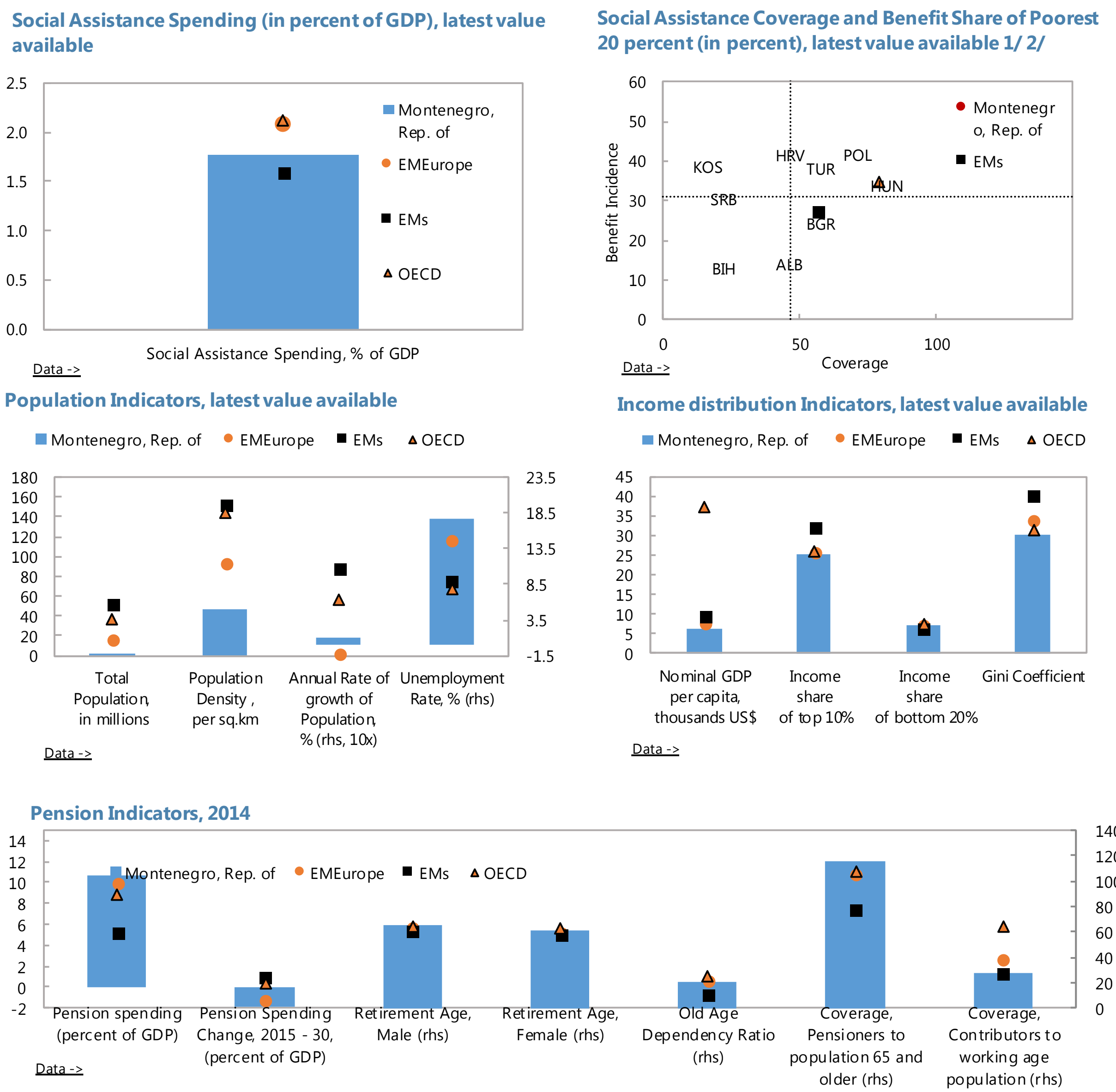
1/ Dashlines are the average of EMEurope.
Source: IMF FAD Expenditure Assessment Tool (EAT), World Bank. MONSTAT

where the current 20 percent share of 65+ population will increase significantly and persist given the life expectancy development. High unemployment and low potential growth will limit the prospects for growing budget resources to meet expanding needs. An income distribution, with the Gini coefficient at OECD levels suggests that future pressures for social assistance will likely intensify, as the income inequality is unlikely to improve as incomes grow.

15. Pension indicators point to a pension system that is burdened with the generous early retirement pensioners. Pension spending as a share of GDP exceeds the average of all comparators. The retirement age and old age dependency ratio correspond to those of the comparators. However, at 116 percent, the coverage (pensioners as a ratio of the 65+ population) is higher than comparators and suggests a substantial share of the pensioners retiring early. The coverage of contributors to the working age population is low—suggesting that the pension system may become a less effective old-age poverty protection tool in the future.

16. **Montenegro should adopt a social protection strategy that will assure long-term solvency and fairness.** The government should focus on reforms that would assure well-targeted and adequate benefits and create a fiscally and socially sustainable pension system. Early retirement schemes need to be eliminated or severely curtailed to reduce costs and encourage longer working lives. Additional reforms to increase labor market participation and the grey economy would help with social protection and pensions.

Figure 7. Social Protection



Sources: IMF FAD Expenditure Assessment Tool (EAT), World Economic Outlook, ASPIRE, and IMF Pension Indicators.
1/ Dashlines are the average of EMEurope.
2/ Coverage is (number of individuals in the quintile who live in a household where at least one member receives the transfer)/(number of individuals in that quintile). Benefit incidence is equal to (sum of all transfers received by all individuals in the quintile)/(sum of all transfers received by all individuals in the population).

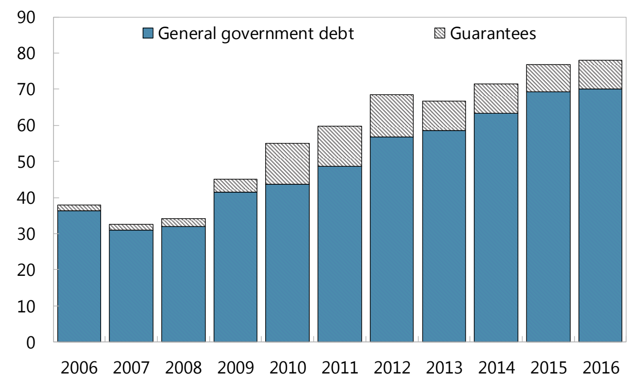
B. Fiscal Adjustment Strategy Options[5]

With general government debt nearing 80 percent of GDP and large market refinancing needs looming, Montenegro needs significant fiscal adjustment. Appropriately, the authorities began the process of adjustment with the 2017 budget and subsequently have begun to implement a medium-term fiscal consolidation plan, which should address debt sustainability concerns. The authorities should also reform government expenditures and local government finances. This chapter address these issues in four parts. In the first section, we explore the rationale for fiscal adjustment, assess the authorities' fiscal adjustment measures, and explore how further fiscal reform could improve macroeconomic outcomes. In the second section, we dive into government expenditures, benchmarking Montenegro's level of current expenditures against other country groups. In the third and fourth sections, we present specific recommendations to improve the sustainability of the pension system and local government finances, respectively.

Introduction

17. Government debt in Montenegro has risen steadily since the global financial crisis, despite an earlier fiscal adjustment effort. From 33 percent of GDP in 2007, general government debt including guarantees increased to 78 percent of GDP in 2016.[6] With the end of the pre-crisis boom severely eroding the revenue base, the general government fiscal deficit averaged 5.2 percent over 2008-11. During this time, the authorities also issued significant guarantees of borrowing by state-owned enterprises, with the stock of guarantees increasing from 1.6 percent of GDP in 2006 to 11.4 percent of GDP in 2010. A subsequent gradual rise in revenues and fiscal adjustment effort reduced the overall fiscal deficit to 0.7 percent of GDP by 2014.

General Government Debt Including Guarantees
(Percent of GDP)



Sources: Montenegrin authorities and Fund staff calculations

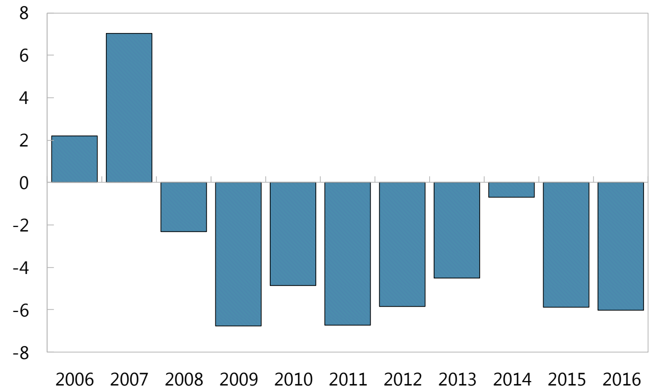
18. The construction of the Bar-Boljare highway is increasing government debt significantly. The highway was originally budgeted at €809 million (23 percent of 2014 GDP), but the financing arrangements have greatly increased the fiscal cost. China ExIm Bank is financing 85 percent of construction cost with a dollar-denominated loan, with the exchange rate

[5] This section was prepared by William Lindquist.

[6] In this paper, "government debt" refers to general government debt including issued guarantees, unless otherwise noted. In 2016, general government debt (which includes central and local government debt) reached 70 percent of GDP, while guarantees comprised 8 percent of GDP. Unless otherwise noted, "fiscal deficit" refers to the general government fiscal deficit.

fixed at the USD/EUR exchange rate at the time the loan agreement was signed in 2014. As the U.S. dollar has subsequently strengthened against the euro, the fiscal cost of the highway has increased to nearly €1 billion (25 percent of 2017 GDP). Due to delays in construction, only 20 percent of the ExIm loan had been disbursed by the end of 2016, portending a further rise in debt by the project's completion in 2019.

Overall Fiscal Balance
(Percent of GDP)



Sources: Montenegrin authorities and Fund staff calculations

19. A fiscal expansion in 2016 added to expenditure pressures. Prior to the 2016 general election, the parliament approved a new lifetime benefit for mothers of three or more children, known as the "Mothers Law." This benefit created 1.7 percent of GDP in additional expenditures. The authorities also provided wage increases up to 16 percent for public sector workers, and the public-sector wage bill increased from 10.6 percent of GDP in 2015 to 11.2 percent of GDP in 2016.[7]

20. A medium-term fiscal adjustment plan is needed to reduce government debt and create space for increased capital and other priority spending. In the absence of fiscal adjustment, staff projects that government debt would approach 90 percent of GDP by 2019, at a time when large Eurobonds need to be rolled over. The highway has also crowded out non-highway capital spending, despite Montenegro's large investment needs, including those related to EU accession (waste and water treatment) over the medium term.

21. Recognizing the need for fiscal adjustment, the authorities have moved in two phases to design a medium-term adjustment plan. Fund staff has recommended that the authorities target a primary fiscal surplus of 4½ percent of GDP in 2020. In the 2017 budget, the authorities identified 2 percent of GDP in fiscal measures. Subsequently, in June 2017 the authorities announced a medium-term fiscal strategy with an additional 2¼ percent of GDP in measures, which staff assesses would deliver a primary surplus of 4½ percent of GDP in 2020, placing debt on a strongly downward trajectory.

22. Fiscal adjustment also provides an opportunity to reorient the mix of public expenditures while bolstering economic growth. Building on the authorities' fiscal adjustment plan, staff has also identified some additional policy measures that would put pensions on a more sustainable footing, tackle air pollution through a larger coal excise tax, and reform local government finances. The authorities should also consider reforms to social contributions that could help reduce the labor tax wedge and promote the growth of formal employment.

[7] The average wage of central government employees increased 8.8 percent in 2016.

Initial fiscal adjustment steps – 2017 budget

23. Recognizing the need for fiscal adjustment, the authorities included several important measures in the 2017 budget. The measures are nearly evenly split between the revenue and expenditure sides. Staff believes that the measures will likely deliver 2 percent of GDP in fiscal adjustment, though about one-third of the measures are temporary in nature. The most significant measures are

- *Fuel excises:* The excise tax on fuel has been increased by €90 per 1000 liters.
- *Extension of the "crisis tax":* The personal income tax rate of 11 percent, compared to the 9 percent standard rate, will continue to apply through 2019 for income in excess of the average wage.
- *Tax administration:* As part of their overall efforts to reduce the gray economy, the authorities expect a slow increase in formalized employment, which can boost tax revenues. The authorities also plan to improve monitoring of cash registers through electronic fiscalization. Their overall efforts to improve tax administration should boost tax revenues over time, though gains will likely be slow.
- *Mothers' Law benefit:* The parliament amended the Law on Social and Child Protection to change the amount of the "Mothers Law" benefit from 70 percent of the average net wage (previously €336 per month) to €264 per month.
- *Public sector wages:* The wages of senior officials were reduced by 8 percent, and the payment for years of service was frozen for 2017-2018.[8]
- *Other expenditure cuts:* The authorities also plan to reduce a range of discretionary expenditures, including capital expenditures and other current spending.

24. At the time, the authorities also signaled their intention to contain the public-sector wage bill and limit the fiscal cost of the "Mothers' Law." During the February mission for the 2017 Article IV consultation, the authorities stated their intention to freeze the overall size of the public-sector workforce at its current level and limit annual nominal wage increases to 1 percent, at least through 2019. While the constitutionality of the mothers' benefits was being challenged in the Montenegrin constitutional court, in case the benefits were to continue to be paid, the authorities intended to implement policies to hold the nominal fiscal cost of the benefits constant. This could be achieved by means-testing of the benefits or further adjustments to the amount of the benefit. Together, these measures would have delivered an additional estimated 1¾ percent of GDP in durable fiscal adjustment by 2020.

[8] The authorities amended this measure in March 2017 to decrease the wages of certain positions by 1 percent, instead of freezing the payments for years of service. The new measure has the same fiscal impact as the previous one.

Table 1. Montenegro: Staff Assessment of Adopted 2017 Fiscal Adjustment Measures

Measure	Description	2017 impact (EUR million)	2017 impact (% of GDP)	Permanent impact (Percent of GDP)
Extension of crisis tax 1/	Crisis tax on personal incomes above EUR 700 per month to continue at 9+2% through 2019	6.0	0.2	...
VAT exemption repeals	VAT exemptions repealed for some products (computer equipment)	0.8	0.0	0.0
Tax administration	Strengthening tax collection	5.0	0.1	0.1
Excises	Increase in excise tax on fuel of EUR 90 per 1000 liters	24.0	0.6	0.6
VAT gains from fuel excise increase	VAT applied on fuel price inclusive of excise increase	5.0	0.1	0.1
Total revenue measures		34.8	0.9	0.9
Public sector wage/hiring freeze/cuts for senior officials	Freeze payment for years of service for 2017-2018, freeze employment levels, reduce wages of senior officials by 8%	5.6	0.1	0.1
Reduce Mothers Law benefit	Adjustment of benefit from EUR 336 to EUR 264 per month	8.3	0.2	0.2
Capital expenditure reduction	Reduction in the non-highway capital budget	10.0	0.3	...
Personal income	Reduction in expenditures for personal income	0.4	0.0	0.0
Materials and services	Reduction in materials and services spending	0.9	0.0	...
Subsidies	Cut in subsidies	1.4	0.0	0.0
Redundancy fund	Reduction in payments to redundant workers for employees from KAP entitled to pension	3.8	0.1	0.1
Health insurance	Reduction in other rights from health insurance	1.6	0.0	...
Transfers	Reduction in transfers to institutions, individuals, NGOs, and the public sector	7.3	0.2	...
Net lending	Reduction in loans and borrowings	0.2	0.0	...
Budgetary reserve	Cut to current budgetary reserve	3.2	0.1	...
Other expenditure		2.0	0.1	...
Total expenditure measures		44.7	1.1	0.5
Total adjustment		79.5	2.0	1.4

Sources: Ministry of Finance and Fund staff calculations

1/ Because the crisis tax extension represents a continuation of previous policy, it is not included in the accounting of fiscal measures.

25. Based on policies communicated during the February Article IV mission, Fund staff assessed that government debt would have peaked in 2019 around 89 percent of GDP and fallen thereafter at a relatively slow pace. After the completion of the highway, the primary balance would have moved into a surplus in 2020 of roughly 2½ percent of GDP. With a debt-stabilizing primary balance of roughly 1 percent of GDP, if the primary surplus were held at 2 percent of GDP over the longer term, government debt would have only fallen to 70 percent of GDP by 2030, a level still considered elevated for an emerging market economy.

Staff-recommended path for fiscal adjustment

26. During the February 2017 Article IV consultation, staff recommended that the authorities implement additional fiscal adjustment measures to reach a primary surplus of 4½ percent of GDP by 2020. This is a very high primary balance, but staff recommended that the authorities take strong steps to reduce market refinancing needs in 2019 and 2020 to facilitate continued market access. In 2019 and 2020, Montenegro must roll over €280 million and €500 million (7 and 11 percent of GDP) in Eurobonds, and overall unidentified financing needs were estimated at 8 and 11 percent of GDP. If a primary surplus of 4½ percent of GDP were achieved by 2020, unidentified fiscal financing needs would have declined to 6 and 9 percent of GDP (€370 and €530 million) in 2019 and 2020, respectively, levels that may be more feasible for Montenegro to finance in Eurobond markets.[9] Also, perhaps equally important, by establishing a track-record of fiscal adjustment, markets would be convinced of Montenegro's creditworthiness.

27. Staff recommended that the fiscal adjustment be phased in gradually over 2017-19, which would have a more moderate impact on economic growth than would a fully upfront adjustment. To have a material impact on market refinancing needs in 2019 and 2020, the staff-recommended adjustment would be complete by 2019. Staff recommended that the authorities consider an additional 0.5 percent of GDP in measures in 2017, which could be achieved on the revenue side. Staff also recommended further adjustment of 1 percent of GDP in 2018 and 0.5 percent of GDP in 2019, for a cumulative 2 percent of GDP in additional adjustment. While the primary balance would remain in deficit through 2019, given projected highway spending, a strong primary surplus would emerge in 2020 upon completion of the first phase of the highway. Assuming a fiscal multiplier of 0.5, average economic growth over 2017-19 would decline by about 0.3 percentage points per year. Overall, the economy should be better positioned to absorb fiscal adjustment over 2017-19 while maintaining economic growth due to the continued stimulative impact of the highway construction.

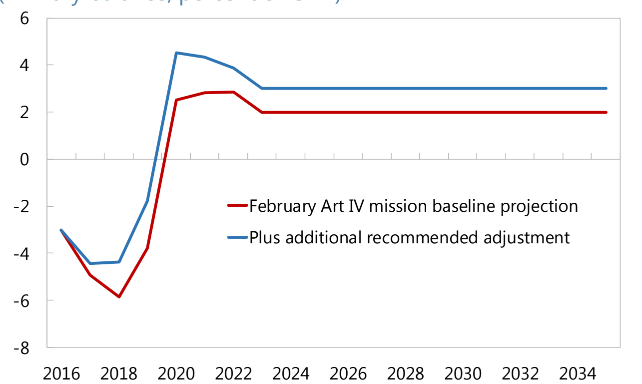
28. As part of a fiscal adjustment plan, staff also recommended increasing social and capital spending. Apart from the highway, Montenegro has large public investment needs, and well-targeted social spending would help soften the impact of the adjustment on the most vulnerable parts of the population. Staff recommended that the authorities build in fiscal space

[9] Montenegro's previous Eurobond issues have ranged from €180 to €500 million in size.

to increase capital spending by ½ percent of GDP and social spending by ¼ percent of GDP. Thus, to achieve a 2 percent of GDP improvement in the primary balance by 2020 relative to the baseline, Montenegro would need to identify fiscal measures totaling 2¾ percent of GDP.

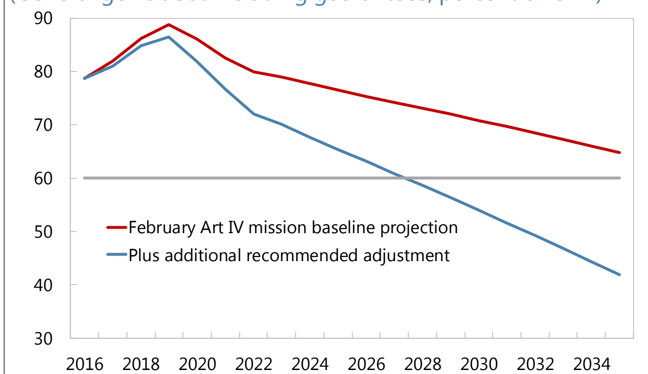
29. Staff recommended that the primary surplus be held over the longer term at 3 percent of GDP, leading government debt to fall to 60 percent of GDP by 2027. After 2020, the primary surplus could be gradually relaxed to 3 percent of GDP, once the debt refinancing hump is overcome. This would also allow for an increase in non-highway capital spending, which has been depressed in recent years. Montenegro still has large investment needs, including in areas related to EU accession, such as water and sanitation.

February Article IV Mission Fiscal Scenarios: 2016-2035
(Primary balance, percent of GDP)



Sources: Montenegrin authorities and Fund staff projections

February Article IV Mission Fiscal Scenarios: 2016-2035
(General gov't debt including guarantees, percent of GDP)



Sources: Montenegrin authorities and Fund staff projections
Note: Projections assume fiscal multiplier of 0.5 for adjustment measures

Montenegro's June 2017 fiscal adjustment strategy

30. Seeking a stronger fiscal adjustment, the authorities announced in June 2017 a well-specified medium-term fiscal strategy. Cognizant of the risks of rising debt and the need to refinance significant Eurobond maturities in coming years, the authorities opted to elaborate a detailed set of fiscal adjustment measures to communicate to market participants and ratings agencies their strategy for debt reduction.

31. The authorities' fiscal strategy is broadly consistent with Fund staff's previous recommendations, and staff assesses that the new measures would deliver an additional 2¼ percent of GDP in net fiscal adjustment by 2020. While the bulk of the measures would be implemented in 2018-19, implementation of some measures (i.e. cigarette excise increases) has already begun in the second half of 2017, and parliament approved the schedule of excise increases in the Law on Excise Taxes in July 2017. The measures are more heavily weighted towards revenue gains (¾) versus expenditure reductions (¼). While staff had preferred a more expenditure-heavy approach (given Montenegro's high level of public expenditure), revenue measures can be more predictable in delivering adjustment, which seems appropriate given refinancing needs. Specific measures include:

Revenue measures

- *VAT increase:* The most significant revenue measure is the VAT increase. The parliament has already approved legislation to increase the value-added tax (VAT) from 19 to 21 percent in January 2018. The lower-rate VAT rate of 7 percent, which covers basic foods, medicines, and some services, will not be changed. The decision not to increase the lower-rate VAT, which taxes goods that are consumed relatively more heavily by less-well-off members of society, reduces the impact on these groups. The VAT increase will raise an additional 1 percent of GDP in revenues.

- *Cigarette excise:* The parliament has passed legislation that will increase the specific tax on cigarettes from €24 per 1000 to €50 per 1000 by 2019, with the first increase to €30 per 1000 already occurring in the second half of 2017. By 2019, Montenegro would be compliant with the EU directive on cigarette taxation. To discourage substitution of cigarettes with other tobacco products, the authorities have also increased the taxation of fine-cut tobacco and introduced excises on e-cigarettes and heat-not-burn cigarettes. These excises should raise an additional 0.5 percent of GDP in revenues by 2019.

- *Soft drink and alcohol excises:* The specific excise on sweetened carbonated beverages will increase from €0.10 per liter to €0.40 per liter in 2020, raising 0.2 percent of GDP in revenues. The authorities also plan to increase the excise on ethyl alcohol from €650 per hectoliter of pure alcohol to €1,500 by 2020, beginning in the second half of 2017, which would increase revenues by 0.1 percent of GDP by 2020.

- *Coal excise:* Consistent with the EU directive on coal excises, the parliament has approved the introduction of a specific excise tax on coal in 2019 at the EU minimum rate of €0.15 per gigajoule (GJ), with the rate increasing to €0.30 per GJ in 2020. This is projected to increase revenues by 0.1 percent of GDP by 2020.

- *Tax debt rescheduling:* In early 2017, the authorities launched a program that would permit tax debts to be repaid over five years, with forgiveness of interest/penalties.[10] Of some 14 percent of GDP in tax debts, approximately 5,400 taxpayers with debts representing 4 percent of GDP have entered the rescheduling program. The fiscal strategy includes these additional anticipated revenues. The program provides significant incentives for tax debtors to adhere to their payment schedules, but staff conservatively projects that around 2/3 of the tax debts now in the rescheduling program will be eventually repaid. The proceeds will temporarily boost revenues through 2022, assisting in the fiscal consolidation effort.

[10] The rescheduling includes an amnesty element because interest is being cancelled in addition to penalties. Currently, the Montenegrin late payment fees combine both interest and penalty elements, and it is difficult to separate the two elements. The authorities are planning to introduce a modern interest and penalty regime.

Expenditure measures

- *"Mothers' Law" reform:* In April, Montenegro's Constitutional Court ruled that the lifetime benefits for mothers with three or more children were unconstitutional. The authorities have designed (and the parliament approved in June 2017) compensation for the former beneficiaries—some of whom left jobs to claim the benefit—facing the loss of a lifetime benefit. (See Box 1 for a discussion of the "Mothers' Law" and detailed description of the successor benefits.) Importantly, the new benefits carry no permanent fiscal cost and represent a net savings relative to the original benefits and the policies implied by the 2017 budget. Fund staff estimates that these reforms will reduce spending by nearly ¾ percent of GDP by 2020, with further savings over the medium term as the successor benefits are phased out.

- *Public sector wage bill:* The authorities will take further steps to reduce the public-sector wage bill. The wages of senior officials will be reduced by 6 percent, on top of the 8 percent reduction already implemented in the 2017 budget. The authorities also intend to freeze the size of the public-sector workforce and refrain from granting discretionary wage increases.

- *Discretionary spending cuts:* Unspecified cuts to discretionary spending are envisioned (on both current and capital spending) that would amount to 1/3 percent of GDP by 2020.

Newly identified expenditure requirements

- As part of the fiscal strategy document, the authorities have identified new expenditure requirements that will offset a small portion of the consolidation gains. These include some one-off expenditures such as the 2018 presidential election and other more permanent spending, such as defense spending increases related to NATO accession. These expenditures are expected to permanently increase spending by 0.4 percent of GDP by 2020.

32. In parallel with the fiscal adjustment, the authorities plan to increase targeted social spending, and Fund staff recommends that they also increase capital expenditures. The authorities are working with the World Bank to redesign social benefits for the poor and families with children and increase the overall spending envelope for these benefits by 0.1 percent of GDP. Staff recommends allocating an additional 0.1 percent of GDP in social spending by 2020 to cushion the impact of fiscal adjustment on the most vulnerable. Staff also believes that the authorities should budget for an increase in capital spending of 0.4 percent of GDP by 2020. The increased capital spending also provides a buffer that could be reduced should fiscal targets be more difficult to reach than anticipated.

Box 1. Montenegro's "Mothers' Law"

In 2015, Montenegro's Parliament approved amendments to the Law on Social and Child Protection, creating a new lifetime benefit for mothers with three or more children known as the "Mothers' Law." Such mothers would be eligible for a monthly benefit equal to 40 to 70 percent of the net wage, depending on their employment status and history.

By 2016, nearly 22,000 women had become beneficiaries, of which 64 percent were unemployed, 22 percent were pensioners, and 14 percent were employed. The benefit in 2016 ranged between €193 and €336 per month. On a gross basis, the benefit cost 1.7 percent of GDP and 1.4 percent of GDP on a net basis, subtracting the cost of pensions that otherwise would have been paid.

As part of the 2017 budget, the authorities reduced the benefit to €144 to €264 per month to rein in its cost. In April 2017, Montenegro's constitutional court ruled that the benefit was unconstitutional. The authorities subsequently designed compensation for the beneficiaries to ensure that no one was worse off than before the benefit was introduced, and the parliament adopted these amendments to the Law on Social and Child Protection in June 2017.

Compensation will depend on the beneficiary's former employment status. Previously unemployed women will regain eligibility for unemployment benefits and will have priority access to active labor market policy programs. Pension-eligible women will receive pension benefits. The lowest-income women will also be eligible for social assistance, which the authorities will increase.

Compensation for previously employed women will vary depending on their prior wage, with compensation varying between €193 and €336 per month (with a weighted average of €230 per month). The compensation benefit will be time-limited and vary according to the woman's age. Women older than 55 will receive the benefit until they become pension eligible (currently at age 62). Those between 45 and 54 will receive the benefit for five years, while those between 33 and 44 will receive it for three years.

On a net basis, the replacement of the "Mothers' Law" benefit will reduce government expenditures by nearly ¾ percent of GDP by 2020, with further savings over the medium term as compensation for previously employed mothers is phased out. By phasing out compensation over time, the reform will ensure that the "Mothers' Law" carries no permanent burden on expenditures.

33. If the authorities implement their fiscal strategy, staff projects that government debt would peak at 81 percent of GDP in 2019 and fall rapidly thereafter. The non-highway primary balance would improve steadily, reaching 4½ percent of GDP already in 2019. After 2020, the authorities could begin to relax the fiscal stance by increasing capital spending on priority projects. By 2022, general government debt (including guarantees) would reach 66 percent of GDP, a significant improvement over staff's prior projections based on the 2017 budget and related policies, where debt would have fallen to 80 percent of GDP by 2022. Importantly, under the authorities' definition of debt for the Fiscal Responsibility Law, they would be below 60 percent of GDP by 2022, thus complying with the Law. Over the longer term, the authorities should maintain a primary surplus of 3 percent of GDP, a level sufficient to ensure a continued rapid decline in debt, preferably to below 40 percent of GDP over the long term.

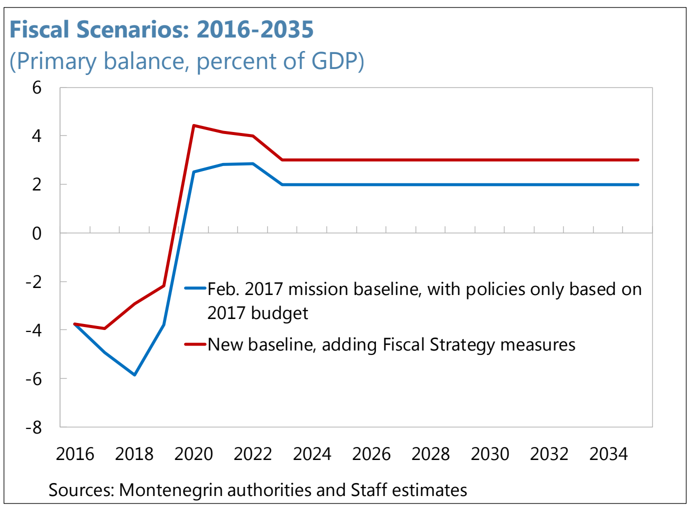
Table 2. Montenegro: Staff Assessment of "Fiscal Strategy" Adjustment Measures

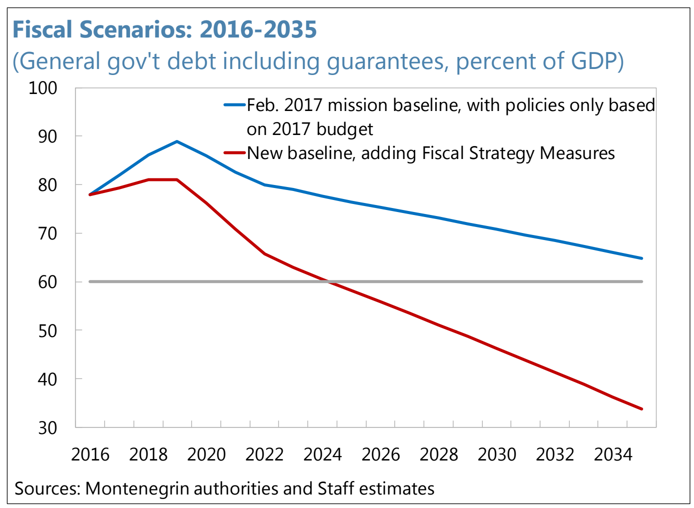
Permanent fiscal impact (Percent of GDP) 1/

Measure	2017	2018	2019	2020	Total	Approved
VAT increase	...	1.02	...	...	1.02	1.02
Cigarette, coal, alcohol, and sugar drinks excises	0.08	0.34	0.32	0.12	0.86	0.86
Tax debt rescheduling	0.37	-0.12	-0.05	-0.04	0.16	0.16
Contributions for previously employed mothers	0.04	0.08	-0.11	...	0.01	0.01
VAT impact of excise increases	0.02	0.10	0.06	0.03	0.21	0.21
Total revenue measures	0.51	1.42	0.23	0.10	2.25	2.25
Public sector wage bill	...	0.09	-0.06	-0.06	-0.03	-0.03
Savings from "Mothers' Law" reforms	0.23	0.04	0.21	0.14	0.63	0.63
Reduction in discretionary spending	...	0.10	0.09	0.07	0.25	...
Total expenditure measures	0.23	0.23	0.24	0.15	0.85	0.60
Total measures	0.73	1.65	0.47	0.25	3.10	2.85
Additional budgeted spending	...	-0.64	0.30	-0.02	-0.36	...
Total measures, net of new spending	0.73	1.01	0.77	0.23	2.74	2.85
Increase in social spending (social assistance)	-0.03	-0.04	-0.11	...	-0.18	...
Recommended new capital spending	...	-0.25	-0.14	...	-0.39	...
Total measures, net of new/recommended spending	**0.71**	**0.72**	**0.52**	**0.23**	**2.18**	2.85

Sources: Montenegrin authorities, and Fund staff estimates.

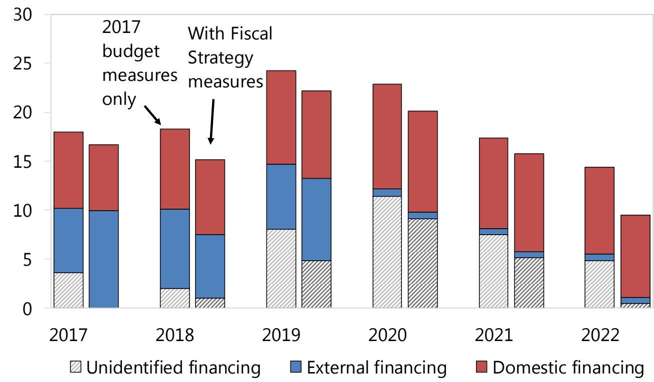
1/ In this table, a positive (+) sign indicates an improvement in the fiscal balance, while a negative (-) sign represents the opposite.





34. The fiscal strategy measures would also significantly strengthen market refinancing prospects. Montenegro's unidentified financing needs (those not covered by currently identified domestic or external financing) would average 9 percent of GDP without the strategy. These amounts would likely need to be covered by accessing the Eurobond market. The implementation of the fiscal strategy would reduce unidentified financing needs by 2-3 percentage points of GDP each year over 2019-21. The track record of adjustment involved in the implementation of the strategy would also help Montenegro's market refinancing prospects.

Gross Financing Needs and Sources of Finance
(Percent of GDP)



Sources: Montenegrin authorities and Fund staff projections

35. The authorities also intend to strengthen their debt management capabilities. They have started putting into place a debt management strategy that would help smooth the refinancing profile and improve market access through increased transparency and better investor relations. Part of this strategy could include a market-friendly, proactive liability management operation to smooth out the 2019–21 Eurobond redemption schedule. The authorities are receiving technical assistance from Fund staff and are exploring possibilities with market participants.

Future fiscal considerations

36. Over the medium term, the authorities should build on their strategy to strengthen growth and address longer-term fiscal challenges. If implemented, the authorities' fiscal strategy should lead to a substantial primary surplus and place debt on a strongly downward path, addressing debt sustainability concerns. Beyond debt sustainability, however, future fiscal reforms could improve the mix of revenues and expenditures to produce a more efficient public-sector workforce, bolster the sustainability of the pension system, strengthen local government finances, reduce pollution, and promote the growth of formal employment. Together, these reforms could also lead to stronger economic growth over the longer run.

37. The introduction of a coal excise tax at a higher rate would reduce large local pollution costs and create fiscal space to reduce other taxes. The burning of coal in Montenegro (mainly for the generation of electricity) contributes to local pollution and global warming and imposes health costs on the population. While the authorities already plan to enact a coal excise at or slightly above the EU minimum level of €0.15 per GJ, a tax at this level will raise only a small amount of revenues and leave the price of coal well below its true cost (including pollution and global warming). FAD's expenditure analysis tool estimates that coal subsidies (mostly related to local pollution) amount to 14 percent of GDP.[11] The authorities could consider phasing in a tax of €10 per GJ by 2020, which could raise an additional 2 percent of GDP in revenue and would substantially reduce energy subsidies. Similarly, the authorities could also increase the excise on diesel fuel by 15 percent to €506 per 1000 liters, raising an additional 0.2 percent of GDP in revenues. At this level, diesel prices would fully incorporate any externalities.

38. With additional revenues from a coal excise, the authorities could lower social contributions, reducing the labor tax wedge and potentially boosting formal employment. Between contributions for pensions, health insurance, and unemployment insurance, employees currently pay 24 percent of their salary towards contributions while employers pay 10.3 percent of salaries. The overall contribution of 34.3 percent of salaries creates a high labor tax wedge that may act as a deterrent to the expansion of formal sector employment. The authorities could consider the following measures, which would lower revenues by 2.8 percent of GDP by 2020 (mainly offset by the coal and diesel excises):

Table 3. Montenegro: Current Structure of Social Contributions (Percent of Salary)

Contribution	Employee Contribution	Employer Contribution
Pensions	15	5.5
Health insurance	8.5	4.3
Unemployment	0.5	0.5
Total	24	10.3

Source: Law on Contributions for Compulsory Social Insurance

- *Eliminate employer health contributions:* Employers currently pay 4.3 percent of salaries towards health insurance. Funding health care through payroll taxes is not necessarily the most efficient option, and this would also improve Montenegro's competitiveness as employers would face lower costs. Eliminating these contributions would reduce revenues by 1.2 percent of GDP.

- *Reduce employee contribution for health insurance:* The employee contribution for health insurance would be lowered gradually from 8.5 percent of GDP to 3.5 percent, which would lead to a fall in revenues of 1.6 percent of GDP.

- *Shift pension contributions to employees:* Currently, employees contribute 15 percent and employers 5.5 percent. To lower the cost for employers, contributions could be shifted towards employees by 1 percentage point per year to 18 percent by 2020. This would be revenue neutral for the pension fund, and employees still be better off if this reform were combined with a reduction in the health insurance contribution. Pension contributions would be shifted to those who benefit from pensions, and employers would gain competitiveness.

[11] See section A on the public expenditure diagnostic.

- *Shift contributions for unemployment to employees:* Employers pay 0.5 percent of salaries; eliminating this would reduce employer charges, but be revenue neutral. This would also follow the logic that benefits should be paid by those who will receive them.

- *Total wage contributions would decline by 9.3 percentage points to a total of 25 percent, thus significantly reducing the labor tax wedge.* Employer contributions would fall by 7.8 percentage points and employee contributions by 1.5 percentage points.

39. The upper rate of the personal income tax (PIT) could also be made permanent. Montenegro has imposed a 2 percentage point surcharge for incomes in excess of the average wage in addition to the regular 9 percentage points PIT (the surcharge is known as the "crisis tax"). In the 2017 budget, the "crisis tax" was extended through 2019, but given Montenegro's fiscal situation and the relatively low rates of income taxation in Montenegro, the "crisis tax" should be made permanent, raising an additional 0.2 percent of GDP in revenue after 2019.

40. Reforms to local government taxes would put local government finances on a more sustainable footing.[12] Currently, real estate transactions are taxed at 3 percent of market value at the time of transaction, with the revenue split between the central government (10 percent), local governments (80 percent), and an equalization fund (10 percent). Local governments can charge a tax on real estate values at a rate between 0.1 and 1.0 percent, with the current effective rate being 0.25 percent. A tax on transactions may distort the real estate market by discouraging transactions. The authorities could consider eliminating the transactions tax while increasing the effective value tax to 0.4 percent, which could raise 0.6 percent of GDP on net in revenues for local governments. Local governments also get a share of PIT collections as a "tax on a tax," but this structure passes down revenue volatility to local governments when the PIT rate changes. Simply setting local government PIT surtax as a percentage point of income instead of the income tax would avoid this volatility.

41. On the expenditure side, the public-sector wage bill remains high and should be further reduced. While the authorities are already taking steps to contain the wage bill, they should also consider a comprehensive civil service reform that reduces the overall level of public employment. A modest reduction in public employment of 1 percent per year through 2020 would lead to 0.3 percent of GDP in savings.

42. Pension reforms are also needed to put the pension system on a more sustainable fiscal and social footing.[13] While pensions are not overly generous, pension spending has been exacerbated by ad-hoc decisions to grant early retirements, and the pension system runs a deficit that must be financed by other revenues or borrowing. Specific pension reforms to be considered include:

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[12] These reforms are discussed in more detail in section D on local government finances.

[13] These reforms are discussed in more detail in section C on pension reform.

- *Elimination of early retirement options:* The full repeal of early retirement options could save 1 percent of GDP in spending by 2020.
- *Reform to valorization/indexation formula:* Currently, pensions are both valorized and indexed according to a formula weighted 75 percent towards the consumer price index (CPI) and 25 percent to wages. Over the long run, this formula will yield fiscal savings at the expense of increasingly lower pension benefits, which will not be socially sustainable. Pensions should be valorized with wage growth and indexed with CPI growth. Such a formula would lead to 0.3 percent of GDP in fiscal savings by 2020, though it would raise fiscal spending over the longer term.
- *Faster increase in retirement age:* The pension system is currently transitioning to a retirement age of 67, with full implementation for men by 2025 and for women by 2041. This transition could be accelerated so that the female retirement age reaches 67 by 2025, lowering spending by 0.2 percent of GDP by 2020.

43. The implementation of these reforms, combined with the measures the authorities have already identified, would create significant fiscal space to increase social and capital spending.[14] In total, these additional reforms would create 5.6 percent of GDP in additional fiscal space through 2020, versus 2.7 percent of GDP in the authorities' "Fiscal Strategy." In this scenario, expenditure measures comprise nearly half the adjustment, compared to one-quarter in the authorities' plans. Staff already projects the primary surplus to reach 4½ percent of GDP in 2020 based on the measures the authorities intend to implement. Rather than improve the primary balance further, staff believes that the authorities could use the additional fiscal space to increase spending in priority areas such as social assistance (0.6 percent of GDP by 2020), water/sanitation investment at the local level (1 percent of GDP by 2020), new non-highway capital spending (1 percent of GDP by 2020), and current maintenance spending (0.5 percent of GDP by 2020).

44. These additional reforms would leave the projected fiscal path broadly unchanged, but engineer substantial changes to the composition of government revenues and expenditures. As in the baseline scenario, the primary balance would improve to 4½ percent of GDP by 2020, with a similar overall path of adjustment. The overall level of taxes and expenditures also remains broadly similar. However, in the scenario with further reforms, tax revenues increase (driven by the larger coal excise tax), while social contributions decline. Current expenditures also fall, due to further consolidation of the wage bill and social security spending. (Within social security spending, however, pension spending would fall while social benefits increase due to the rise in targeted social assistance.) Capital expenditures would also increase, both on new capital spending (1½ p.p. of GDP higher by 2022) and current maintenance spending (0.7 p.p. of GDP higher by 2022).

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[14] We keep the elements of the authorities' "Fiscal Strategy" except for the cuts to discretionary spending and the compensation for previously employed mothers. Further savings could be found by paying a one-time severance (for a one-off cost of €8 million in 2017) rather than a multi-year benefit. This would save an additional €3 million through 2022.

Table 4. Montenegro: Considerations for Future Fiscal Reforms 1/

Permanent fiscal impact (Percent of GDP)

Measure	2017	2018	2019	2020	Total
Cigarette excise	0.1	0.2	0.2	...	0.5
Sweet carbonated drinks excise	...	0.1	0.0	0.0	0.1
Coal excise	...	1.4	0.5	0.4	2.2
Alcohol excise	0.0	0.0	0.0	0.0	0.1
Diesel excise	...	...	0.2	...	0.2
VAT increase	...	1.0	...	...	1.0
Tax debt rescheduling	0.4	-0.1	0.0	0.0	0.2
Contributions for previously employed mothers	0.0	0.1	-0.1	...	0.0
VAT impact of excise increases	0.0	0.4	0.1	0.1	0.7
PIT "crisis tax" rate of 11% made permanent	...	...	...	0.2	0.2
Elimination of real estate transactions tax (central gov't)	...	0.0	...	...	0.0
Elimination of real estate transactions tax (local gov't)	...	-0.3	...	...	-0.3
Increase in real estate value tax rate (local gov't)	...	0.9	...	...	0.9
Local gov't PIT surtax at set p.p. rate (local gov't)	...	...	...	0.0	0.0
Eliminate employer-paid contribution for health insurance	...	-1.2	...	...	-1.2
Reduce employee contribution for health by 2.0/1.5 p.p. per year	...	-0.6	-0.5	-0.5	-1.6
Total revenue measures	0.5	1.8	0.4	0.2	2.9
Reduction in public sector workforce 1% per year	...	0.1	0.1	0.1	0.3
Elimination of "Mothers' Law"	0.6	0.6	...	...	1.2
"Mothers' Law" beneficiares return to pension system	-0.1	-0.2	0.0	0.0	-0.3
Unemployment benefits for Mothers' Law beneficiaries	-0.1	-0.2	0.1	0.1	0.0
Compensation for previously employed mothers	-0.2	...	...	...	-0.2
Cost of contributions for previously employed mothers	0.0	-0.1	0.1	...	0.0
Social benefits for former Mothers' Law beneficiaries	0.0	0.0	...	...	-0.1
Increase women's retirement age to 67 by 2025	...	0.1	0.1	0.1	0.2
Eliminate early retirement options	...	0.3	0.3	0.5	1.0
Revise formula for indexation and valorization of pensions	...	0.1	0.1	0.1	0.3
Shift pension contributions to employees by 1 p.p. per year	...	0.1	0.1	0.1	0.3
Total expenditure measures	0.1	0.8	0.9	1.0	2.8
Total measures	0.6	2.6	1.3	1.1	5.6
Additional programmed spending	0.0	-0.6	0.3	0.0	-0.4
Total measures, net of new spending	0.6	2.0	1.6	1.1	5.3
Increase in social spending (social assistance)	-0.1	-0.2	-0.2	...	-0.6
Water/sanitation spending increase (local gov't)	...	-0.6	-0.2	-0.2	-1.0
New non-highway capital spending (central gov't)	...	-0.2	-0.3	-0.4	-1.0
Increase in current maintenance spending (central gov't)	...	-0.2	-0.2	...	-0.5
Total measures, net of new and recommended spending	0.5	0.7	0.6	0.5	2.2

Source: Montenegrin authorities, Fund staff calculations

1/ In this table, a positive (+) sign indicates an improvement in the fiscal balance, while a negative (-) sign

45. Further fiscal reforms would also alter broader macroeconomic outcomes, by bolstering economic growth in the medium term.[15] The imposition of a substantial excise on coal could lead to lower economic growth in the very short term as the economy adjusts to the realignment of prices. At the same time, however, the increase in capital spending would provide some offsetting stimulus and the very large negative externalities related to coal would be reduced and boost growth and welfare in the longer term. We conservatively project that economic growth in 2017-19 would average 2.7 percent, modestly lower than 2.8 percent in the baseline scenario. The increase in electricity prices would also boost inflation, which we project would average 3 percent per year over 2017-2019, versus 2.2 percent in the baseline. Over the medium term, the increase in capital spending would lead to stronger economic growth, especially as supply side effects begin to take hold, with growth averaging 0.5 percent higher over 2021-22. While not modeled, the reduction of the labor tax wedge and faster economic growth should be expected to increase formal employment and lower the unemployment rate. The faster growth of nominal GDP, due to higher inflation and faster economic growth, would also lower government debt ratios, with general government debt (including guarantees) falling to 64 percent of GDP in 2022 versus 66 percent of GDP in the baseline.

Conclusion

46. Reversing the large public debt buildup of recent years will be challenging and take time, underscoring the need for a steadfast implementation of the authorities' fiscal strategy. The authorities have articulated and begun to implement a credible medium-term fiscal consolidation plan that, if fully implemented, should substantially improve Montenegro's debt sustainability and market financing prospects. The adjustment plan also gives the authorities the opportunity to tackle longstanding challenges related to the public-sector wage bill and pension system imbalances. The authorities could also consider a set of further fiscal reforms that could help boost economic growth, create opportunities for employment in the formal economy, and eventually establish a cleaner, more inclusive, and resilient economy.

[15] The macroeconomic implications of the scenario with further fiscal reforms were modeled as follows. The coal excise tax increase would raise coal prices, and thus the price of electricity produced from coal, over 2018-2020. Electricity has a 7 percent weight in the CPI basket, and about 50 percent of electricity is produced from coal. The increase in price would lower demand, and thus production of electricity, which comprises nearly 4 percent of GDP from the supply side. Additional government capital spending boosts growth due to contemporaneous effects on demand and later supply effects, with the supply effect assumed to begin two years after the associated capital spending.

Table 5. Montenegro: Selected Economic Indicators, 2017-2022

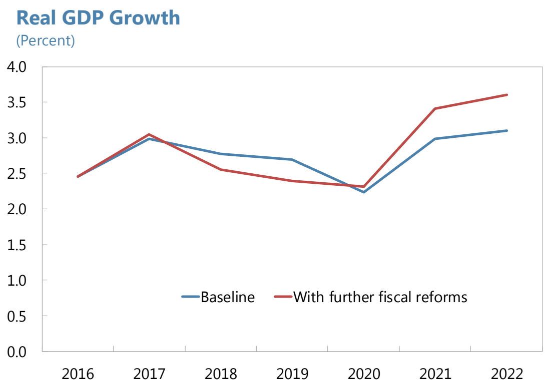
Percent of GDP (unless otherwise noted)

	Baseline Scenario						Scenario with Further Fiscal Reforms					
	2017	2018	2019	2020	2021	2022	2017	2018	2019	2020	2021	2022
	Projections						Projections					
Total revenues and grants	**43.5**	**45.1**	**45.2**	**45.1**	**45.0**	**44.9**	**43.5**	**45.4**	**45.5**	**45.4**	**45.3**	**45.1**
Taxes	27.9	29.3	29.5	29.5	29.5	29.4	27.8	31.3	32.1	32.6	32.5	32.4
Personal income tax	4.3	4.3	4.3	4.1	4.1	4.1	4.3	4.3	4.2	4.3	4.3	4.2
Taxes on turnover of real estate	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.0	0.0	0.0	0.0	0.0
Value added tax	13.6	14.7	14.7	14.7	14.7	14.7	13.6	14.9	14.9	15.0	14.9	14.9
Excises	5.4	5.7	6.0	6.1	6.1	6.1	5.4	7.0	7.8	8.3	8.3	8.3
Local government taxes	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.9	2.9	2.9	2.9	2.8
Social security contributions	11.4	11.5	11.4	11.4	11.4	11.4	11.4	9.7	9.2	8.7	8.7	8.6
Total expenditures and net lending	**50.0**	**50.7**	**50.0**	**43.2**	**43.2**	**43.0**	**50.2**	**51.1**	**50.3**	**43.4**	**43.4**	**43.4**
Current expenditures	40.9	40.1	39.2	38.9	38.6	38.4	41.1	40.0	38.9	37.8	37.5	37.2
Gross salaries	10.8	10.3	10.0	10.1	10.0	10.0	10.8	10.0	9.5	9.3	9.3	9.2
Goods and services	3.7	3.6	3.4	3.3	3.4	3.6	3.7	3.7	3.5	3.5	3.6	3.7
Current maintenance	0.7	0.7	0.7	0.7	0.8	0.9	0.7	0.9	1.2	1.2	1.3	1.4
Interest payments	2.5	2.6	2.7	2.6	2.3	2.1	2.5	2.6	2.7	2.5	2.2	2.0
Social security transfers	14.2	13.9	13.7	13.5	13.4	13.2	14.4	13.7	13.3	12.5	12.4	12.2
Capital expenditures	9.2	10.6	10.9	4.3	4.5	4.6	9.2	11.0	11.5	5.7	5.9	6.2
Non-highway capital expenditures	3.3	4.1	4.3	4.3	4.5	4.6	3.3	4.6	5.0	5.7	5.9	6.2
Highway capital expenditures	5.9	6.5	6.5	0.0	0.0	0.0	5.9	6.4	6.4	0.0	0.0	0.0
Primary balance	**-3.9**	**-2.9**	**-2.2**	**4.4**	**4.2**	**4.0**	**-4.2**	**-3.0**	**-2.2**	**4.5**	**4.2**	**3.8**
Nonhighway primary balance	1.9	3.5	4.3	4.4	4.2	4.0	1.7	3.4	4.2	4.5	4.2	3.8
General government debt	71.6	73.6	74.1	69.5	64.4	59.7	71.9	73.1	73.3	68.6	63.2	58.5
Gen. govt debt, including guarantees	79.3	81.0	81.1	76.2	70.8	65.8	79.6	80.3	80.2	75.2	69.5	64.5
Real GDP growth	**3.0**	**2.8**	**2.7**	**2.2**	**3.0**	**3.1**	**3.0**	**2.6**	**2.4**	**2.3**	**3.4**	**3.6**
Nominal GDP growth	5.2	5.5	4.7	4.0	4.9	5.1	5.3	6.6	4.9	4.4	5.3	5.6
Nominal GDP (millions of euros)	3,970	4,187	4,385	4,562	4,785	5,027	3,973	4,240	4,448	4,634	4,886	5,159
Consumer prices (period average)	**2.1**	**2.6**	**1.8**	**1.7**	**1.8**	**1.9**	**2.1**	**4.4**	**2.4**	**2.2**	**1.8**	**1.9**
Consumer prices (end of period)	1.6	2.6	1.9	1.8	1.9	2.0	1.6	4.3	2.5	2.3	1.9	2.0

Source: IMF staff projections

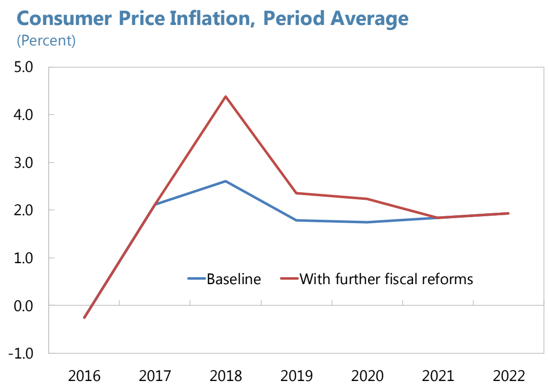
Figure 8. Baseline Versus Scenario with Further Fiscal Reforms

With further fiscal reforms, GDP growth would slow at first but accelerate over the medium term…



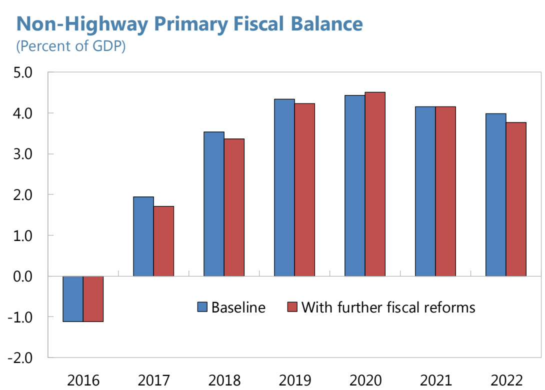
Source: Fund staff estimates

… and inflation would rise further in 2018 due to the implementation of a larger coal excise tax.



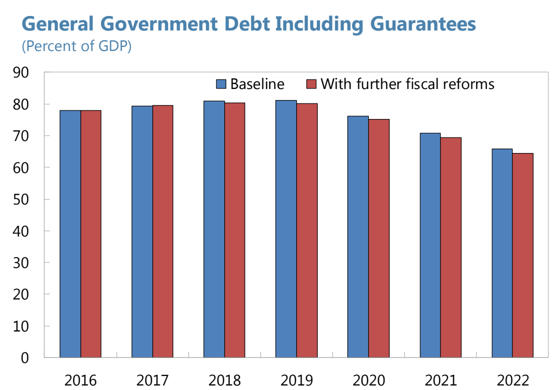
Source: Fund staff estimates

The improvement in the non-highway primary balance would be similar as in the baseline…



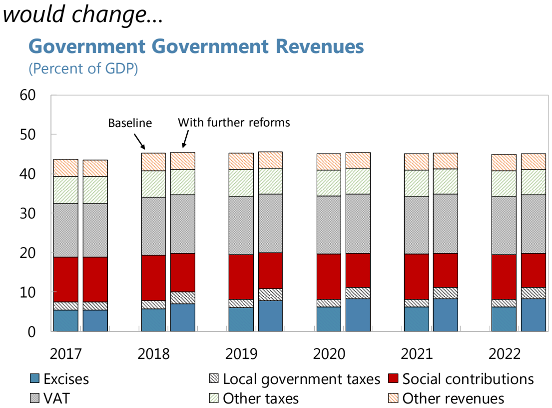
Source: Fund staff estimates

…and government debt would also begin to fall quickly after 2019.



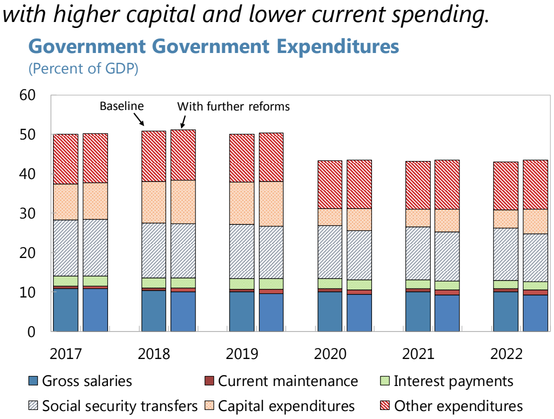
Source: Fund staff estimates

The mix of government revenue sources, however, would change…



Source: Montenegrin authorities and Fund staff projections

…as would the composition of government spending, with higher capital and lower current spending.



Source: Montenegrin authorities and Fund staff projections

C. Pension Reform Priorities[16]

The pension system in Montenegro is in deficit, with benefits consistently exceeding contributions. Past reforms have undermined its sustainability, while an aging population will put further pressure on pension expenditures. Staff models the pension system in the medium- to long-term based on no-change assumptions (baseline) and alternative scenarios with reform options, using the FAD pensions projection tool. The findings suggest that stabilizing replacement rates to ensure the long-term social sustainability of pension benefits should be a top priority, but this would come at a cost. Discouraging early retirement and eliminating or rationalizing the accelerated service period pensions would contribute most significantly to pension sustainability. Raising retirement ages in line with increasing life expectancy would also have measurable effects. Increasing formal employment either through later retirement, reduction in the grey economy, or active labor programs would increase contributions. Implementing multiple types of reforms quickly would result in less drastic changes now and provide fairer future outcomes.

Background

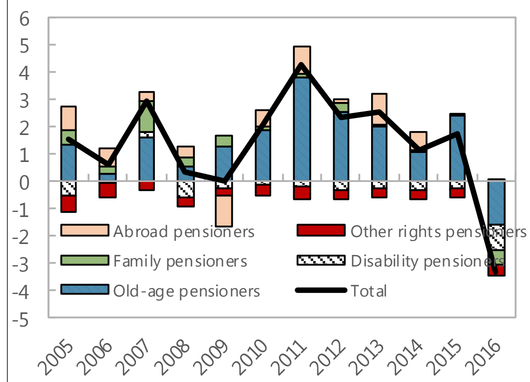
47. Montenegro's pension system has a consistently large funding gap (Figure 9), reaching 3.1 percent of GDP in 2016. Pension spending has outpaced contributions for years and is high relative to international levels. At 10.4 percent of GDP, pension spending is much higher than the average in advanced economies (9 percent) or emerging economies (5 percent). Demographic pressures and high levels of early retirement have increased the number of old age pensioners, which has increased by 36 percent since 2008. Pensioners below the current statutory retirement age of 66 for men and 61 for women constitute about one third of pensioners and pose a particularly high cost for the pension system. Since 2010, about 70 percent of new pensioners were early retirees at a great cost to the sustainability of the system. At the same time, low levels of labor participation and formal employment constrain pension contributions. Currently, the ratio of pensioners to employed workers is about 60 percent, but this is projected to decline further given population developments.

48. Montenegro has undertaken two major pension reforms since 2004 with mixed results. The 2004 reform episode is considered largely a success by introducing a point system with a 50–50 Swiss-formula for valorization and indexation, phasing in a higher retirement age, phasing out early retirement, and tightening disability and survivor eligibility. However, a reform package passed in 2010 introduced several unproductive reform measures. While it did include a

[16] This section was prepared by Jesse Siminitz using the FAD pensions projection tool. Mauricio Soto (FAD) provided useful comments.

further increase in retirement age to 67, it simultaneously introduced several early retirement schemes. The pension formula was also changed to 75 percent CPI and 25 percent wage valorization and indexation, which yields fiscal savings in the long-term at the expense of increasingly lower pension benefits, which will ultimately become socially unsustainable. In 2016, Parliament introduced a life-time mothers' benefit, which resulted in a drop in old age pensioners as mothers with three or more children switched to the new, more generous benefit, although at a high fiscal cost (some 2 percent of GDP).

Contribution to Growth of Pensioners
(Percent, contribution to growth)

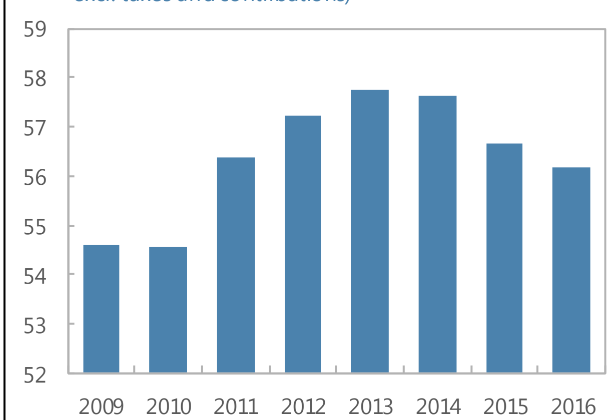


Source: Montenegro Fond Pio.

49. The pension system in Montenegro is not inherently generous. The gross replacement rate for the average new retiree at the standard retirement age is about 37 percent, which is not particularly high. The average benefit is about €280 per month, which is 55.5 percent of GDP per-capita and around 56.2 percent of net wages. Also, on the positive side, the system covers most elderly. The coverage ratio (pensioners relative to the population 65 and above) is well above 100 percent, but this reflects the fact that 37 percent of pensioners are below the age of 65. However, only about 42 percent of the working age population contribute to the system, which means that future coverage ratios will decline.

50. The current old-age pension valorization formula underestimates lifetime earnings. Pension contributions are converted into points for each calendar year of contributions. The individual points are valorized with 75 percent CPI and 25 percent of wage growth during that time and summed up. However, adjusting past pension contributions below the full wage growth does not fully reflect the pensioner's contribution to productivity of the economy over their working life. This is particularly relevant in recent years when real wage growth increased, and replacement rates have begun to fall. Similarly, pension indexation over the retirement period allows retirees to benefit from productivity growth to which they did not contribute. International best practice generally uses 100 percent wage valorization to properly measure life-time contributions and 100 percent CPI indexation for pension benefits. This practice has become common in many OECD countries. This formula ensures fiscal sustainability of the pension system by stabilizing the initial replacement rate by ensuring that the life-time contributions of new pensioners are fairly valued, but also preserving purchasing power of the elderly.

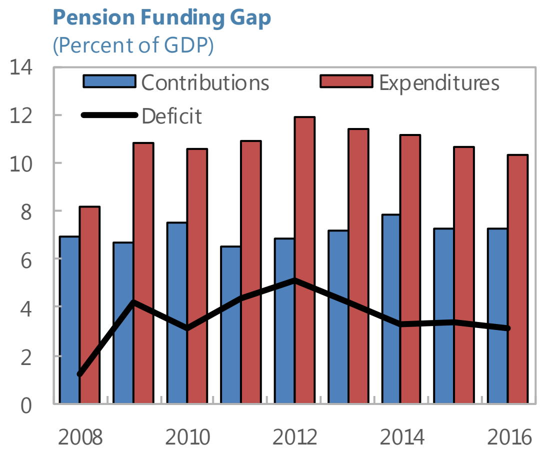
Net Replacement Rates
(Average pension in percent of average earnings excl. taxes and contributions)



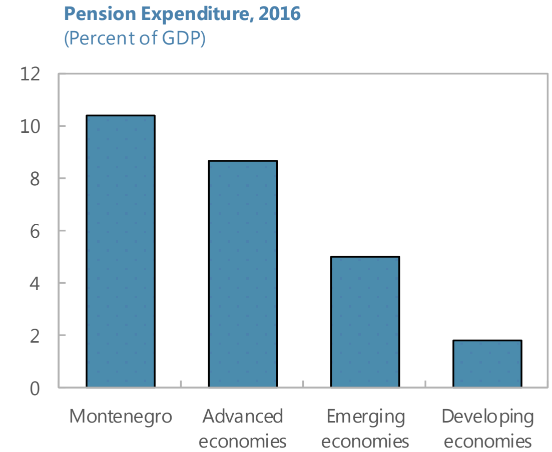
Source: Fond Pio.

Figure 9. Recent Pension Trends

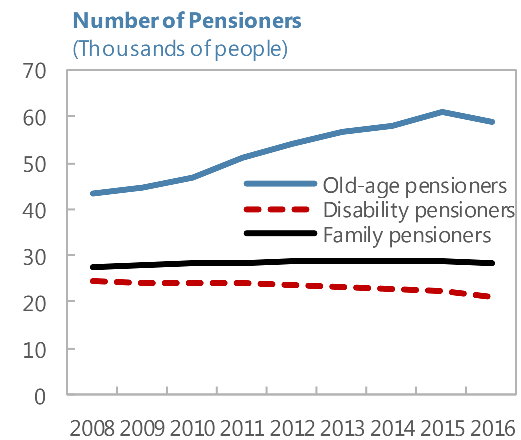
The pension system is consistently underfunded…



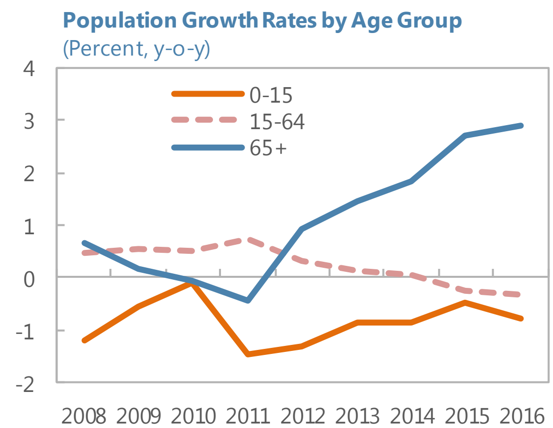
… with pension spending above international levels.



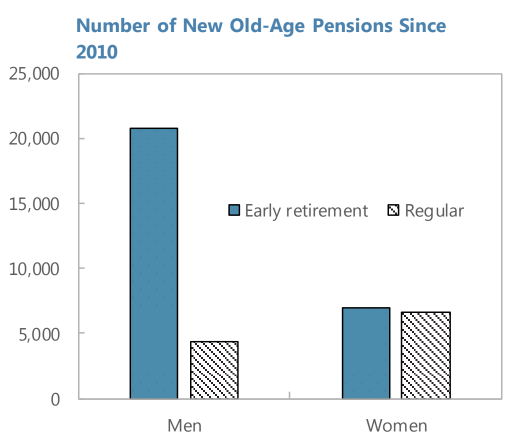
The system is stressed by an increasing number of old-age pensioners…



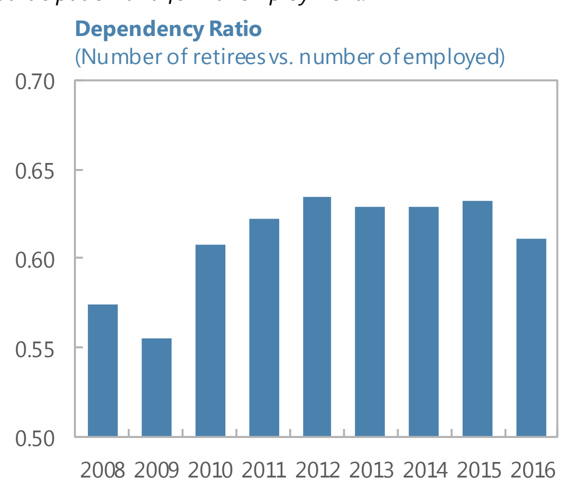
…caused by an aging population…



…and high levels of early retirement.



Contributions are insufficient due to low levels of labor participation and formal employment.

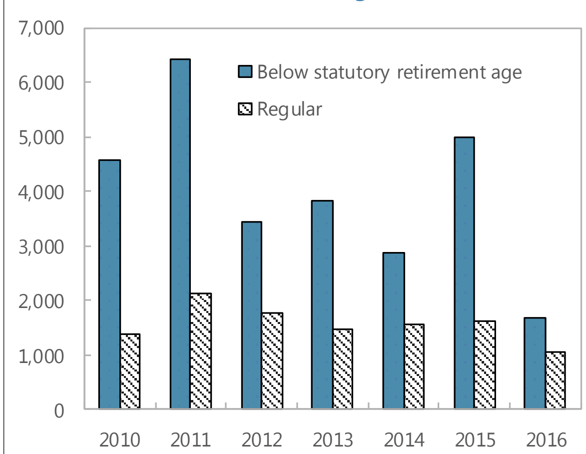


Sources: Monstat; Ministry of Finance; Fond Pio; and IMF staff calculations.

Table 6. Montenegro: Major Changes to the Pension System

Reform period	Major reforms	Number of pensioners impacted, as of Dec 2016
2004 reform	Point formula system introduced (from accrual based)	
	Introduction of Swiss formula with 50% CPI and 50% wage valorization and indexation	
	Widened calculation period for benefit (best 10 years to full career in 2-year increments)	
	Increased retirement age (60 to 65 for men, 55 to 60 women)	
	Began phasing out early retirement	
	Tightening disability and survivor eligibility and control	
2010 reform	Raised retirement age further to 67 (phase in for men by 2025, women by 2041)	
	Introduction of 75% CPI and 25% wage valorization and indexation	
	Under penalty free early retirement at 40 years of service regardless of age, increased requirement for women from 35 to 40 by 2033	11,263
	Introduced early retirement at 62 with 15 years of service	4,856
	Reintroduced special early retirement options, since eliminated	3,084
	Accelerated rate early retirement pensions extended for miners	590
	Early retirement for parents of a child with disability	325
Adhoc reforms post 2010	Life-time mothers' benefit	4,761
	Penalty-free retirement introduced for police/military and for workers in bankrupt companies of majority state ownership and metallurgy, equalized after 2012-13	2,782
Total penioners benefiting		16,398

Source: Fond Pio.



Source: Fond Pio.

51. Attempts to increase the average retirement age are undermined by early retirement eligibility. In 2004, the authorities began phasing in a higher minimum retirement age from 60 to 65 for men and 55 to 60 for women. Early retirement provisions began to be phased out as well. In 2010, the retirement age was increased further to 67 for men and women, although only fully realized by 2025 for males and 2041 for females. However, in addition to penalty-free early retirement at 40 years of service regardless of age, retirement at 62 years with 15 years of service was introduced (pensions are reduced by 0.35% for every month of early retirement) and early retirement for miners was extended. These early retirement options have allowed 70 percent of pensioners to retire earlier than the official minimum retirement age since 2010. Reducing the early retirement window and raising the early retirement decrement penalty to a more than actuarially fair level would discourage early exits from the labor force and retain pension contributors for longer.

Table 7. Montenegro: Summary of Montenegro's Pension System, 2016

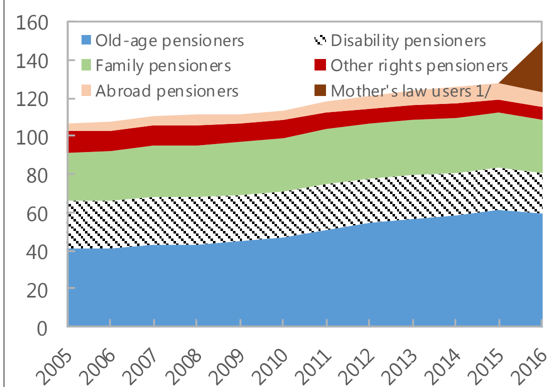
Coverage	Workers in the formal sector
Funding	Pay-as-you-go
Contribution (% of wages)	15% worker and 5.5% employer
Benefit formula	Defined benefit formula
Pensionable age	Age 65.5 (men), 60.75 (women)
Contributions in 2016	
Million EUR	274
Percent of GDP	7.3
Contributors in 2016	
Thousand	178
Percent of pop. 15-64	42.3
Contributers to workers	79.5
Expenditure in 2016	
Million EUR	391
Percent of GDP	10.4
Beneficiaries in 2016	
Thousand of pensioners	117
Percent of pop. 65+	133.7
Percent over 65 that get a pension	63.1
Average pension benefit in 2016	
EUR, per month	280.4
Percent of GDP per capita	55.5
Average minimum benefit in 2016	
EUR, per month	121.9
Percent of GDP per capita	24.1
Minimum number of years to qualify	15

Sources: Fond Pio; MOF; and IMF staff calculations.
Note: Combines Old-age, disability, and family pensions.

52. **Hazardous occupations have accelerated service periods, but contributions are insufficient to finance such early retirement.** The occupations benefiting from this special treatment receive additional service credit for each year of service and employers pay supplementary contributions based on the speed of acceleration. For instance, in the case of a worker who receives 14 months of service credit for 12 months of work, their employer pays a 6 percent supplementary contribution rate. Employers pay higher contributions for faster rates of acceleration, which is determined by occupation type. Many problems arise in accelerated pensions, especially because the accelerated service years count towards even earlier retirement with 40 years of service, allowing for exceptionally young retirement. The increased contribution rates of employees and employers are insufficient to cover the cost of such early retirement. Additionally, the list of hazardous occupations is too broad and includes professions that do not have long-lasting impacts on health such as truck drivers, flight attendants, ballet dancers, and opera singers.

53. Ad-hoc measures by policymakers undermine improvements by pension reforms. In July 2016, all pension benefits were increased by 3 percent and the minimum pension was increased by 20 percent. Such decisions weakened the fiscal gains made during a three-year pension freeze. In addition, policymakers have opted to provide special privilege pensions for certain circumstances and occupations. For instance, metal workers and employees of public companies impacted by bankruptcy were given special early-retirement windows, benefiting over 2,400 workers. Most of these measures were temporary in nature and only two special privilege pension types remain: for miners (who can retire with 30 service years, 20 in mining) and parents of disabled children (who can retire with 20 service years). These two measures account for less than 1 percent of total pensioners.

Number of Pensioners and Mother's Law Users
(Thousands of people)



Source: Montenegro Fond Pio.
Note: 1/ Mother's law users are estimated based on latest data provided by authorities.

54. Recently, the mothers' benefit law incentivized mothers to give up pension rights for life-long social benefits at a large fiscal cost. The changes in 2015 to the Law on Social and Child Protection gave mothers with three or more children the right to financial support. If a mother's benefit exceeds her pension benefit she can choose the life-time benefit instead of her pension. Approximately five thousand mothers thus gave up their pension rights, which explains the 3.3 percent drop in the total number of pensioners in 2016. In total, 21,822 women claimed the new mothers' benefit, with a fiscal cost of nearly 2 percent of GDP. More worrisome, the program incentivized labor force exits, as nearly 3,200 women left the labor force to receive this benefit. The constitutional court declared the law unconstitutional in May 2017, and the authorities are implementing a less costly and time-limited successor benefit. In this context, the 5,000 women that previously received a pension will rejoin the pension system, which is currently not included in these projections.

55. Disability pension expenditure is declining, but remains one of the most generous in Europe. The number of claimants of disability pensions have declined since the 2004 reform after the tightening of eligibility conditions (Figure 9). However, disability expenditure in 2013 absorbed 2.1 percent of GDP, which is 1 percentage point of GDP above the EU average. In 2016, disability expenditure accounted for 1.8 percent of GDP, continuing its downward trend toward the EU average. However, an issue remains as to whether the formula for computing disability benefits is too generous, which calculates benefits assuming 40 years of service for all qualified beneficiaries. With fewer–but more expensive–beneficiaries, further analysis might be warranted to ensure individual benefits are not overly generous and whether it discourages labor force participation from those able to work.

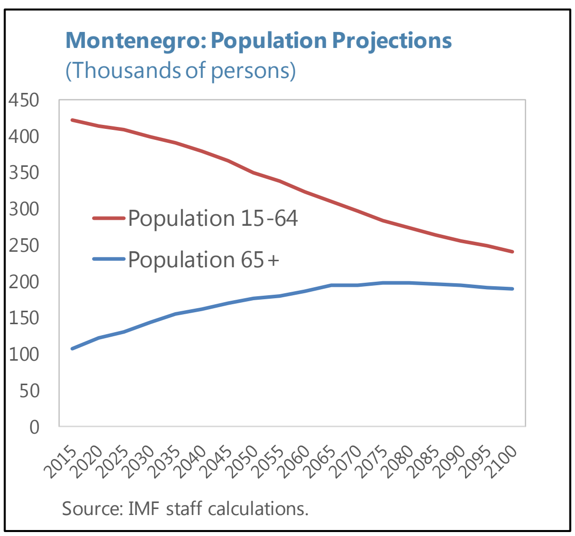
Baseline, simulations, and discussion

56. The FAD pension projection tool is used to project long-term pension system dynamics and assess the impact of some key reform options. In the absence of reforms, pension spending will be driven mostly by demographics. Pension expenditure (PE) as a ratio to GDP is modeled using the below ratios, which can be predicted with some degree of confidence:

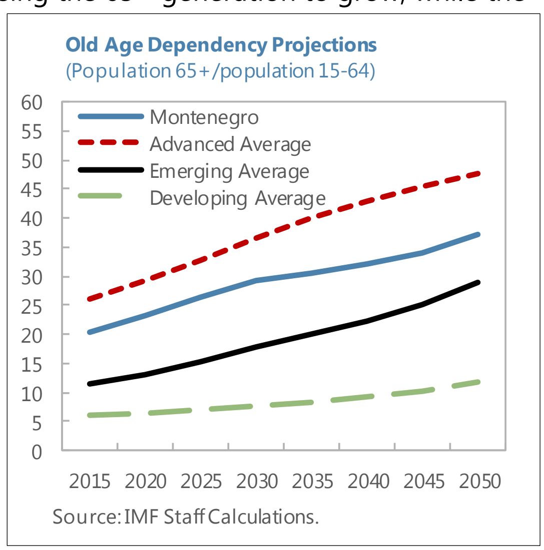
- the modified replacement rate, defined here as the average pension relative to GDP per employed worker,[17]
- the coverage ratio, defined as the number of pensioners relative to the elderly population (over 65 years old),
- the dependency ratio, defined as the elderly population relative to the working age population (15-64 years old), and,
- the labor force participation rate, the number of employed workers relative to the working age population.

$$\frac{PE}{GDP} = \frac{\frac{PE}{Pensioners}}{\frac{GDP}{Workers}} * \frac{Pensioners}{Pop65+} * \frac{Pop65+}{Pop15-64} * \frac{1}{\frac{Workers}{Pop15-64}}$$

57. Demographic pressures will weigh on the fiscal sustainability of the pension system. Montenegro's population is projected to decline over time, due to a negative natural growth rate. The population is also rapidly aging, causing the 65+ generation to grow, while the



Source: IMF staff calculations.

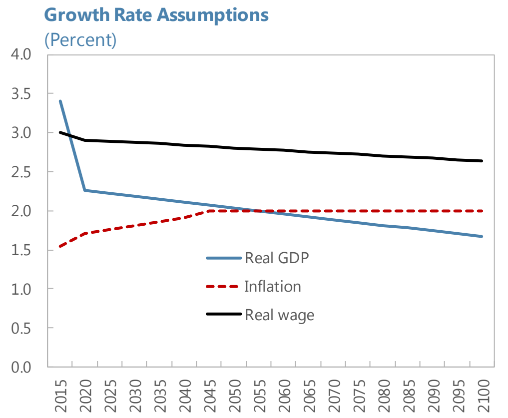


Source: IMF Staff Calculations.

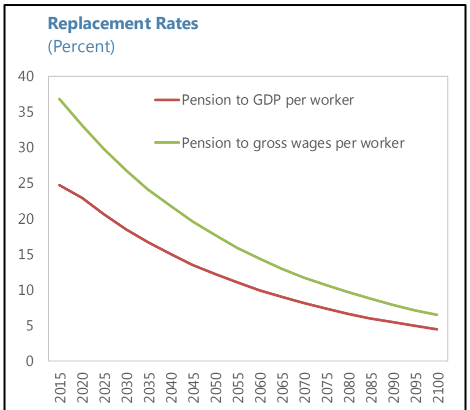
[17] Normally the replacement rate is defined as the percentage by which the pension replaces the salary. This ratio should be close to but lower than the average gross replacement ratio since gross wages account for a large part of GDP.

working-age population shrinks. The old-age dependency ratio will almost double from about 20 in 2015 to almost 40 in 2050, and the working-age population will face an increasing financial burden to support the elderly. Montenegro's dependency ratio is significantly above the average of emerging economies, but not quite as high as that of advanced economies.

58. In the baseline, we project replacement rates to fall significantly because of the valorization formula. The current pension system valorizes pension contributions at 75 percent inflation and 25 percent wage growth, thus undervaluing lifetime earnings and the corresponding pension benefit. Assuming a long-term average inflation of 2 percent and real wage growth of 3 percent that declines linearly to 2.6 percent over the projection period, the replacement rate will decline overtime to an unsustainable level. The gross replacement rate falls from 37 percent in 2015 to 6.5 percent in 2100, while the modified replacement rate falls from 25 percent to below 5 percent. The fiscal savings from the diminishing replacement rate outweigh the costs from an aging workforce, driving down pension expenditure.

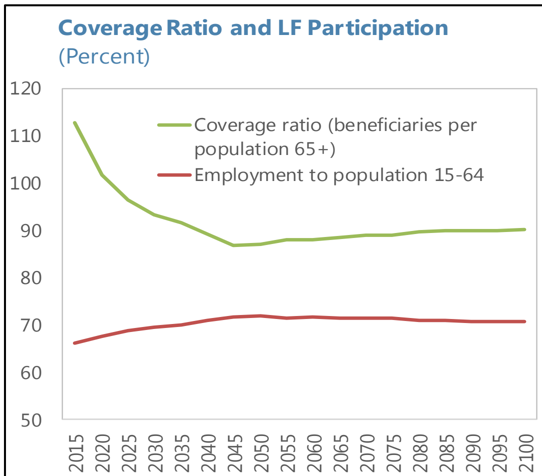


Source: IMF staff estimations.



Source: IMF staff calculations.

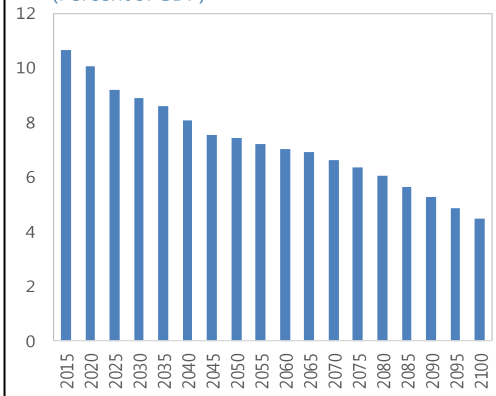
59. The coverage ratio and the labor force participation rate are more stable over the projection period. The coverage ratio will likely decline until 2045, as workers remain in the workforce for longer, due to the increases in the statutory retirement age. This might become a policy problem if old age poverty for those not covered becomes a political issue. The labor force participation rate will likely increase marginally because the increase in the retirement age will cause the number of employed to increase slightly faster than the number of the active population (ages 15-64).



Source: IMF staff calculations.

60. Staff project pension spending to GDP to decline as the replacement rate falls. In the baseline scenario, in which no reforms are enacted, pension spending is projected to decrease from 10.7 percent of GDP in 2015 to 7.4 percent by 2050, falling below the projected advanced and emerging economies average (Table 8). Still, the accrued pension liability of 200 percent of GDP is similar to that of advanced economies (220 percent). Pension spending would fall further to 4.5 percent of GDP by 2100. The fall in pension expenditure is positive given high pension spending by international comparison, but it comes at the expense of falling replacement rates, meaning that pensions will become significantly less sustainable over time. Average net replacement rate (average pensions to average net wages) would likely fall to less than 10 percent by 2100, which is likely not sustainable, as it is generally estimated that pensions below 20 percent of GDP per-capita are not sufficient to protect the elderly from poverty.

Pension Expenditures
(Percent of GDP)



Source: IMF staff calculations.

61. Pension contributions are likely to be more stable in the absence of reforms. Contributions can be projected using a similar methodology, where pension contributions (PC) as a ratio to GDP are modeled using the below ratios:

Table 8. Montenegro: Pension Projections

	Pension Expenditure (% of GDP)			2015-2050 Expenditure Increase		Accrued Pension Liability (% of GDP)
	2015	2030	2050	Percentage Points	Present Discounted Value (% of GDP)	
Montenegro	10.7	8.9	7.4	-3.3	-52.2	200.8
Advanced Average	8.7	9.3	9.7	1.0	17.3	219.9
Emerging Average	5.0	6.0	8.0	3.0	36.7	124.7
Developing Average	1.8	2.2	3.3	1.6	17.3	44.6

Source: IMF, pension expenditure tool developed by FAD; and IMF staff calculations.
Note: Accrued Pension Liability shows the present discounted value of all future pension obligations owed if the system were to be shut down today.

- the modified contribution rate, defined here as the average contribution relative to GDP per employed worker,[18]

[18] The modified contribution rate is higher than the standard contribution rate of 20.5 percent because GDP per capita is higher than gross wages.

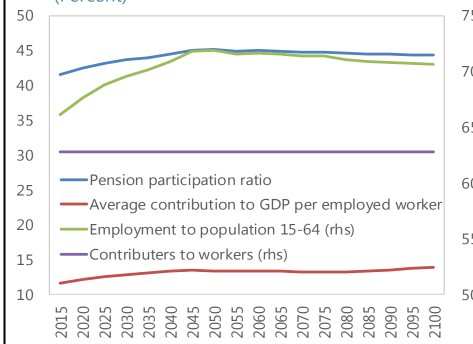
- the pension system participation ratio, defined as the number of contributors relative to the working age population (15-64 years old), and,

- the labor force participation rate, the number of employed workers relative to the working age population.

$$\frac{PC}{GDP} = \frac{\frac{PC}{Contributors}}{\frac{GDP}{Workers}} * \frac{Contributors}{Pop15-64} * \frac{1}{\frac{Workers}{Pop15-64}}$$

62. Pension contributions depend mostly on the number of contributors, which are unlikely to change significantly in the absence of reform. The modified contribution rate is projected to stay relatively stable over the projection period because wages grow only somewhat faster than GDP. Also, the pension participation rate is unlikely to change significantly, unless there is much more progress with reducing the grey economy. However, revenue to GDP would probably decline overtime, given that the working-age population is projected to decline along with employment. It would probably not be offset by the increase in the statutory retirement age for women and men to 67, given the long phase-in window and ample early retirement options.

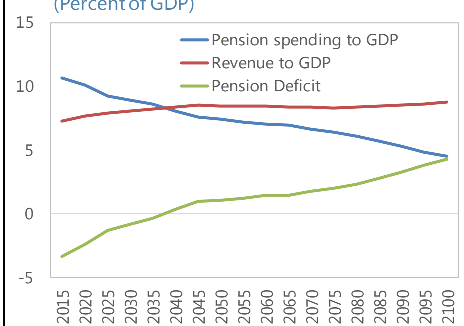
Pension Contribution Model
(Percent)



Source: IMF staff calculations.

63. The pension deficit would turn into to a surplus by 2040 (see Figure 10). Given a relatively stable pension-contribution-to-GDP ratio, but steadily declining expenditures, the pension system would generate large surpluses over the long run. The baseline projections assume that no reforms are taken in the long-term. Since wages are projected to outpace GDP growth, the pension benefit valorization formula will lower the value of pension benefits overtime, which will also decrease pension spending. This will be the ultimate driver of pension surpluses in the long-run.

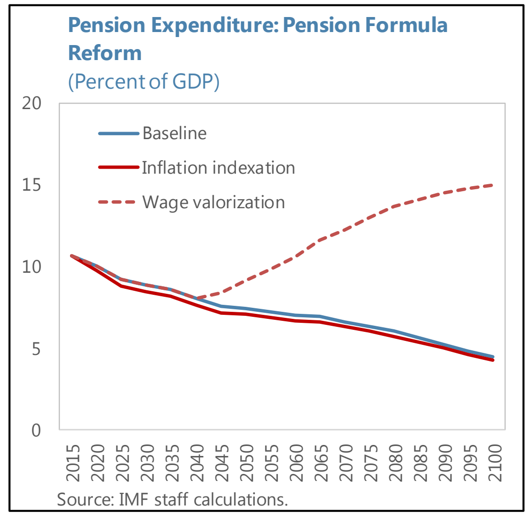
Pension Revenues and Expenditures Projections
(Percent of GDP)

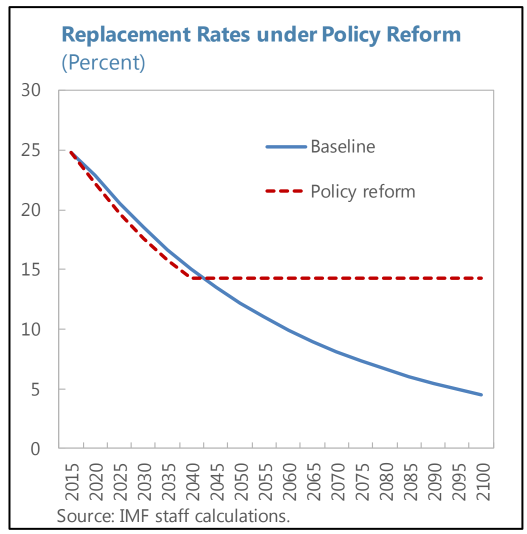


Source: IMF staff calculations.

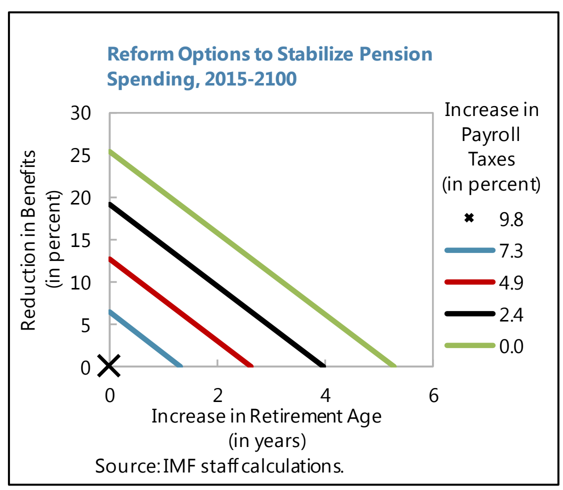
Policy recommendations

64. The most important, but also costliest, reform would be to change to full wage valorization and full pension benefit CPI-indexation. Stabilizing the initial replacement rate should be a top priority and can be achieved by changing the valorization formula to 100 percent wage valorization. Then, to preserve the purchasing power of pension benefits, they should be subjected to 100 percent CPI indexation. Wage valorization and CPI indexation have become international best practice because new pensions are valued based on lifetime earnings and productivity increases (stabilizing the replacement rate), preserving purchasing power of pensioners as they age, and are fiscally and socially sustainable in the long-run. The reform would save money in the short-run, but increase spending in the long run. This is because the switch to CPI indexation will affect all current pensions immediately, while the new valorization formula will only kick in gradually, which results in short-term savings of about 0.4 percentage points of GDP relative to the baseline in the early years. However, as the impact of the valorization formula kicks in, pension spending will worsen to 1.3 percent per year by 2050, and a staggering 5.0 percentage points of GDP by 2070 compared to the baseline. Delaying the reform would result in long-term savings because replacement rates would be stabilized at lower average levels, but also there would be no short-term savings.





65. A combination of additional reforms can stabilize increasing pension spending resulting from the wage valorization and CPI-indexation reform. This would reduce the need for more drastic future measures. Implementing multiple types of reforms quickly would result in less drastic changes now and provide fairer future outcomes. The trade-offs between increases in the retirement age, increases in contribution rates, and cuts in benefits are presented in the graph. For the pension spending-to-GDP ratio to reach a sustainable level in the long-term, there would need to be an additional increase in the retirement age of about 5 years without triggering an increase in the payroll tax rate or a lowering of pension benefits (see



green line). Alternately, reducing benefits by about 25 percent or increasing payroll taxes by 9.8 percent would also stabilize pension spending-to-GDP. However, since Montenegro already has a relatively high payroll tax rate of 20.5 percent and because average pensions are not particularly high, a combination of reform options with emphasis on lengthening the effective working lives of contributors would be the least drastic reform strategy.

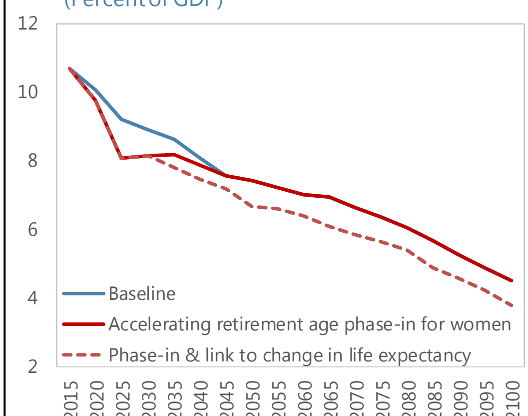
Table 9. Montenegro: Early Retirement Cost Saving Measures

Measure	Savings in 1st year (% GDP)	Savings in year t+5 (% GDP)
Abolish all early retirement	0.25	0.98
40 years of service regardless of age	0.18	0.71
62 years with 15 years of contributions	0.05	0.19
Early retirement decrement increase from 4.25 to 7%	0.02	0.09
Length of early retirement window reduced from 5 years to 2-3 years	0.05	0.09
Eliminate special retirement schemes for miners and parents with disabled children	0.01	0.04
Eliminate accelerated pensions	0.01	0.04

Source: IMF staff estimates.

66. Restricting early retirement should be a major additional reform. First, the ability to retire with 40 years of service regardless of age should be eliminated.[19] Second, the early retirement penalty (decrement) should be increased from the current 4.25 percent per year to 7 percent, which would imply a small actuarial penalty to discourage early retirement,[20] and the length or early retirement should be reduced from 5 years to 2-3 years. In addition, the special retirement schemes for miners and parents with disabled children should be eliminated. Also, accelerated pensions should be eliminated, or at a minimum, be restricted to truly hazardous occupations,[21] and with contribution rates that are actuarially fair. Finally, allowing retirement at 62 years for those who have 15 years of contributions should be eliminated. Implementing

Pension Expenditure: Increasing Statutory Retirement Age
(Percent of GDP)



Source: IMF staff calculations.

[19] Accelerated pensions (see below) should not count towards the 40-year service requirement.

[20] The actuarially fair decrement is estimated to be between 4 and 5 percent.

[21] The list of hazardous occupations with accelerated service periods includes professions that should not be considered extreme working conditions, which are detrimental to the health of the worker. Providing special treatment to nonhazardous occupations encourages other industries to lobby for inclusion.

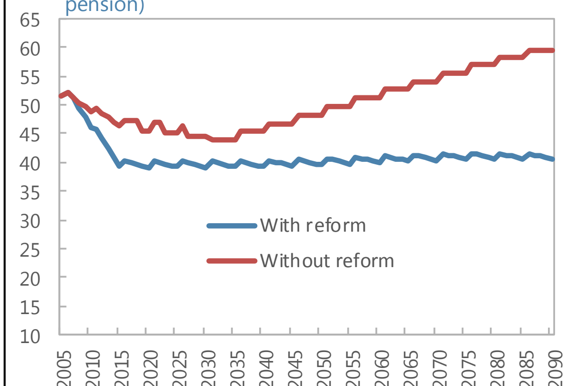
these reforms to limit early retirement could reduce pension expenditures by up to 1 percentage points of GDP per year and would result in higher GDP growth since workers would stay in the labor market for longer periods of time.

67. Increasing the statutory retirement age would also help achieve savings. Phasing in the planned retirement age increases more for women quickly so that it reaches 67 by 2025 instead of 2042 could save about 1 percent of GDP per year until 2042.[22] Given that women have a longer life expectancy than men, it would seem fair that they reach the higher retirement age at the same time.

68. The statutory retirement age should be linked to change in life expectancy. Montenegro has already planned the increase in the statutory retirement age of 67 to one of the highest in Europe. However, life expectancy at age 60 is projected to increase from 80 today to 88 in 2100, which is an average of 11.4 months every decade. As a result, the expected length of pensions decreases as the retirement age increases, but then grows again after 2042 to reach 20 years on average by 2100 compared to 17 years today. Encouraging longer working lives can provide important gains in pension sustainability, but they would have to be accompanied by reforms that increase the ability of older workers to continue in employment through re-training and better possibilities for part-time work. Additionally, linking the statutory retirement age to the expected change in life expectancy would help to alleviate future policymakers from the political costs of increasing the retirement age in the future. Finally, linking the statutory retirement age to the change in expected life expectancy in a way that stabilizes the ratio of expected pension years to the number of contribution years would improve inter-generational fairness.[23] Linking the retirement age to life expectancy at retirement would raise the retirement age to 69 by 2050 and 70 by 2075. This would deliver a gain of about 0.8 percentage points of GDP per year, against the baseline.

Pension Years to Working Years

(In percent, average expected years of pension to number of working years contributing to pension)



Sources: UN; Monstat; Fond Pio; and IMF staff estimations.

69. The combination of the reforms discussed above could make the pension system sustainable (see Figure 10). The policy package would in include: (i) moving to wage

[22] There is an added fiscal benefit, because female pensioners retire earlier, but withdraw from the pension fund for longer periods.

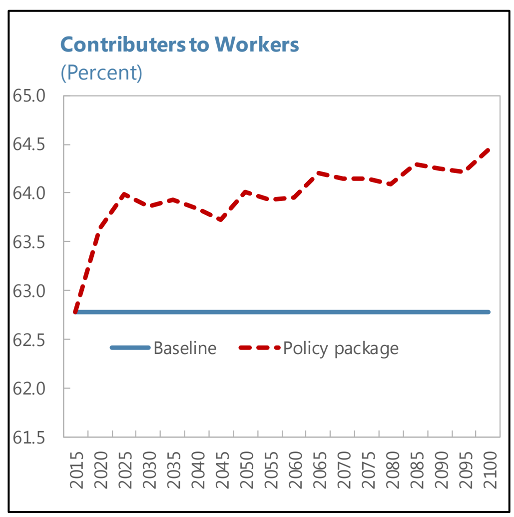
[23] The idea would be to stabilize the ratio of working years to retirement years. If life expectancy at retirement increases by 11.4 months every decade, and the average contribution years are 33 years and the average pension years is 17 years, then the retirement age would have to increase by 7.5 months every decade (7.5 = 11.4 months * 33 working years/ (17 pensions years + 33 working years)).

indexation for pension valorization; (ii) moving to CPI indexation for pension adjustments; (iii) restricting early retirement options; (iv) accelerating the move to statutory retirement age for women; and (v) linking the statutory retirement age to future changes in life expectancy. Thus, pension spending as a share of GDP would decline from above 10 percent of GDP today to around 6 percent of GDP in 2040, but would then slowly rise again before stabilizing in the long-term. Pension revenues would increase from around 7.3 percent of GDP today to 10.4 percent by 2100. Therefore, under the reform package, the pension deficit would turn into a surplus by 2025 compared to 2040 for the baseline. In the long-run, the pension balance may return to a deficit by 2070 as spending exceeds revenues. Additional measures such as reducing the grey economy should be undertaken to address the pension deficit. As a last resort contribution rate increases could be considered.

Additional reform options

70. Higher-paid pensioners should contribute to the healthcare system and pay personal income tax. Pension income is currently tax-free and pensioners do not contribute to the healthcare system directly (though the pension system does make 1 percent contribution to the health system on their behalf). Pensioners are the largest users of the healthcare system and should contribute more to ensure its sustainability, preferably those earning above the average pension. Similarly, better off pensioners should contribute to the personal income tax to improve the fiscal accounts of the government and help subsidize all the social services provided by government. Pensioners may be more receptive to pension taxes than healthcare contributions, with earmarking of the revenues to the healthcare system.

71. Reducing the grey economy would improve tax collection. Broadening the tax base while improving enforcement would allow the government to cut tax rates without negatively impacting revenues. Grey firms tend to be small to avoid detection, which limits their ability to improve their productivity through new business practices and technology. In other words, the benefits from evading taxation often outweighs the improvements in productivity from economies of scale. In the baseline, contributors and workers grow at the same pace, based on the projected changes in the working age population. In the policy package, the contributors to workers' ratio will at first increase sharply as early retirement is curtailed, and will gradually increase in the long-term as the statutory retirement age is increased in line with life expectancy, as pension contributors are retained in the labor force for longer.



Concluding remarks

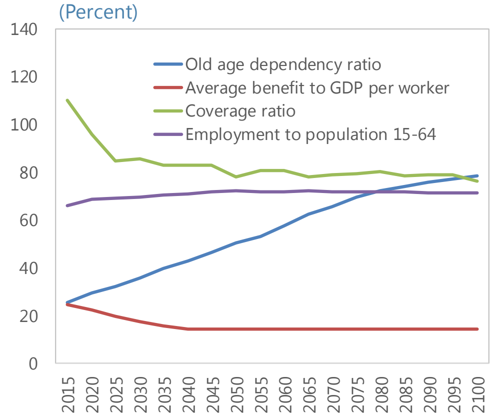
72. The authorities should accelerate efforts on pension reform, particularly regarding early retirement, which poses great risks to the financial sustainability of the pension system. Adverse demographic pressures, low rates of labor participation, and high numbers of early retirees threaten the long-term sustainability of the pension system. Delaying reforms regarding wage valorization and CPI indexation would reduce short-term savings, but also be politically problematic in the long-term as benefits fall to unsustainable levels. The indexation reforms should be accompanied by increases in retirement ages to make the reforms sustainable. Also, delays could necessitate eventual sharp adjustments in the form of increased taxes, large spending cuts, or increased debt, which could weigh on long-term growth.

73. Current reform proposals should focus on the long-term viability of the system. Staff welcome the authorities' plans to reform the pension system. Going forward, periodic reassessment should take place to take stock of adverse developments related to the pension outlook, such as unexpected behavioral, demographic, and macroeconomic changes. Successful reforms will aim at delaying exit from the labor market while incentivizing more to join the formal labor market.

Figure 10. Pension Reform Package

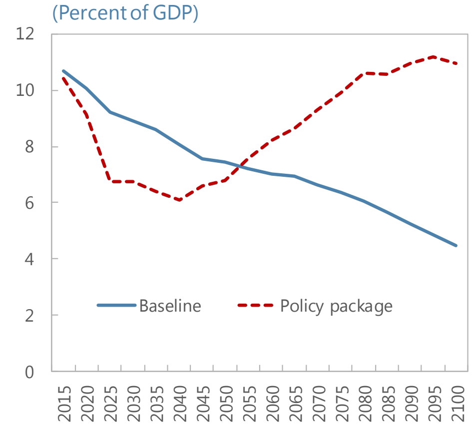
The most important result of the reforms is that the modified replacement rate stabilizes.

Pension Expenditure Ratios under Policy Reform Package
(Percent)



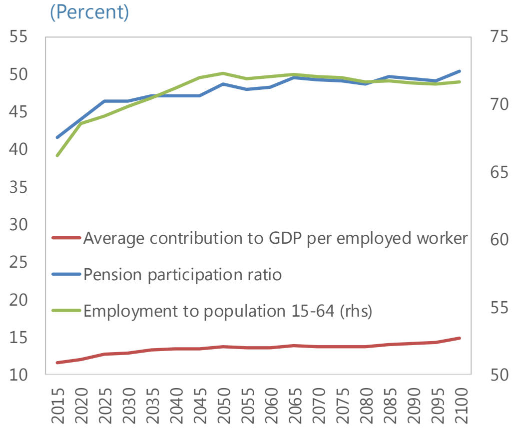
Pension spending would decline to 6 percent by 2040, but would rise again before stabilizing in the long-term.

Pension Expenditure: Policy Package
(Percent of GDP)



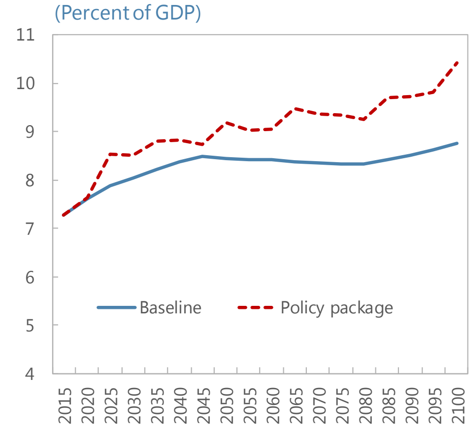
The number of contributors is permanently increased, due to elimination of early retirees...

Pension Contribution Model
(Percent)



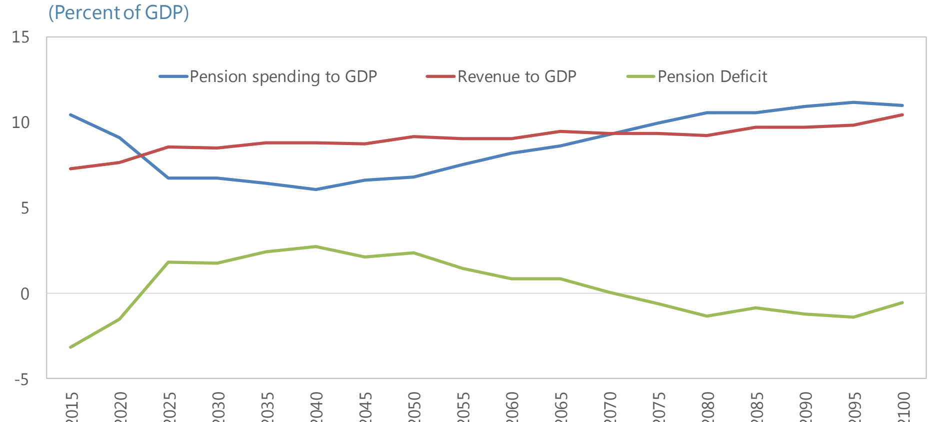
...pension revenues would increase from around 7.3 percent of GDP today to 10.3 percent by 2100.

Pension Revenue: Policy Package
(Percent of GDP)



The pension deficit would turn into surplus by 2025 compared to 2040 for baseline. In the long-run, additional measures may be required to address the deficit.

Policy Reform Package Projections
(Percent of GDP)



Source: Fund staff projections.

D. Local Government Fiscal Sustainability[24]

Montenegro's municipalities exhibit varying degrees of fiscal and administrative capacity. Revenues have declined in recent years and are insufficient to meet spending needs, despite local governments' limited responsibilities. Revenue sharing and equalization transfers are encouraging moral hazard behavior, instead of incentivizing revenue collection. Budgets are burdened with overstaffing and excessive payroll expenses. Staff rationalization and debt reprogramming contracts have not worked well in the past, but current attempts are promising. Municipal bank debt and arrears are still high and limited fiscal space is crowding out capital investment, which is troubling given ambitious infrastructure needs and EU mandates.

Introduction

74. **Montenegro's government is highly centralized with local government having limited responsibilities**. Local government expenditure accounted for 5 percent of GDP in 2016, which is only 11 percent of general government spending. Municipal functions include road maintenance, water services, waste management, street lighting, greening, culture, and sports. Notable exclusions are education, health services, and social welfare, which constitute a large share of local expenditure in other countries.

Table 10. Montenegro: Local Government Fiscal Operations

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Revenues	8.7	6.6	5.7	5.0	5.8	5.7	5.7	5.5	5.3
Expenditure	9.8	8.4	6.0	5.7	6.1	5.9	5.5	5.7	5.3
Deficit	-1.1	-1.8	-0.2	-0.8	-0.3	-0.1	0.2	-0.2	-0.1
Financing	1.1	1.8	0.2	0.8	0.3	0.1	-0.2	0.2	0.1
Total debt	…	…	5.9	6.6	7.1	8.5	8.3	7.6	6.8
of which:									
Bank debt	…	…	2.8	3.6	3.6	5.1	4.8	4.9	4.7
Arrears	…	…	3.0	3.0	3.5	3.5	3.4	2.7	2.1

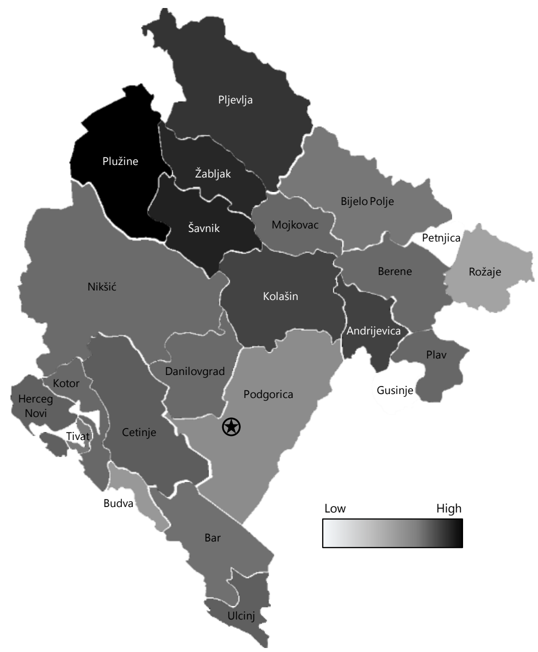
Source: MOF.

[24] This section was prepared by Jesse Siminitz. It is partly based on a World Bank policy note: "Montenegro - Options to restore fiscal sustainability and improve spending efficiency at subnational level," by Pradelli et al., 2015.

Population
(Number of Inhabitants)

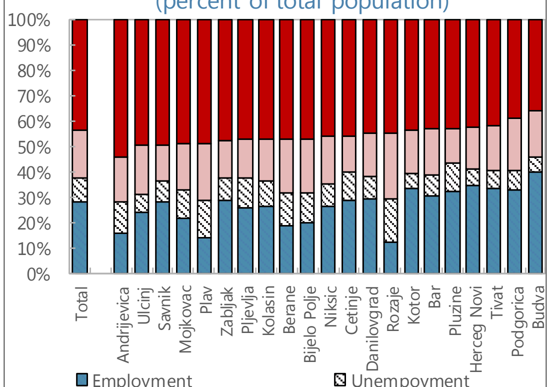
Source: Monstat; and IMF staff calculations.

Old Age Dependency Ratio
(Population 65+ in percent of population 15-64)



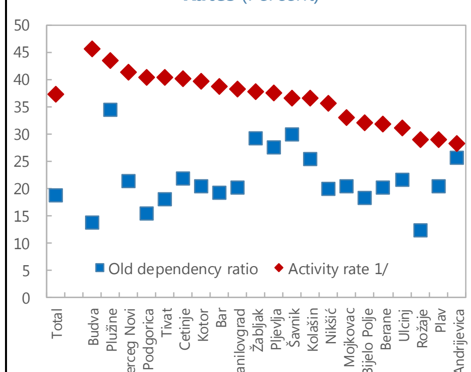
Source: Monstat; and IMF staff calculations.
Note: Municipalities of Gusinje and Petnjica have no available data.

Population Activity
(percent of total population)



Source: MONSTAT.

Old Age Dependency and Activity Rates (Percent)



Source: MONSTAT.
Note: 1/ Activity rate is labor force in percent of total population.

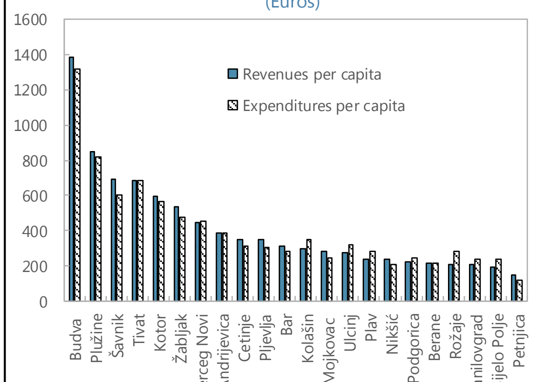
75. **There are 23 municipalities, but 31 percent of the population lives within the capital municipality of Podgorica**, which is the highest concentration in the Western Balkans (text figure). The other 22 municipalities average only about 19,500 people per municipality. In addition, Montenegro has a relatively high age dependency, which is unevenly distributed as well

76. Divergences between municipalities in activity rates cause differences in fiscal capacity. Also, high dependency ratios burden finances and cause inequality between service delivery. The northern region of Montenegro will likely become more dependent on pensions and social transfers as their activity rates are lower and dependency ratios higher than other parts of the country. Some municipalities have high inactivity mixed with high dependency causing an erosion of the tax base and putting pressure on fiscal sustainability. This is also evident in the discrepancy in revenue per capita across municipalities, where the difference between the richest and poorest municipalities is sevenfold. Given current limitations in statistics, these measurements may be the best proxy for the fiscal capacity of municipalities. These large differences in fiscal capacity has led to inequality of public service delivery, which is reflected in infrastructure outcomes.

Total Revenues, 2016

Source: Monstat; and IMF staff calculations.

Revenues and Expenditure Per Capita, 2016
(Euros)

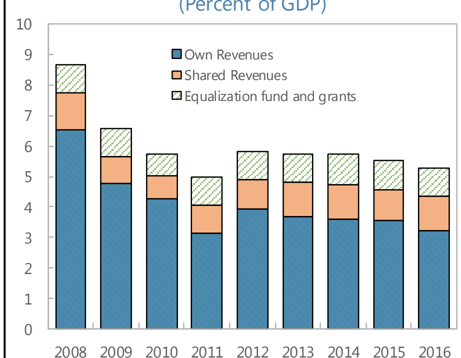


Source: MOF.

Revenues

77. Municipal governments rely mostly on their own-source revenues, despite efforts to boost shared resources. Own-source revenues account for about sixty percent of budget revenues, while shared revenues and the equalization fund each provide twenty percent of the budget. Federal reforms from 2008–11 sought to reduce traditional sources of local revenues with the aim of eliminating distortionary taxation and reducing abuses of taxing power. However, the simultaneous collapse of the real estate boom caused additional problems and so far, it is uncertain whether the reforms had a net positive effect on municipality fiscal capacity.

Municipality Budget Revenues
(Percent of GDP)



Source: MOF.

Table 11. Montenegro: Revenue Sources

	Tax on Individual	Transfers to Municipality	Exceptions
Own Revenues			
Surtax on personal income tax (PIT)		Up to max of 13% surtax on PIT	Up to max 15% surtax on PIT transferred to Historic Capital and to Capital
Real estate tax	0.25 to 1% of market value		Higher rates can be charged when land is not utilized in accordance with planning
Charge for provision of utilities of buildable land	Investors shall pay compensation for communal service infrastructure of buildable land, defined by special agreement between investor and municipality		
Charge for use of buildable land			
Other local taxes, fees, and charges			
Shared Revenues			
Personal income tax (PIT)	9% of earnings; 11% on earnings exceeding the average wage	12% of revenues from PIT collected in Muni is transferred	16% revenues from PIT transferred to Historic Capital and 13% to Capital
Charges for use of assets and natural resources (concessions)	Any user of natural resources will pay real cost of utilization and reclamation	70% of natural resource and forest revenue and 20% port concessions transferred	
Property sales tax	3% of market value at moment of acquisition	80% revenues transferred	
Annual charge for vehicle registration	€25 – €1500 per passenger car based on engine capacity per year; boats and aircraft similarly taxed at higher rates	30% revenues transferred	Tax reduced by 5% for each year vehicle has aged up to 50% of tax
Equalization fund and grants			
Equalization fund		Funded by 11% of PIT, 10% property sales tax, 100% motor vehicle tax, 40% of concession fees from games of chance. Allocated 60% on basis of fiscal capacity and 40% on budgetary needs.	
Conditional grants		Grants conditional that municipalities adopt a perennial capital investment plan. Grants issued at maximum of 50% of funds envisaged for realization of an investment project if revenues of municipality per capita are lower than 50% revenues of all municipalities. Grants provide less funding for municipalities the higher municipal revenue per capita.	
Other transfers and grants			

Source: MOF.

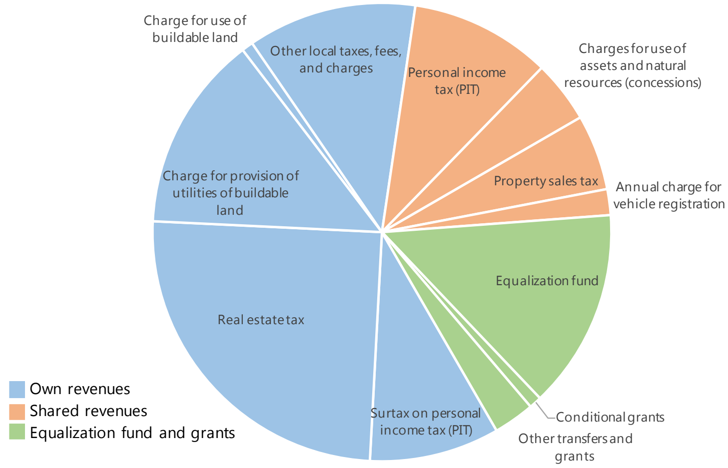
78. **Municipalities have autonomy to set the majority of their own revenues** (see Table 11).[25] All municipalities have chosen the maximum allowable surtax on personal income tax (PIT) of 13 to 15 percent, while the central government requires an additional tax transfer of 12 to 16 percent of PIT collected in a municipality. The rate for the immovable property tax is set by municipalities in the range of 0.25 percent to 1 percent and most have chosen a rate in the middle, though the property sales tax is nationally set at 3 percent of market value with 80 percent of revenues transferred back to municipalities. Fees for the provision of utilities and use of buildable land are determined through negotiated contracts between investors and municipalities to compensate for public use infrastructure on buildable land. Concession fees for use of assets and natural resources are centrally collected to pay for the real cost of utilization and reclamation of resources, with 70 percent of revenues transferred back to municipality of resource origin. The Equalization fund is fed by a number of revenue sources, but allocated to municipalities 60 percent on the basis of fiscal capacity and 40 percent on budgetary needs. Conditional grants are issued for funding of municipal investment projects, up to 50 percent the

[25] Excludes financing transactions such as sale of property, loans, and carry-over from previous years. Some presentations include these as revenues, but should be accounted as below-the-line financing.

cost of investment project, with less funding provided to municipalities the higher their revenue per capita.

79. Strengthening the real estate value tax and reducing the property sales tax would improve efficiency of the property market by encouraging turnover. The rate for the immovable property tax is set by municipalities in the range of 0.25 percent to 1 percent, while the transaction tax is set by the central government at 3 percent. This discourages the efficient turnover of unproductive immobile properties, since holding costs are low and transferring property to more productive entities comes at a higher cost. Ideally, real estate transaction fees should be reduced and real estate value taxes increased to boost revenues and incentivize a more efficient property market. Increased reliance on the real estate tax was intended to offset the abolishment of the tax on use of buildable land (eliminated to improve the World Bank's doing business ranking) and the limitation of the tax on utility provisions (abused by some municipalities). However, the immovable property tax has increased €34 million since 2008, while the tax on buildable land and limit of tax on utility provisions fell €93 million. Part of this fall is due to the collapse of the real estate boom. The MOF should encourage municipalities to increase their real estate value tax, while reducing the centrally mandated transaction tax, but it will also be important to update valuations of properties regularly.

Municipal Budget Revenues, 2016
(Percent of total revenues)



Source: MOF.

80. Active enforcement of illegal settlements could improve tax revenues and compliance rates. Current estimates for real estate tax compliance for all properties is less than 50 percent, but 70 to 80 percent in those municipalities that do not receive Equalization Fund transfers. Improving the tax base will improve the finances of local governments and raising awareness with residents about the importance of paying taxes to support municipal development and service delivery should help ease efforts in cracking down on tax evasion. In a push to improve tax compliance rates, a new law was signed in July 2016 for the Ministry of Sustainable Development and Tourism to begin reviewing the outstanding stock of illegal settlements and estimate possible revenue capacity. A satellite photo survey will audit tax payer inputs against actual square footage. Starting in June 2017, illegal settlements will have 9 months to comply before legal recourse is taken. Initial revenue estimates of €500–800 million over 20 years are highly uncertain, since the estimates do not include the total number of buildings or square footage.

Table 12. Montenegro: Budget Revenues

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Total Revenues	**8.7**	**6.6**	**5.7**	**5.0**	**5.8**	**5.7**	**5.7**	**5.5**	**5.3**
Own Revenues	**6.5**	**4.8**	**4.3**	**3.2**	**3.9**	**3.7**	**3.6**	**3.6**	**3.2**
Surtax on personal income tax (PIT)	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Real estate tax	0.5	0.7	0.8	0.9	1.1	1.2	1.2	1.3	1.3
Charge for provision of utilities of buildable land	3.0	2.2	2.1	1.1	1.6	1.1	1.1	1.1	0.7
Charge for use of buildable land	0.9	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other local taxes, fees, and charges	1.4	1.2	0.9	0.7	0.8	0.9	0.8	0.7	0.6
Shared Revenues	**1.2**	**0.9**	**0.7**	**0.9**	**1.0**	**1.1**	**1.1**	**1.0**	**1.1**
Personal income tax (PIT)	0.5	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5
Charges for use of assets and natural resources (concessi	0.1	0.1	0.1	0.2	0.1	0.3	0.2	0.2	0.2
Property sales tax	0.6	0.3	0.3	0.3	0.4	0.3	0.3	0.3	0.3
Annual charge for vehicle registration	0.1	0.1	0.0	0.0	0.1	0.1	0.1	0.0	0.1
Equalization fund and grants	**0.9**	**0.9**	**0.7**	**0.9**	**0.9**	**0.9**	**1.0**	**0.9**	**0.9**
Equalization fund	0.7	0.6	0.5	0.7	0.7	0.7	0.8	0.7	0.7
Conditional grants	0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.0	0.0
Other transfers and grants	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.2	0.2

Source: MOF.

81. **The equalization fund transfers revenues to poorer municipalities, but its redistribution formula discourages tax collection and to right size staff.** Underdeveloped municipalities—defined those with lower fiscal capacity per capita—benefit from the equalization fund since it redistributes revenues from richer to poorer municipalities. The current formula allocates the Fund's revenues 60 percent based on fiscal capacity and 40 percent on budgetary needs. The methodology and criteria for the estimation of fiscal capacity and budgetary needs, however, is based on the 3-year average of past revenue collection and the number of local government staff. For instance, a lower tax collection and a larger staff headcount equates to a higher equalization transfer, which provides a disincentive to collect revenues and to reduce staff. This disincentive is reflected in the real estate value tax compliance rates of municipalities. Podgorica and Kotor do not receive equalization fund transfers, so they have improved tax collection to receive additional revenues, while poorer municipalities have not seen similar improvements.

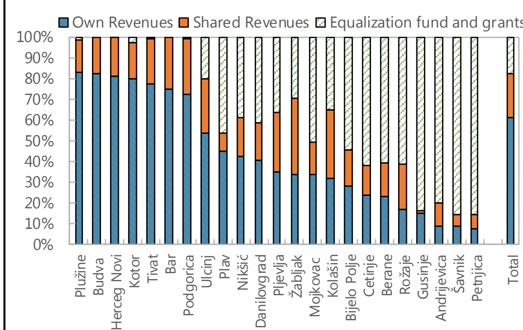
Revenues Per Capita, 2016

Source: Monstat; and IMF staff calculations.
Note: Municipalities of Gusinje has no available data.

82. Given the large discrepancies in per-capita revenues between municipalities consideration should be given to increasing the size of the Fund, but only after its allocation formula has been improved. The MOF should improve their redistribution formula methodology by calculating the theoretical tax capacities of municipalities in collaboration with the tax administration. Municipalities should be incentivized to improve their collection rates of the immovable property tax, right-size staff and expenditures, and reduce outstanding debts and arrear by rewarding improvements with additional revenue from the Equalization fund. This is necessary since no statistics for municipal GDP output exists, so revenue capacity is difficult to measure. The Equalization fund provided only 14 percent of total local revenues in 2016, with a third of municipalities receiving no funds and another third receiving over 50 percent of their revenues from the Fund. Increasing the size of the fund may help to accelerate the development of poorer municipalities and address their financial short-comings. The MOF local government team has created working groups to address outstanding issues with the Equalization fund and are preparing a report for July 2017.

83. Municipalities with structural issues should be granted additional revenue on a temporary basis and conditional upon commitments to expenditure rationalization. Serious structural problems such as deindustrialization, scarcity of private sector employment, shrinking economic activity, and population migration prevent some regions from generating sufficient own-source revenues. Migration and deindustrialization in the northern regions have eroded their local tax bases. Municipalities facing structural problems need to be identified and granted additional revenues to help restore financial sustainability and reduce borrowing costs, but those municipalities also need to address their structural short-comings on the revenue and expenditure side.

Total Revenues, 2016
(Percent)



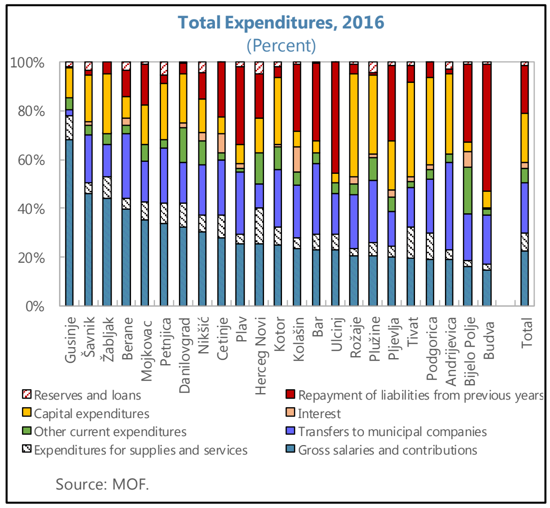
Source: MOF.

84. The sharing of the personal income tax should be changed to a percentage point instead of a percentage of income tax revenues. Currently, a change in the federal PIT automatically leads to a change in local government revenues, which is not desirable. In addition, the surcharge on the PIT could be structured similarly by taxing personal income directly instead of taxing the PIT, which would stabilize revenues further and could allow the municipalities more autonomy to determine their own tax rates.

85. Merging waste management and water companies could serve multiple municipalities at the same time while achieving economies of scale and scope. Authorities are fully aware of the EU requirements to bring waste management and water treatment plants up to EU standards. To reach EU requirements within 10 years, investments in the magnitude of one billion euros will be needed. Current fees levied by municipalities do not even cover basic maintenance costs of these public services. By combining operations of utility companies of smaller municipalities, savings from economies of scale might cover current maintenance and future infrastructure development projects. Authorities should raise public awareness about the benefits of paying fees for the development and maintenance of basic public services and an explain the negative externalities associated with underfunding waste and water treatment plants.

Expenditures

86. Lack of resources and poor budget planning has severely reduced capital spending, while urgent infrastructure upgrades are needed. Capital expenditure has decreased from 5.4 percent of GDP in 2008 (€166 million) to 1.1 percent in 2016 (€41 million). At the same time, most other expenditure items stayed about constant in nominal terms, but declined as a share of GDP. Over the same period, the repayment of liabilities from previous years has increased from 5 percent to 20 percent of total expenditures. This reflects the large efforts of some municipalities to repay their debts at the expense of capital projects and infrastructure maintenance. Basic local services and infrastructure are likely to continue deteriorating if current expenditures are not rationalized and outstanding debts restructured. Municipalities can apply to the central government for financing of capital projects, as some have for waste water plants. However, much more financing will be needed to comply with EU requirements on waste and water treatment plants.



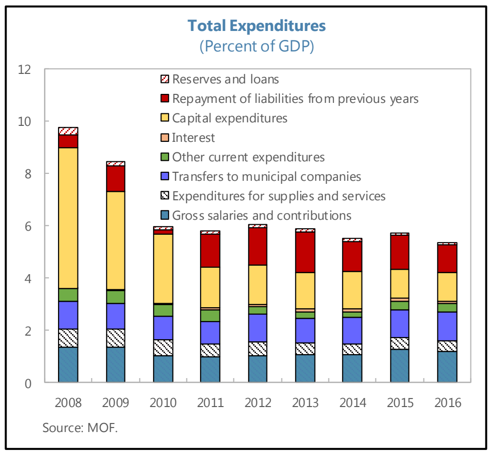


Table 13. Montenegro: Budget Expenditures

(Percent of GDP)

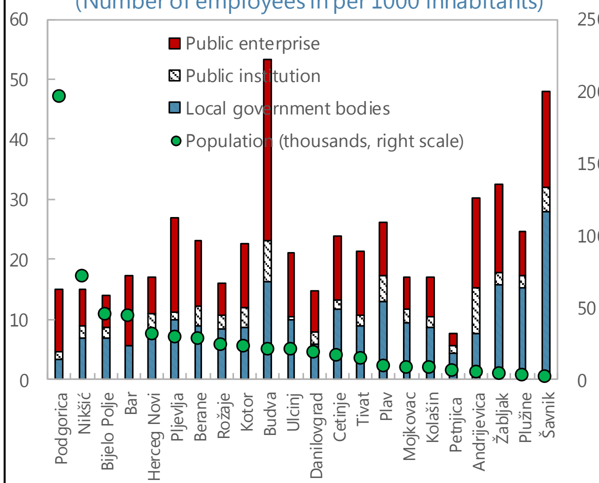
	2008	2009	2010	2011	2012	2013	2014	2015	2016
Gross salaries and contributions	1.4	1.4	1.1	1.0	1.0	1.1	1.1	1.3	1.2
Expenditures for supplies and services	0.7	0.7	0.6	0.5	0.5	0.4	0.4	0.5	0.4
Transfers to municipal companies	1.1	1.0	0.9	0.8	1.1	1.0	1.0	1.0	1.1
Other current expenditures	0.5	0.5	0.4	0.5	0.3	0.2	0.2	0.3	0.3
Interest	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditures	5.4	3.8	2.7	1.6	1.5	1.4	1.4	1.1	1.1
Repayment of liabilities from previous years	0.5	1.0	0.2	1.3	1.4	1.6	1.2	1.3	1.1
Reserves and loans	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total	9.8	8.4	6.0	5.7	6.1	5.9	5.5	5.7	5.3

Source: MOF.

87. The local public sector is overstaffed in some municipalities. Montenegro municipalities with smaller populations are statistically more likely to have additional public sector employment per thousand inhabitants, due to indivisibilities in the administrative responsibilities. However, the medium-sized municipalities of Plav, Budva, and Pljevlja are certainly overstaffed relative to their population. The smallest municipalities of Andrijevica, Pluzine, and Savnik, have the highest staff-to-population ratios of all municipalities, besides Budva, which has around 50 employees per 1000 inhabitants compared to 15 in Podgorica. The variation for public enterprises and public institutions is particularly striking and possibly due to structural difficulties (see next paragraph). Amending the public administration law to allow for cutting staff in indebted municipalities would improve the productivity of local governments, but should be coupled with promotion of job-creating private sector activities to absorb labor reductions from the public sector such as re-training programs and financial support during periods between jobs.

Municipal Employment, 2016

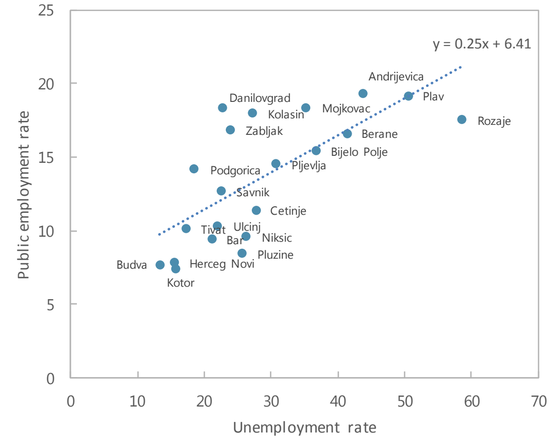
(Number of employees in per 1000 inhabitants)



Source: MONSTAT.

88. Local governments act as 'employer of last resort' in municipalities with severe structural problems. High public sector employment is common in municipalities with a scarcity of private-sector jobs, shrinking economic activity, and population migration. There is a strong relationship between the municipal unemployment rate and the public employment rate. The economic crisis resulted in massive layoffs from large firms that previously employed a significant number of workers, which then ended up in unemployment. Local governments absorbed the excess labor in the absence of commercial activity. The structural issues of some municipalities are reflected in their local finances.

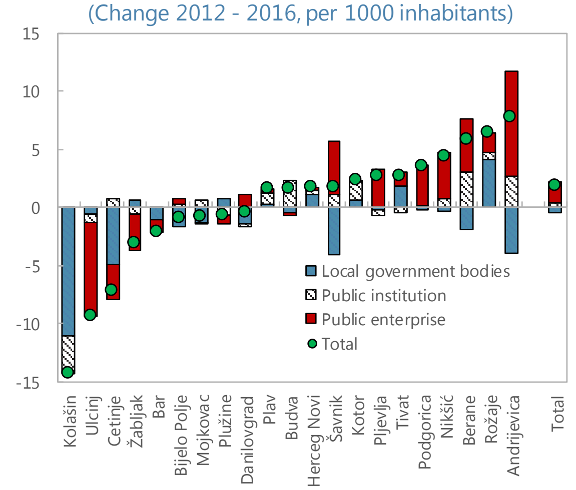
Municipal Unemployment and Public Employment
(Percent, 2011)



Source: MONSTAT.

89. MOF staff rationalization plans from 2013 have not reduced public sector employment as envisaged. Municipal public employment has grown from 2012 to 2016 in many municipalities, often by shifting employment from local government bodies to public enterprises and institutions. The central government target of 5 percent reduction in municipal employment in 2014 and 2015 was not reached in most municipalities. Given the legal autonomy of local governments, the central government has few mechanisms available to induce local government employment reductions. Public administration law protects public employees from layoffs, so employment reduction has been limited to offering voluntary severance packages to current employees and limiting new hiring. Since employment exit proposals were voluntary—due mainly to labor market regulations—only staff close to retirement age accepted early-retirement packages. Most staff preferred to maintain public employment in a weak private sector labor market, given the relatively high public sector salaries.

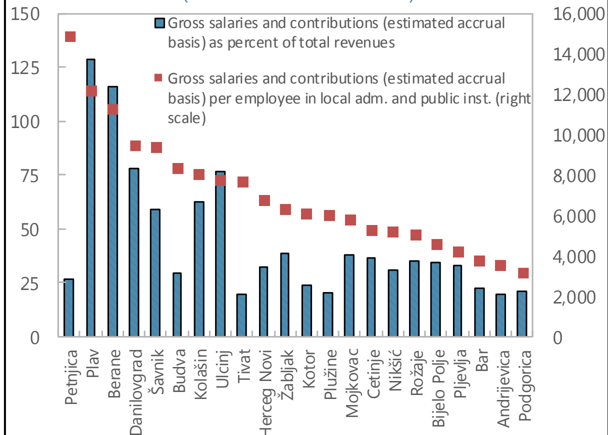
Municipal Employment
(Change 2012 - 2016, per 1000 inhabitants)



Source: MONSTAT.

90. Excessive payroll expenses absorb a large share of the recurrent revenues in some municipalities. The gross salaries and contributions (on an estimated accrual basis) per employee greatly differ among municipalities, reflecting the regional disparities in terms of economic development and per-capita income as well as the autonomy of municipalities to manage their employee wage compensation policies. Annual averages range from around €3,000 in Podgorica to almost €15,000 in Petnjica. Excessive local wage bills are the result of generous wage compensation and overstaffing. More importantly, the accrual local government wage bill exceeded 100 percent of total revenues for Berane and Plav; which is the main reason for years of underpaying salaries and contributions. For instance, Plav has the equivalent of 6 years of unpaid salaries to its local public employees.

Gross Salaries and Contributions (estimated accrual basis), 2016
(Percent of total revenues)

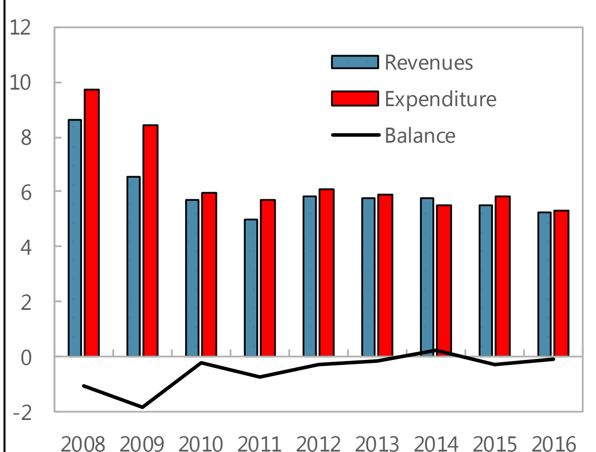


Source: Ministry of Finance.
Note: Accrual basis estimated assuming that salares were fully paid in 2016 and represented 60 percent of the gross salaries and contributions arrears due.

Deficits and debt

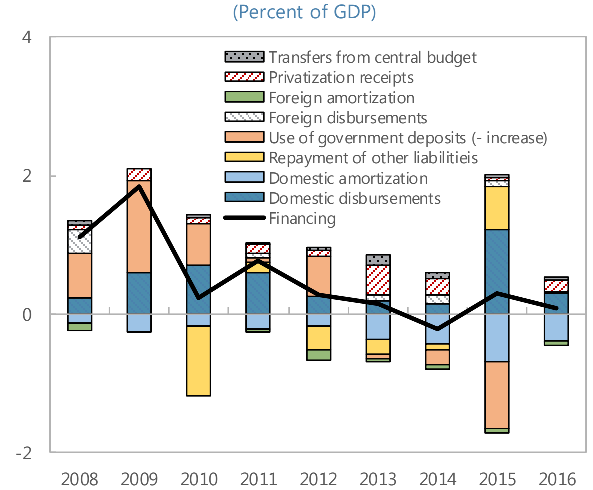
91. The fiscal deficit has declined in recent years as expenditures adjusted to stabilized revenues, while financing was used mainly for repayment of debt. The local government fiscal deficit has reduced from 1.8 percent of GDP in 2009 to 0.1 in 2016, reducing the financing needs of municipalities. Most new borrowing has been domestic and used for repayment of outstanding debt, which has fallen from 8.5 percent of GDP in 2013 to 6.8 percent in 2016. Privatization and transfers from the central government have also been providing additional financing in recent years to help address the local government debt overhang.

Municipal Fiscal Balance
(Percent of GDP)



Source: MOF.

Municipal financing
(Percent of GDP)



Source: MOF.

Table 14. Montenegro: Municipal Deficit and Financing

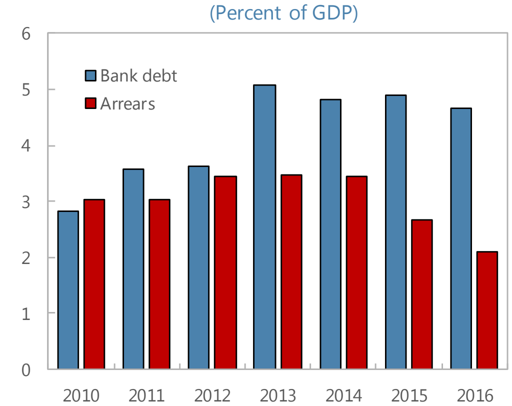
(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Revenues	8.7	6.6	5.7	5.0	5.8	5.7	5.7	5.5	5.3
Expenditure	9.8	8.4	6.0	5.7	6.1	5.9	5.5	5.7	5.3
Balance	**-1.1**	**-1.8**	**-0.2**	**-0.8**	**-0.3**	**-0.1**	**0.2**	**-0.2**	**-0.1**
Financing	**1.1**	**1.8**	**0.2**	**0.8**	**0.3**	**0.1**	**-0.2**	**0.2**	**0.1**
Domestic financing	0.7	1.7	0.1	0.6	0.3	-0.5	-0.6	0.1	-0.1
Use of government deposits (- increase)	0.6	1.3	0.6	0.1	0.6	-0.1	-0.2	-1.0	0.0
Net borrowing from other sources	0.1	0.3	-0.5	0.5	-0.3	-0.4	-0.4	1.1	-0.1
Disbursements	0.2	0.6	0.7	0.6	0.2	0.2	0.1	1.2	0.3
Amortization	-0.1	-0.3	-0.2	-0.2	-0.2	-0.4	-0.4	-0.7	-0.4
Repayment of other liabilitieis	0.0	0.0	-1.0	0.1	-0.4	-0.2	-0.1	0.6	0.0
Foreign financing	0.2	0.0	0.0	0.0	-0.2	0.0	0.1	0.0	-0.1
Disbursements	0.3	0.0	0.0	0.1	0.0	0.1	0.1	0.1	0.0
Amortization	-0.1	0.0	0.0	0.0	-0.2	-0.1	-0.1	-0.1	-0.1
Privatization receipts	0.1	0.2	0.1	0.1	0.1	0.4	0.2	0.1	0.2
Transfers from central budget	0.1	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0
Total debt	**...**	**...**	**5.9**	**6.6**	**7.1**	**8.5**	**8.3**	**7.6**	**6.8**

Source: MOF.

92. Municipal debt is falling mostly due to the repayment of arrears, but is still unsustainable in some municipalities. Municipal debt is small relative to total public debt, but amounted to €255 million at end-2016, of which bank liabilities were €176 million and arrears were €79 million. In absolute terms, 38 percent of total municipal debt is held by one municipality, Budva. However, there are ten municipalities with high amounts of debt relative to total revenues (100 percent).

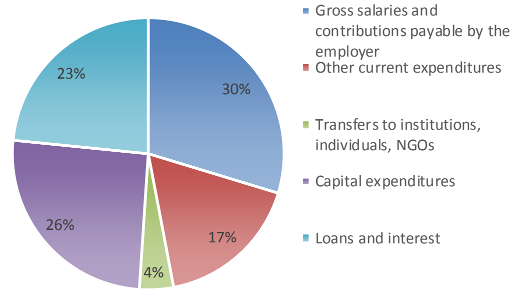
Municipal Debt
(Percent of GDP)



Source: MOF.

93. Unpaid expenditure commitments are still accumulating in some municipalities and hide their true spending. Montenegro's municipalities spent €202 million on a cash-basis in 2016, but also had €79 million of outstanding arrears (slightly reduced from 2014). When expenditure commitments go unpaid under cash-basis accounting, the arrears that accumulate are not documented until settled and recorded under the category "repayment of liabilities from previous period"—and not under the original expenditure category. Migrating systems to accrual-based accounting would make it possible to properly monitor local budget expenditure commitments over time. The MOF does not yet have a timeline for the adoption of accrual-based accounting for municipalities, however some employees have begun training on this accounting methodology.

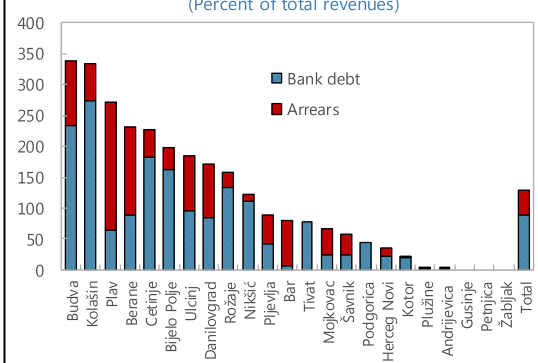
Total Municipal Arrears, 2016
(Percent of total arrears)



Source: MOF.

94. Some municipalities are dependent on financing from Equalization Fund transfers, bank debts, and incurring arrears. After the crisis, some municipalities did not adjust spending to reflect lower own-source revenues, which has led some to over-rely on transfers from the central government. Short-term bank loans and arrears mostly in the form of unpaid salaries continue to be incurred to meet the additional liquidity shortfalls. The debt burden in these municipalities is unsustainable and disproportionate relative to the revenue available for repayment.

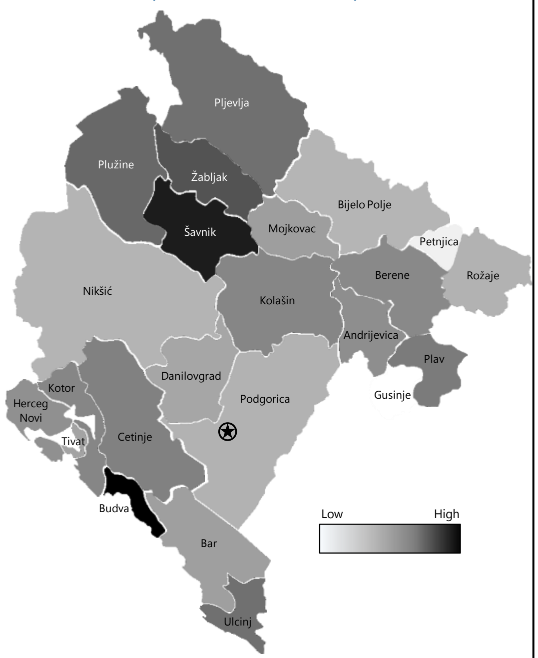
Composition of Debt, 2016
(Percent of total revenues)



Source: Ministry of Finance.

95. The July 2015 public administration reform seeks to improve municipal finances, while reducing overstaffing. New tax and bank debt restructuring contracts seek to improve local government financing and restrict hiring. In July 2015, 16 municipalities entered debt-restructuring contracts with the MOF under which they received financing for the repayment of tax liabilities, (€90 million of unpaid PIT and social contributions due to the central government including debts of municipal companies) severance programs, and capital expenditure projects. Stipulated in the contracts are restrictions on hiring and on borrowing additional debt, for which the MOF has final approval. The signed contracts require repayment of tax obligations with threat of garnishment or transfer of their portion of the equalization fund to pay obligations. Bank debt restructuring contracts were also signed with 9 municipalities (all of which also entered tax debt restructuring contracts) to resolve high debt levels with high interest rates. Additional hiring and borrowing restrictions were placed in these contracts as well for which the MOF receives municipal bank statements to verify rationalization. Other debt restructuring programs have been undertaken since the crisis, suggesting additional reform may be required to fully address municipal indebtedness. Future MOF contracts should require expenditure and revenue measures such as wage freezes or staff reductions for municipalities with persistent debt overhang.

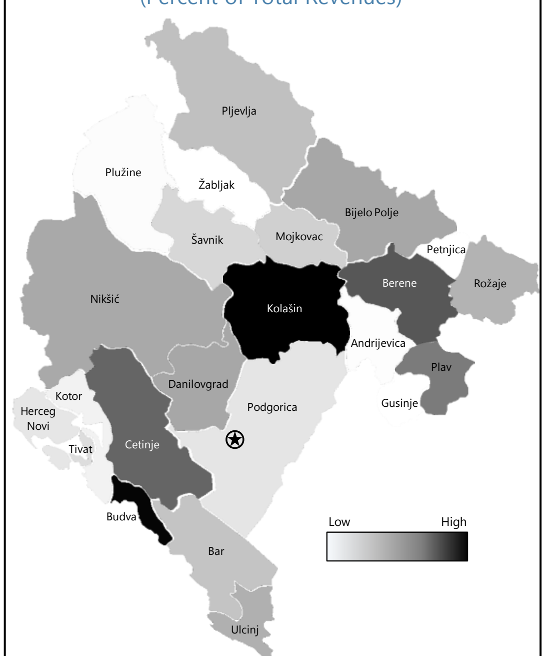
Municipal Public Employment
(Per 1000 inhabitants)



Source: Monstat; and IMF staff calculations.
Note: Municipalities of Gusinje has no available data.

96. Fiscal rules are insufficient to strengthen the finances of local governments. Two articles from the Law on Local Self Government Finances stipulate that (i) current expenditures and debt repayments must be financed from current revenues and (ii) debt payments (including arrears) must not exceed 10 percent of the realized current revenues of the previous year. Over-estimation of revenue forecasts allows municipalities to reach compliance of the fiscal rules by the March 31st deadline, however revenue collection systematically falls short. The law as it currently stands has not addressed over-indebtedness as intended. The

Municipal Total Debt, 2016
(Percent of Total Revenues)



Source: Monstat; and IMF staff calculations.
Note: Municipalities of Gusinje has no available data.

law should be amended to reduce reliance on projected revenue data, include penalties for fiscal rule violations, but also provide a sufficient deadline for municipalities to adhere to the law.

Policy recommendations

97. In general, there is a need to increase own revenues for local governments, particularly from the real estate value tax. However, some municipalities probably do not have enough fiscal capacity and will require increased transfers from the Equalization Fund, whose size should be increased. Some consideration should be given to merging some of the smaller municipalities to create more efficient local government units, particularly because the distances are moderate even for some of the larger municipalities. Also, it would probably make sense to merge some of the waste treatment and water companies, which could serve several municipalities at the same time while achieving economies of scale and scope.

Revenues

- Incentivizing municipalities to increase their real estate value tax collection could provide a reliable source of revenues for local governments. The MOF should similarly reduce the real estate transaction tax to improve efficiency of the property market by encouraging turnover.
- Municipalities should focus on improving tax compliance and valuations. Local governments should utilize their authority to impose tax liens and force the sale of property for highly indebted properties.
- Merging some of the waste treatment and water companies could serve several municipalities at the same time while achieving economies of scale and scope. Savings would help to cover the full costs of maintenance and future infrastructure development projects.
- Incentivize municipalities to improve their collection rates of immovable property tax, by rewarding with additional revenue from the Equalization fund. Additionally, the equalization formula should not be linked to the local staff headcount, as it encourages over hiring, which further erodes local finances.
- Develop statistics to determine fiscal capacity of municipalities.
- Municipalities with structural issues should be granted additional revenues from the central government on a temporary basis and conditional upon commitments to expenditure rationalization.

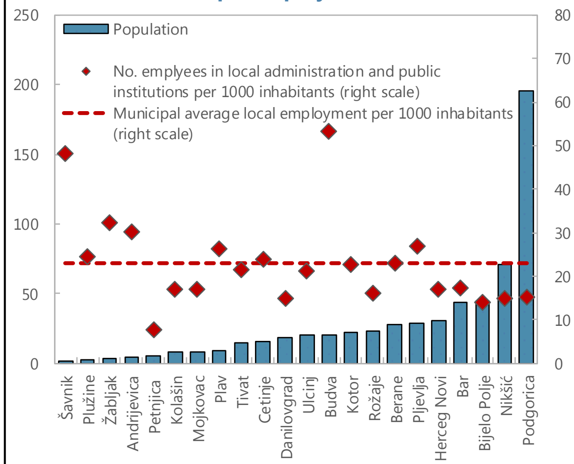
Expenditures

- Labor law should be amended to allow for layoffs when municipalities violate fiscal rules or in cases of severe indebtedness, and for bad performance, since past voluntary exit schemes have been expensive and ineffective.

- Providing financial incentives for municipalities to act prudently could be a long-term solution to discourage moral hazard behavior from municipalities.

- Reforms should promote private sector employment by linking public servant salaries to fiscal parameters and incentivizing staff to leave public employment by providing training and financial support.

Municipal Employment, 2016



Source: MONSTAT.

- Audit the budgets and staffing of municipalities and provide incentives to reach MOF targets.

- Accrual based accounting should be fully adopted for municipalities, so arrears record as debt when they occur.

Debts

- In addition to the current measures enacted by debt reprogramming contracts, new contracts should require expenditure and revenue measures such as wage freezes or staff reductions. Also, given the limited sizes of some municipalities, contracts could require merging utility services amongst smaller municipalities to improve service delivery and benefit from economies of scale.

- MOF should encourage local governments to apply for capital project funding from the central government to address the recent decline in capital expenditure.

- Fiscal rules should be amended to reduce reliance on projected revenues, include penalties for fiscal rule violations, but also provide a sufficient deadline for municipalities to adhere to the law.

ANALYSIS OF MACROFINANCIAL LINKAGES AND OTHER FINANCIAL SECTOR ISSUES[1]

Financial development in Montenegro ranks relatively well within the Western Balkan region and financial inclusion in Montenegro appears in line with the country's level of development. The expected further financial sector deepening should result in growth benefits given the observed relationship between the two. Similarly, reducing disparities related to gender, levels of education, and regions would aid with economic development. The process of balance sheet repair is ongoing—the private sector remains highly indebted, with the implied leverage for households relatively high. This calls for caution in lending decisions especially if the economy were to recover rapidly. A simple VAR model for Montenegro suggests that credit has a relatively strong effect on output, compared with some regional and European peers.

1. **Montenegro's recent boom and bust history draws attention to macrofinancial linkages.** This appendix looks at the role of the financial system in promoting growth and welfare and, in particular, the effects of credit on output. It looks first at the link between Montenegro's level of financial development and growth, and then turns to the related issue of financial inclusion and welfare. These issues are conditional upon the level of economic development. Finally, the analysis turns to the questions of the cyclical effects of recent deleveraging and the role of credit in the business cycle.

A. Financial Development

2. **Theory and evidence suggests a non-linear and sign-reversing relationship between financial development and growth.** In theory, a more efficient and developed financial system should boost economic growth. However, as illustrated by recent empirical evidence, very high levels of credit generated within large financial sectors could result in a boom bust cycle. In addition, human capital could be diverted from relatively more productive, but less profitable sectors toward the financial sector suggesting a negative effect on growth. Indeed, empirical analysis by the IMF researchers indicates that there is a non-linear, bell-shaped relationship between financial development and growth.[2]

3. **Given the starting point, increased financial development would likely support higher growth in Western Balkan States.** The estimated degree of financial development among Western Balkan States (WBS)[3] is below the turning point where the relationship between

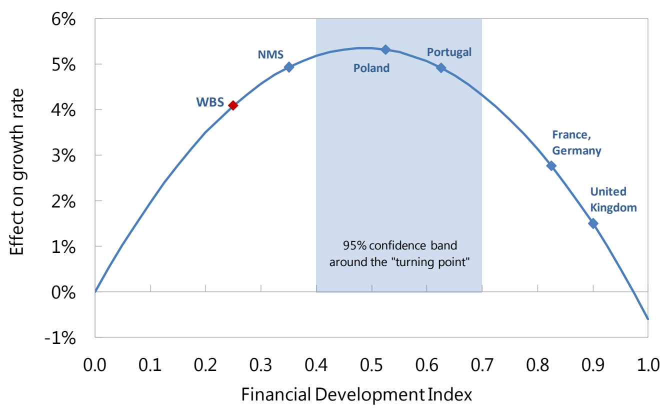
[1] Prepared by Mariusz Sumlinski.

[2] See Sahay, R., et al. "Rethinking Financial Deepening: Stability and Growth in Emerging Markets", IMF Staff Discussion Note (SDN 15/08), International Monetary Fund, Washington DC.

[3] Western Balkan States comprise Albania, Bosnia and Herzegovina, Croatia, Kosovo, FYR Macedonia, Montenegro, and Serbia.

the financial development and growth becomes negative. The level of financial development in Montenegro (proxied by the ratio of corporate credit to GDP), appears similar to the rest of the Western Balkans. Hence, one can expect that more financial development would likely spur higher growth.

Financial Development Effect on Growth



Sources: IMF staff estimates

Financial Development Index by Region, 2014

(index from 1-0; 1 indicates full development)

	Index
Western Balkan States (WBS)	**0.26**
Montenegro 1/	***0.24***
Albania	*0.21*
Bosnia and Herzegovina	*0.25*
Croatia	*0.41*
Kosovo 1/	*0.24*
Macedonia	*0.26*
Serbia	*0.24*
New EU Member States (NMS) 2/	**0.34**
Other EU countries	**0.70**
United States	**0.87**

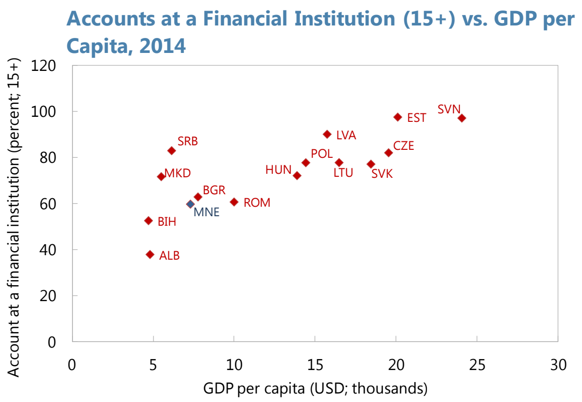
Source: IMF, Financial Development Index Database and SDN 15/08.
1/ Proxied by the ratio of corporate credit to GDP at end-2016.
2/ Comprises Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia,Estonia, Latvia, and Lithuania.

B. Financial Inclusion

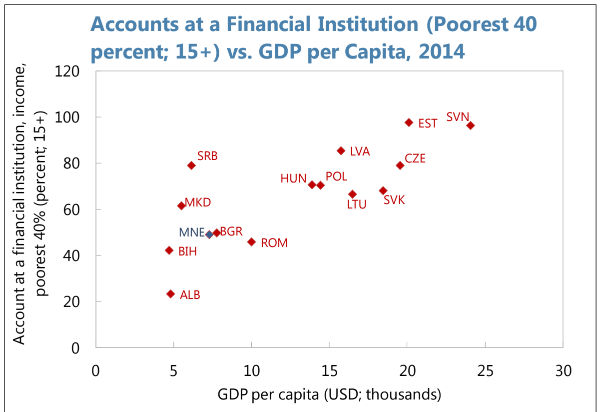
4. The level of financial inclusion in Montenegro is consistent with its level of economic development. Financial inclusion is an important means to reduce poverty and stimulate self-employment. Access to financial services in Montenegro has improved in recent years. Adults with an account at a formal financial institution (a bank, credit union, cooperative, post office, or microfinance institution) have increased by nearly 10 percent over the past three years to 60 percent—close to the average prevailing in the Western Balkan region. The degree of financial penetration in Montenegro is in line with what might be expected given the size of the economy, although still below the new EU member states (NMS),[4] where on average about 80 percent of adults maintain a bank account. The Financial Access Survey (FAS) database[5], indicates that in 2016 the number of deposit accounts with commercial banks per 1,000 adults increased 2.5 times since 2007 and 2.6 times for the accounts held by households.

[4] New Member States (NMS) comprise of Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia. Baltic countries are Estonia, Latvia, and Lithuania.

[5] See this IMF Financial Access Survey database for external access.



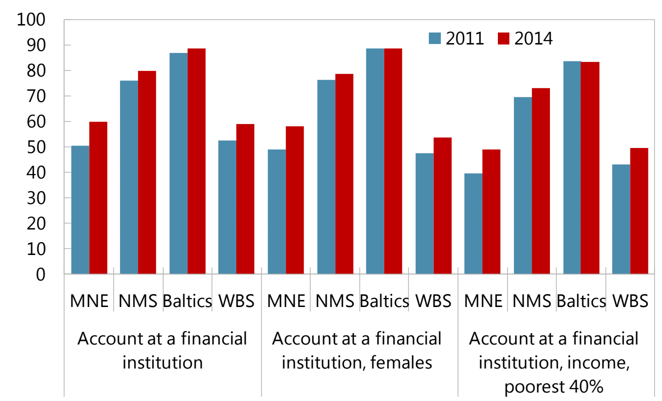
Sources: Demirguc-Kunt et al., 2015; and World Economic Outlook.



Sources: Demirguc-Kunt et al., 2015; and World Economic Outlook.

5. **Financial inclusion is not uniform across different groups in Montenegro.** Although financial deepening advanced rapidly in Montenegro during 2006–08, the poor were not primary beneficiaries, with only half of the population among the bottom 40 percent of incomes having access to some kind of financial institution. This compares to two thirds of the top 60 percent of the population, which is equal to the average for the Western Balkan region.

Share of Adults with an Account at a Financial Institution
(in total percent of adults, 15+)



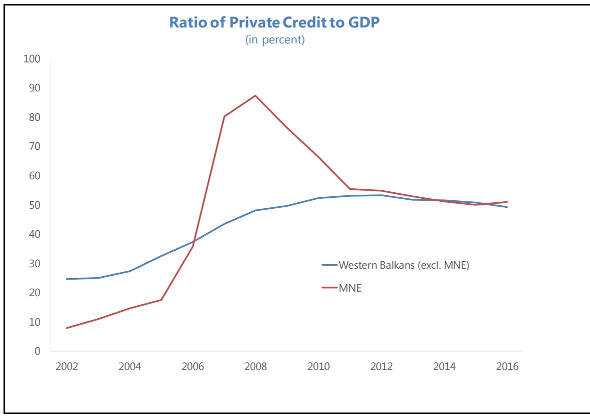
Sources: Demirguc-Kunt et al., 2015

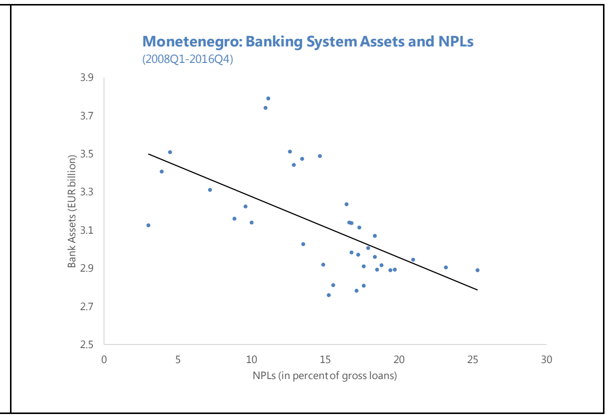
6. **There are also disparities by gender, region, and level of education.** Women have less access to finance (58 percent of females above 15 years of age had an account at a financial institution) than men (62 percent) as in the rest of the Western Balkans, although the disparity is declining somewhat in Montenegro. The difference in inclusion between those living in rural (18 percent of rural residents above 15 years of age borrowed from a financial institution) and urban areas (26 percent), while expected, is one of the highest in the region. Adults with a secondary or higher education are, on average, more than twice as likely to have an account as those with a primary education or less.

7. **The level of financial inclusion can be expected to increase alongside nominal GDP increases.** However, given the noted disparities, the increase in financial inclusion should be aided and steered with appropriate policies remedying the disparities.

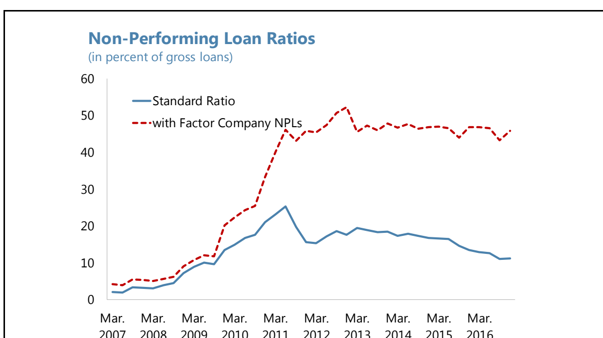
C. Private Sector Indebtedness and the Credit Environment

8. Credit conditions in Montenegro have been tight in the post crisis period, but are improving. The banking sector experienced a surge in lending before the Global Financial Crisis and a consequent surge in NPLs, triggering a prolonged period of balance sheet downsizing, which affected the whole region. Corporate lending at 58 percent of its pre-crisis level still has a long way to return to the pre-crisis lending levels; household lending at 101 percent has recovered to its pre-crisis level. The negative relationship between NPLs and assets suggests that continued progress with the balance sheet repair is needed for assets to grow.

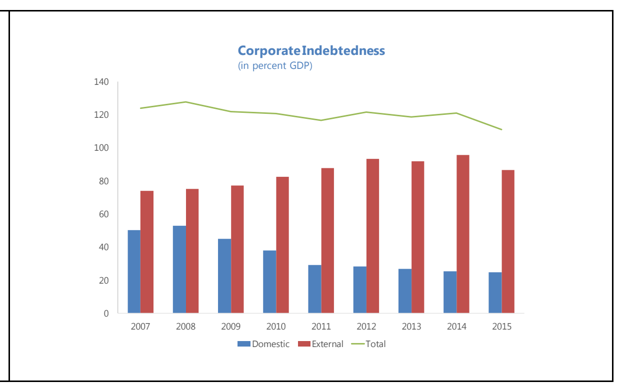




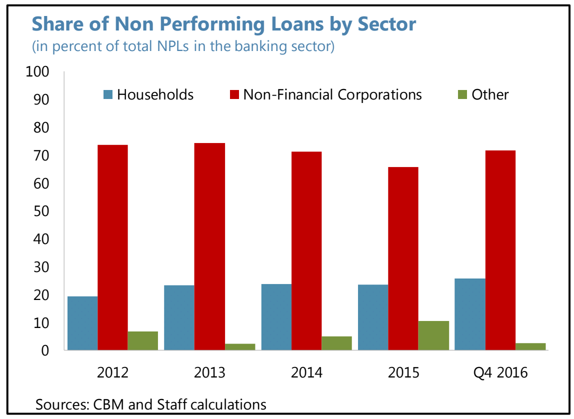
9. Corporate balance sheets have somewhat improved alongside banks' tackling the NPLs. The decrease in corporate liabilities to domestic banks has been somewhat offset by rising indebtedness to non–residents, partially reflecting the transfer of €850 million (23 percent of GDP) of NPLs from bank balance sheets to asset management companies belonging to parent banks. The lack of a functioning secondary market for distressed assets and slow judicial proceedings remain an obstacle to faster NPL resolution. The ratio of NPLs has come down to about 11 percent after the SPV sales—but has not budged below 45 percent since 2013 when adjusted for loans sold to SPVs. All in all, while in nominal terms, total indebtedness of the corporate sector has broadly recovered to its the pre-crisis peak as a share of GDP it is still 17 percentage points below its 2008 level.



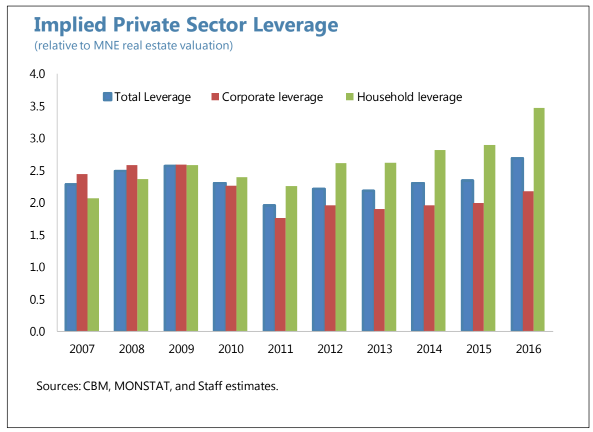
Sources: CBM and Staff calculations



10. Households are taking on new debt and their share of NPLs in the banking sector has slightly increased. Anecdotal accounts indicate banks and Asset Management Companies have been reluctant to aggressively pursue collateral claims against individuals given social sensitivities and perceptions of judicial bias in favor of borrowers. In addition, the decline in household domestic liabilities has begun to reverse—currently they are only about 4 percent below the pre-crisis peak.



11. The implied private sector leverage is estimated to have increased since the crisis. As data on private sector assets are unavailable in Montenegro, given the importance of real estate as collateral, we use real estate prices to gauge the dynamics of assets. The ratio of the index of credit to the private sector and the index of real estate prices suggests that the leverage of the overall private sector is broadly unchanged compared to the peak of the crisis, despite a significant decrease in real estate prices.[6] However, the implied leverage of households has increased much while the one for the corporate borrowers decreased marginally. This is consistent with the observed recovery of lending to the households. Banks should remain vigilant and prudent in their lending decisions so as not to encourage risky household lending.



[6] We use the property price index for new dwellings prepared by MONSTAT. An internal Podgorica-specific property price index that captures re-sale properties prepared by the CBM estimates a 47 percent post-crisis real estate price correction which would imply an even larger increase in leverage.

D. The Effects of Credit on Output

12. Credit growth in Montenegro is highly correlated with economic activity. Montenegro's contemporaneous correlation of 0.89 is the highest among Western Balkan States (0.68), and larger than the correlations in Central and Eastern Europe (CEE, 0.7), Baltics (0.5), and countries of the European Union (0.6). Credit growth in the year t+1 also correlates highly with economic activity (0.74), again somewhat higher than in comparators. From a sectoral perspective in Montenegro, bank lending is especially important for the construction, retail, and tourism sectors, where contemporaneous correlations are above 0.8.

Correlations of the Change in Private Credit and GDP Growth (at varying lags) by Region

	t-3	t-2	t-1	t	t+1	t+2	t+3
Western Balkans (WB)	**0.053**	**0.138**	**0.268**	**0.677**	**0.570**	**0.299**	**0.214**
Albania	-0.065	0.292	0.295	0.632	0.606	0.763	0.694
Bosnia and Herzegovina	0.119	0.129	0.399	0.880	0.640	0.415	0.415
Croatia	0.227	0.722	0.576	0.857	0.753	0.591	0.356
Kosovo	-	-	-	-	-	-	-
Macedonia, FYR	-0.233	-0.008	0.548	0.823	0.365	0.061	-0.054
Montenegro, Republic of	-0.089	-0.032	0.387	0.890	0.735	0.060	-0.056
Serbia, Republic of	0.362	-0.272	-0.596	-0.021	0.318	-0.096	-0.073
WB (excluding Montenegro)	*0.082*	*0.172*	*0.244*	*0.634*	*0.537*	*0.347*	*0.267*
CEE	**0.323**	**0.398**	**0.560**	**0.695**	**0.460**	**0.075**	**0.161**
Baltics	**-0.145**	**-0.126**	**-0.118**	**0.500**	**0.700**	**0.300**	**-0.135**
European Union	**0.214**	**0.257**	**0.453**	**0.604**	**0.341**	**0.042**	**0.017**

Source: IMF Country Report No. 16/79, Appendix II.

Montenegro: Correlations between Credit growth and Growth in selected sectors (at varying lags)

(Baseline period is 2006-2014)

	t-1	t = baseline 1/	t+1
Agriculture vs. Private Sector Credit	0.3078	0.4089	0.6070
Mining vs. Private Sector Credit	-0.0229	0.0068	-0.1469
Manufacturing vs. Private Sector Credit	0.1987	-0.0563	0.3078
Electricity and Water vs. Private Sector Credit	-0.0572	0.2549	0.2309
Construction vs. Private Sector Credit	0.5806	0.9593	0.2696
Wholesale & Retail Trade vs. Private Sector Credit	0.6493	0.8805	0.1114
Hotels and Restaurants vs. Private Sector Credit	0.2911	0.8213	0.5865
Transport and Storage vs. Private Sector Credit	0.5206	0.5784	0.5865
Financial Intermediation vs. Private Sector Credit	0.0909	0.1237	-0.1159
Real Estate vs. Private Sector Credit	0.4483	0.1625	-0.0468

1/ change in period is applied to production components of GDP.

13. We also estimated the impact of credit growth on nominal GDP growth. A single lag VAR of nominal GDP growth, private sector credit growth, and CPI inflation was estimated using quarterly data for Q2 2005 – Q4 2014. Estimated coefficients for variables in the GDP growth equation are statistically significant at conventional levels and carry the expected signs. The model captures about half of the variation in the data. Alterative specifications that included FDI and tourism indicators did not improve fit.

Table 1. VAR Analysis - Montenegro

	GDP	Credit	Inflation
GDP(-1)	-0.317**	0.008	-0.007
Credit(-1)	0.804*	0.904*	-0.015
Inflation(-1)	-1.182	-0.062	0.711
Constant	7.360*	0.437	0.508
Adjusted R-squared	0.48	0.81	0.58

* significant at 5 percent probablity value.
** significant at 10 percent probablity value.

Memorandum 1/

GDP is nominal GDP
Credit is to the private sector
Inflation according to consumer prices

1/ All data is quarterly and variables in percent change (yoy).

14. Orthogonalized impulse responses suggest that a 1 percent shock to nominal private sector credit growth results in 0.2 percent increase in nominal GDP growth. This impact increases to 0.3 percent in the second quarter before tapering off gradually (Figure 1). The accumulated impact of the 1 percent growth rate shock would result in a 3 percent boost to the nominal GDP growth over five years.

15. This effect is relatively large in comparison to regional peers. The same VAR specification was estimated for Croatia, Serbia, and Poland (Table 2). A comparison of impulse responses shows that the immediate impact of a credit shock is indeed larger in Montenegro (Figure 2). This is also consistent with the severity of Montenegro's recent boom-bust cycle. For Croatia and Poland, their relatively higher levels of financial and economic development may be behind a more muted impact of the immediate credit shock. These findings argue for caution in lending decisions and in adopting policy actions to stimulate sustainable credit growth.

Table 2. VAR Analysis – Selected Countries

	Dependent Variable GDP			
	Montenegro	Croatia	Serbia	Poland
GDP(-1)	-0.317**	0.805*	0.493*	0.757*
GDP(-2)		-0.081		0.498*
GDP(-3)				-0.606*
Credit(-1)	0.804*	0.143**	0.150*	0.294*
Credit(-2)		-0.075		-0.403*
Credit(-3)				0.174*
Inflation(-1)	-1.182	0.444**	0.158	0.589
Inflation(-2)		-0.830*		-1.363**
Inflation(-3)				0.747
Constant	7.360*	0.685	0.884	1.344
Adjusted R-squared	0.48	0.85	0.44	0.79

* significant at 5 percent probablity value.
** significant at 10 percent probablity value.

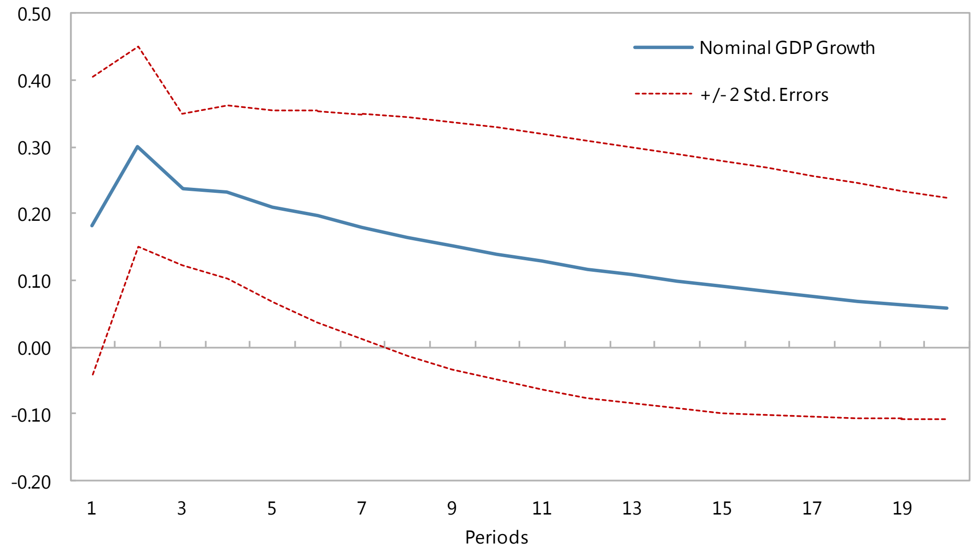
Memorandum 1/

GDP is nominal GDP
Credit is to the private sector
Inflation according to consumer prices

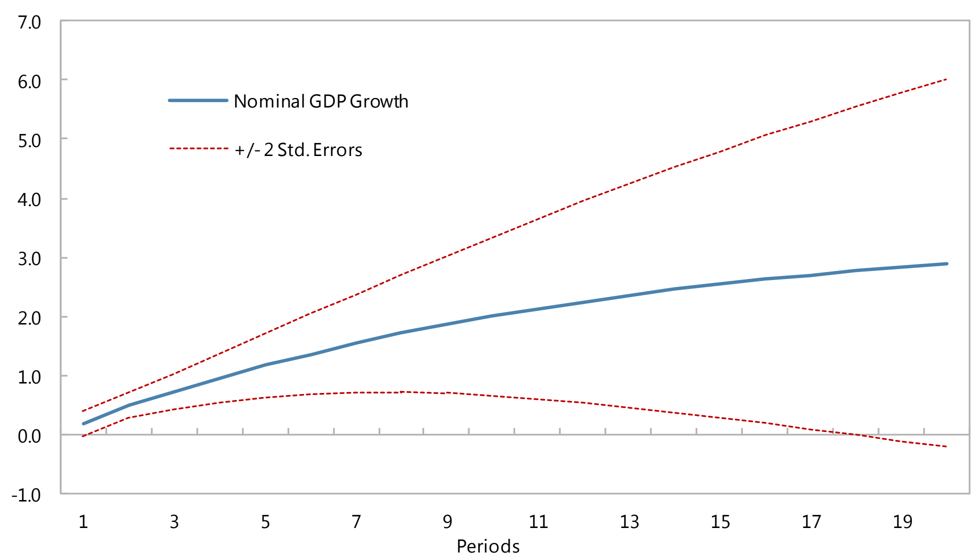
1/ All data is quarterly and variables in percent change (yoy).

Figure 1. Impulse Response Analysis

Impulse Response of GDP Growth
(in percent change to a 1-percent change in credit growth)



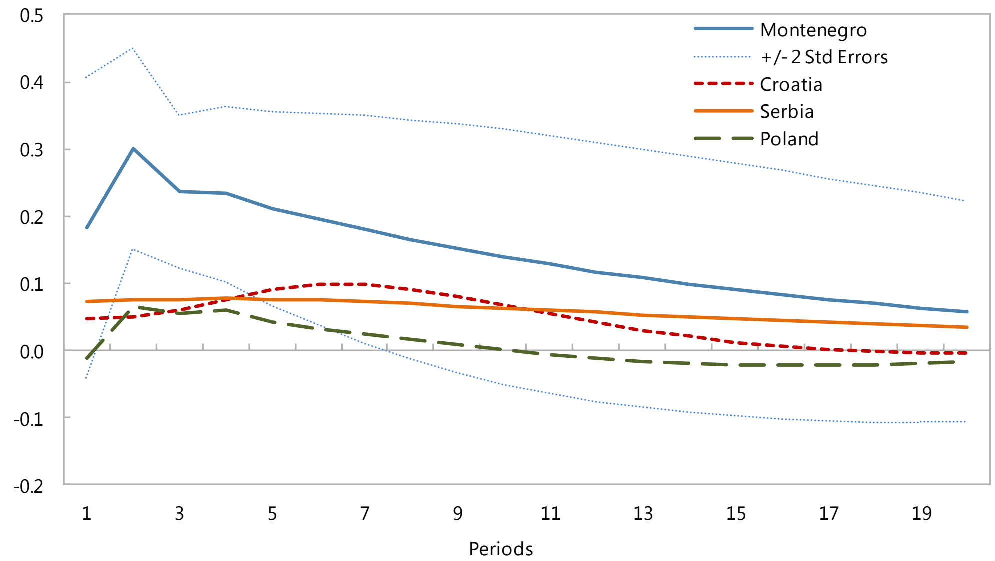
Accumulated Impulse Response of GDP Growth
(in percent change to a 1-percent change in credit growth)



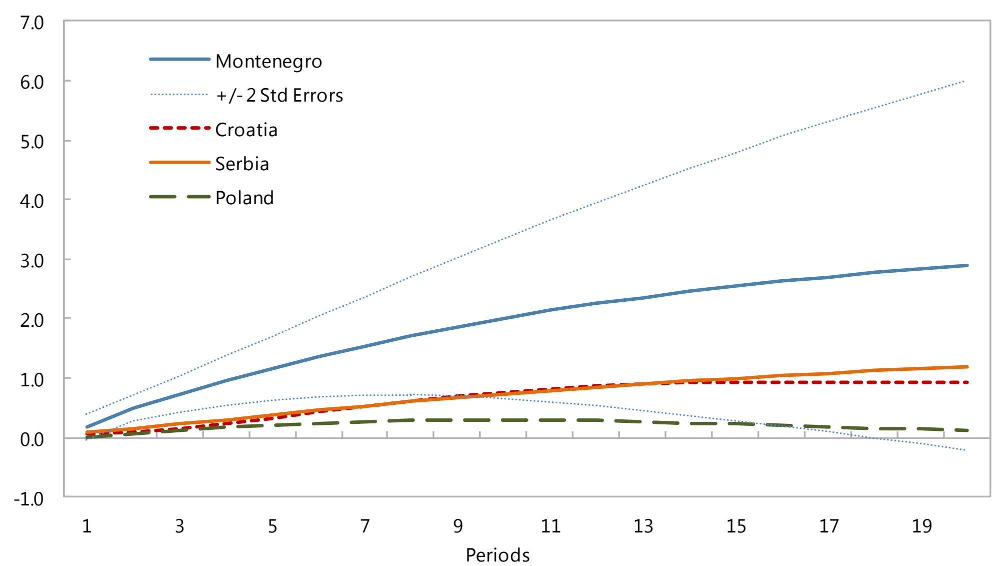
Source: CBCG, Monstat, and Staff estimates.

Figure 2. Cross-Country Comparison: Impulse Response Analysis

Impulse Response of GDP Growth
(in percent change to a 1-percent change in credit growth)



Accumulated Impulse Response of GDP Growth
(in percent change to a 1-percent change in credit growth)



Source: Country Authorities and Staff Estimates

E. Reserve Adequacy

Overall liquidity buffers appear adequate in the event of modest deposit run pressures on banks, especially if foreign subsidiaries receive liquidity support from their parent banks. The buffers have been comfortable over time, especially for the liquid assets of banks. However, euroization constrains the capacity for Emergency Liquidity Assistance (ELA), which puts the onus on banking supervision and building fiscal buffers.

16. Montenegro is one of 13 euroized/dollarized IMF members. The main benefit of using another country's currency is a strong monetary anchor, but it also imposes operational challenges for a central bank when a lender of last resort action is needed. In Montenegro ELA operations are severely constrained since the Central Bank of Montenegro (CBM) cannot create currency to meet the needs of ELA.

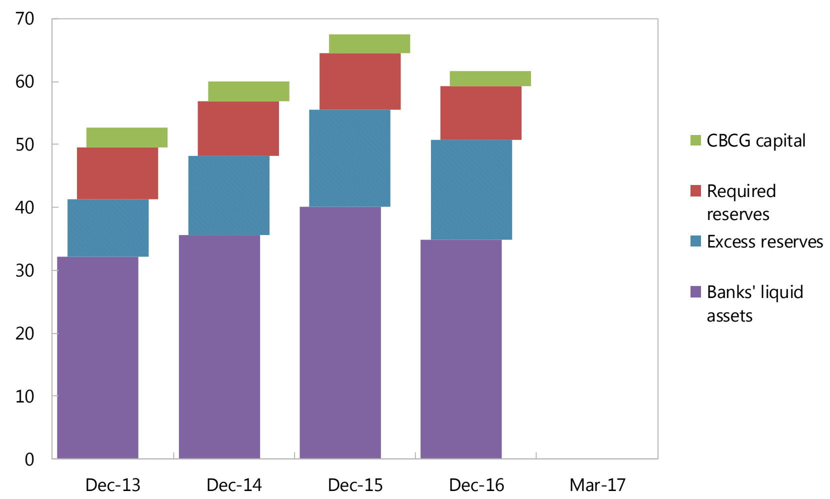
17. In the event of a liquidity shortfall, the CBM's current options to provide liquidity assistance would include: borrowing from liquid banks in the system; borrowing from abroad; reducing required reserves;[7] and drawing down its own capital (i.e. ELA reserves). However, only the latter two options are directly within the CBM's control.

18. Banks own liquid assets are the first line of defense against a liquidity shock, and the banking system is currently very liquid. Liquid assets account for about 30 percent of short-term liabilities. CBM capital provides a small additional buffer of around 2 percent of short-term liabilities. Including required and excess reserves, the combined liquidity buffer (own assets, reserves, and CBM capital) increases to nearly 53 percent (Figure 3). In recent years, the combined liquidity buffer has consistently increased owing to the limited lending opportunities and therefore an ample liquidity in the system. As of March 2017, banks are no longer allowed to count their holdings of Montenegrin T-bills towards their reserve requirement, which will improve the quality and liquidity of required reserves.[8]

[7] CBM can lower reserve requirements in a crisis (as of March 6, 2017, at 7.5 percent on deposits with maturity up to one year and 6.5 percent on deposits with maturity over one year). This possibility refers to a temporary, but beyond intraday, drawdown of reserve requirements—applicable only in the case of illiquid but solvent banks seeking ELA. This could help relieve pressure on banks' liquidity and reduce the need to resort to CBM funding. See: Montenegro Financial System Stability Assessment, IMF Country Report No. 16/88, p. 32, footnote 29. Under regular conditions, a bank may use up to 50 percent of its required reserve on deposit with the CBM to maintain its daily liquidity. If it fails to return the amount at the end of the same day, it shall pay interest to the CBM at the annual interest rate of 12 percent.

[8] Simultaneously, on March 8, 2017, the CBM Council passed the Decision on Amendments to the Decision on Bank Reserve Requirement to be Held with the Central Bank of Montenegro, decreasing the reserve requirement ratio by two percentage points, from 9.5 percent to 7.5 percent and from 8.5 percent to 6.5 percent, depending on the type of deposits. This partly offset the decision to disallow T-bills for reserve requirement purposes and aims to harmonize CBM regulations with the ECB regulation eventually bringing required reserves down to 1 and 2 percent for deposits with maturity of up-to 2 years and above 2 years.

Figure 3. Emergency Liquidity Buffers
(in percent of short-term liabilities)



Sources: CBCG and Staff Calculations

19. ELA reserves appear adequate even as banks' short-term liabilities grew, as expected, since the last Article IV consultation.[9] That said, banks may become less liquid in the future as they expand their lending operations. The bulk of the CBM's ELA reserves are made up of its capital endowment (which is fixed), implying that ELA coverage is likely to decline as bank liabilities grow over time. While this is not an immediate concern, the authorities should consider how they might bolster ELA coverage over the medium term. Options include:

- *A dedicated MOF sub-account at the CBM* for ELA, which the CBM could use at its discretion—in addition to its own limited resources. There should be arrangements for the MOF to reimburse the CBM for losses stemming from ELA within 30 days upon an independent audit report.

- Establishing *contingent credit lines* with foreign banks to be used by the CBM for emergency liquidity assistance. This is a conventional option and does not impose fiscal costs. But it would carry greater-than-average coordination costs, given the range of central banks that supervise parent banks of Montenegrin subsidiaries.

[9] Since 2013 liquid assets increased by nearly 30 percent while short-term liabilities increased by about 45 percent.

(continued)

- *A pooled liquidity arrangement* for ELA, funded by banks. This option is being pursued in Kosovo and was evaluated for Montenegro by the FSAP team, but not found to be practical for Montenegro.[10] The foreign-owned banks appear confident that their parents would provide liquidity in the case of need.[11]

- *A liquid asset contribution* that imposes greater contributions (or reserves) from those banks with the highest liquid assets. Although floated as an option in some other jurisdictions, it would seem to be a perverse incentive against self-insuring by maintaining sufficiently liquid assets.

20. CBM is aware of the limited options at its disposal in case of ELA needs. Among the above options, it favors forming a pooled liquidity arrangement. It is also ready to ask for credit lines from the foreign banks, as needed, but that option has not been developed beyond the conceptual stage. Therefore, the institutional framework to activate such arrangements may be only available in the future.

21. In the presence of limited ELA options, the authorities should concentrate on good practices for banking supervision and building fiscal buffers. It will be particularly important to monitor weak banks so that emergency situations do not arise. The CBM would also have the option to increase minimum liquidity standards or reserve requirements. Finally, the government should build fiscal buffers to be able to increase CBM capital and eventually provide an emergency back-stop in line with the EU Bank Recovery and Resolution Directive (BRRD) as per the first option.[12] The use of fiscal funds to meet ELA needs is an option under the EU regulations most notably in cases of systemic crisis. The use of public funds would be preceded by the banks undertaking all measures to minimize the public intervention.

22. The authorities are creating a bank resolution fund with contributions from the banks in line with the EU directive 2014/59. However, it will take a long time before the resolution fund could cover both the ELA and resolution needs. In addition, using resolution funds to provide ELA may easily coincide with the heightened likelihood of bank failure and,

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[10] Given the high share of foreign subsidiaries in Montenegro, it would be very difficult to agree on this solution with foreign-owned banks, which would essentially lead to their parents providing liquidity to less liquid, mostly domestically owned banks. See: "FSAP Financial Crisis Preparedness and Management—Technical Note," June 2016; IMF Country Report No. 16/199.

[11] "During the financial crisis, deposit outflows led to tightened liquidity, and anecdotal evidence suggested that parent banks provided liquidity assistance to their subsidiaries in Montenegro. Such support helped in part to shield Montenegro from global financial crisis spillovers." See: Montenegro Financial System Stability Assessment, IMF Country Report No. 16/88, p. 23, footnote 20.

[12] See: Directive 2014/59/EU of The European Parliament and of The Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and EU Bank Recovery and Resolution Directive (BRRD), April 2014; on the application of State aid rules to support measures in favor of banks.

consequently, with the need for the funds for resolution purposes. Even with time, events of systemic importance will be too large for the fund to manage. Contributions to the fund would be risk-based, but larger banks in Montenegro already consider that the weaker, smaller banks add to systemic risk disproportionally to their size. There is also concern that such fees would be passed on in lending rates, to the detriment of lending spreads and investment.

F. Implied Interest Rate Spread Analysis[13]

Risk control and quick resolution of non-performing assets are key for lending profitability. The non-lending–income–producing activities have helped to return the system to profitability in 2016, because lending by itself has been a consistent loss-making activity.

23. The analysis is done using aggregate data for gross loans, interest income and expense, and costs reported by the CBM for the entire banking system. The analysis decomposes system-wide interest rate in terms of the costs of lending (in percentage points) and compares them to the actual spread to calculate the profit from lending activities. The two largest components of costs are overhead and provisioning.

24. Lending remains unprofitable because of the high costs of provisioning and overhead. As shown in Figure 4, profits are negative and spreads would need to be higher to cover costs, but losses have shrunk since 2013. This is mostly explained by shrinking provisions and a slight decline of the overhead cost. The break-even spread declined from a high of 13 percent in 2013 to 8 percent in 2016.

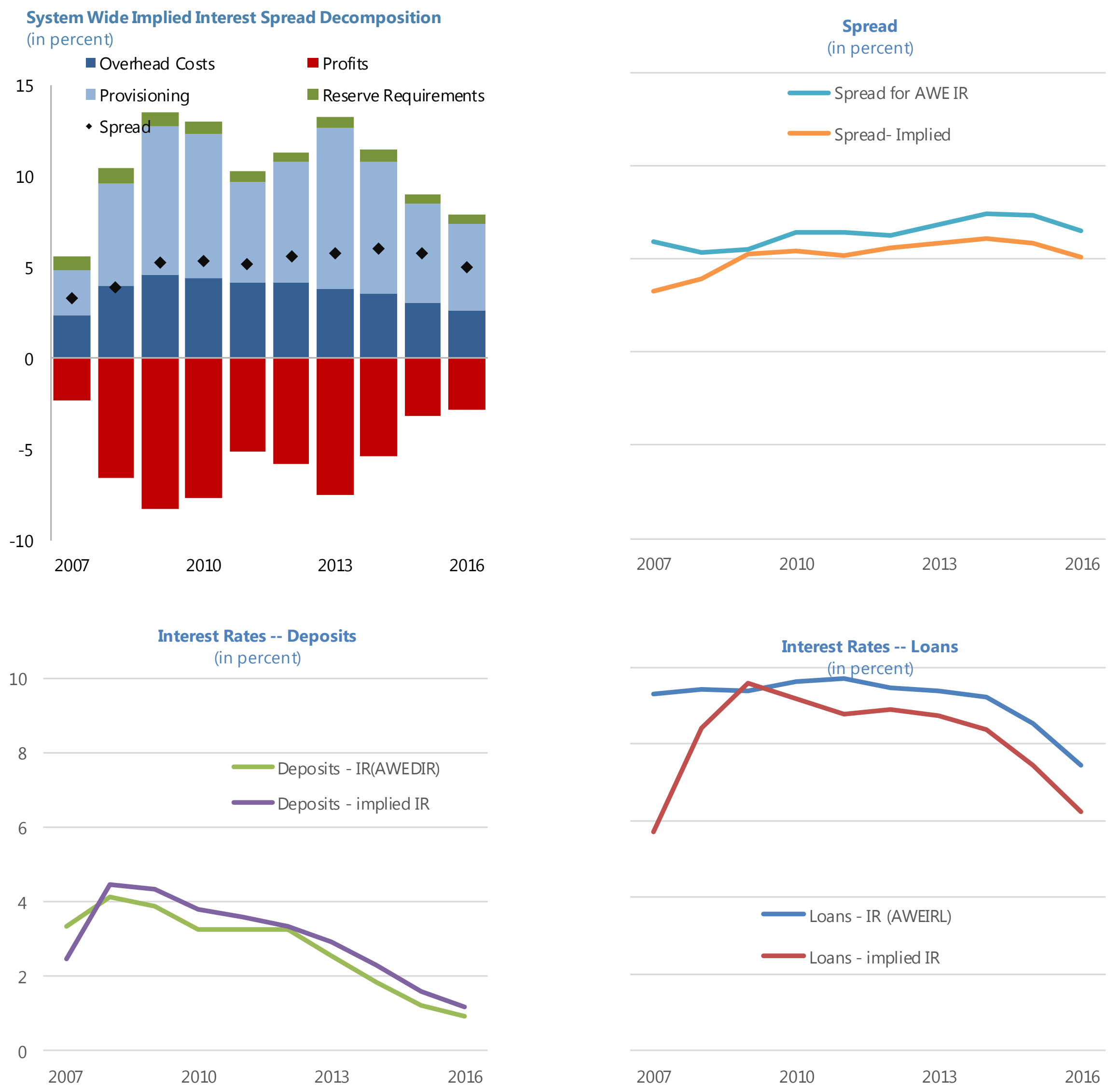
25. The spread declined in 2016 due to increased competition. The spread has been broadly unchanged since 2009 as lending rates have remained high and deposit rates low. Lending rates have been broadly stable until October 2014 but have been on a declining trend since, as banks try to make use of their large liquidity. In the absence of a large supply of bankable projects, competition has resulted in lower lending rates. Deposit rates have been on a declining trend since 2008 in line with international developments, although at around 1 percent, rates are still above those prevailing in core Euro area countries.

26. The implied and actual nominal interest rates track each other closely. The actual nominal interest rate is the average rate for the banking system as reported by the CBM. The implied rates are calculated for the banking system as follows. First, we calculate the interest earned on loans by multiplying the interest income by the share of gross loans in the total earning assets. Then, we divide the implied interest earned by gross loans. The implied interest rate on loans is somewhat lower than the nominal rate reported by CBM but follows the dynamics of the nominal rate closely. We calculate the implied interest rate on deposits as follows. First, we calculate the implied interest paid on all interest-earning liabilities by subtracting the interest income from the net interest income. Next, we multiply it by the share of deposits in total liabilities. Next, we divide the latter by deposits. The implied interest rate paid

[13] Thanks to Claudio Visconti (MCM) for guidance and discussion.

on deposits is somewhat higher than the nominal rate reported by CBM and follows the dynamics of the nominal deposit rate closely. The relative positions of the implied interest rates on loans and deposits seems in line with intuition. One would expect that the implied rate—which is a paid rather than reported rate—would be somewhat lower on loans and higher for deposits. As banks compete against each other, they try to lower their prices (loans) and increase payouts (deposits) to attract customers.

Figure 4. Interest Rate Spread Analysis



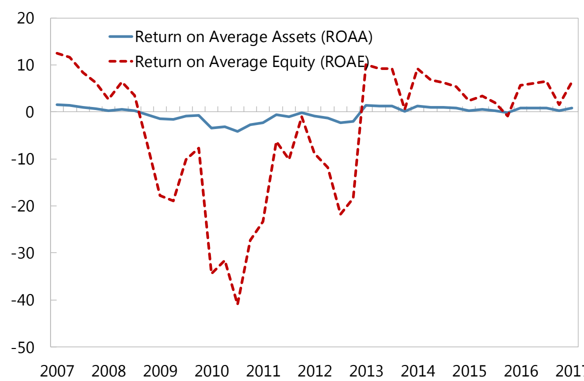
Source: CBCG and staff calculations

27. The nominal spread is higher than the implied spread. This reflects the relative positions of implied and nominal interest rates as discussed above. Intuitively, in an economy like Montenegro's, with a relatively stable banking sector and declining interest rates reflecting growing competition in a somewhat over-banked system, one would expect the nominal spread to be an upper-bound for the implied spread calculation.

28. Provisioning is the decisive factor in the dynamics of the profits. Large provisions for non-performing loans push down profits. The overhead costs dynamics play a much smaller role in profit determination. While overhead costs could probably come down further, it would be difficult to expect that that can turn the losses into profits. In 2016, without a change in provisioning (all else equal) overhead costs would have to be zero for positive profits on lending. However, provisioning could decline substantially if banks select good projects and if the recovery process for NPLs can be improved. Provisioning costs are high relative to international best practices as difficulties with collateral execution persists.

29. While the system-wide lending activity is unprofitable, some of the individual banks are profitable and the system returned to overall profitability at end-2016. That development must have been helped by profitable non-lending activities or decreased losses from lending. However, the ROA was only 1/4 percent at end-2016, and while non-lending activities are profitable, the scope for further profit in this area is likely constrained by subdued activity, small market size, and a macroeconomic outlook with only moderate growth.

Bank Sector Net Profits
(in percent)



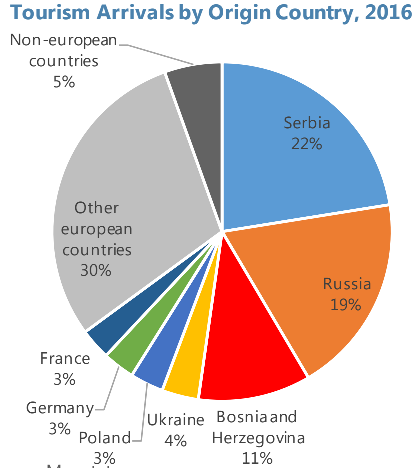
EXTERNAL COMPETITIVENESS AND STABILITY ASSESSMENT[1]

Montenegro's external position is characterized by high external debt, which has grown considerably as persistent current account deficits have only partially been financed by FDI inflows. After adopting the euro, currency and wage developments have impacted cost competitiveness. Productivity has stagnated, and costs have increased in recent years, which has exacerbated problems in the already rigid labor market with high youth and long-term unemployment. The business environment would benefit from additional reforms to improve external competitiveness, but FDI remains strong, indicating the potential for profitable investment.

A. Current Account

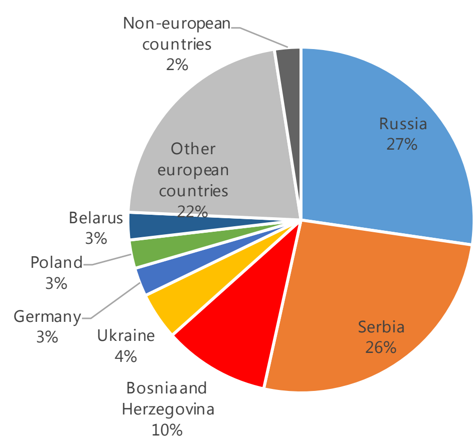
1. Service exports have been robust but concentrated. Service exports grew 3.3 percent in 2016, mostly because tourism had another record year. A concentration of foreign tourism from neighboring countries and Russia raises concerns about sustainability and cost competitiveness, though Montenegro appears to have weathered the downturn in Russia. In 2016, 63 percent of overnight stays from foreign visitors originated from 3 countries (Russia, Serbia, and Bosnia and Herzegovina), which are price sensitive because their currencies have declined in relation to the euro; 98 percent of visitors are from Europe. Foreign tourism is concentrated in the summer months, which account for 70-80 percent of arrivals and overnight stays. Efforts are being made by the authorities to extend the length of the tourism season, such as developing the northern regions with winter resorts. Further tourism development in underutilized regions and the promotion of off-season and non-European travelers could be potential areas for growth, while alleviating concentration risks.

Tourism Arrivals by Origin Country, 2016



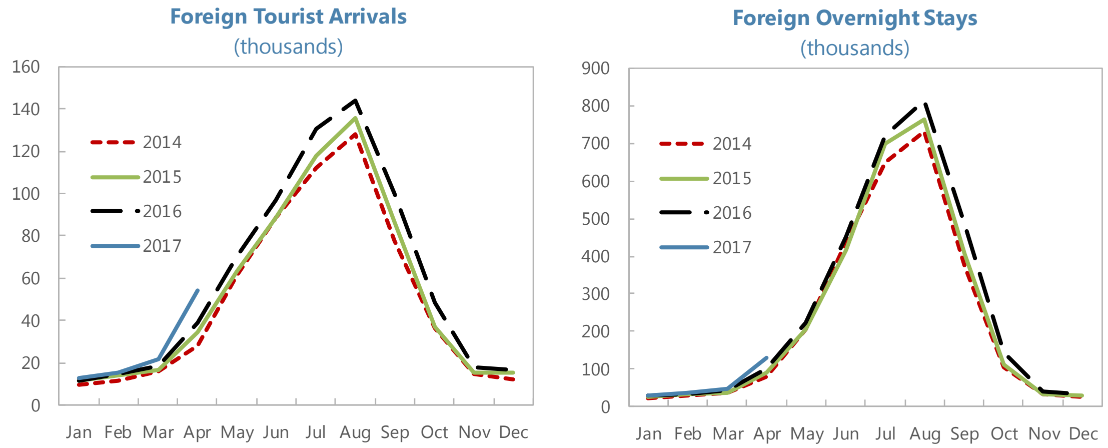
Source: Monstat.

Overnight Stays by Origin Country, 2016



Source: Monstat.

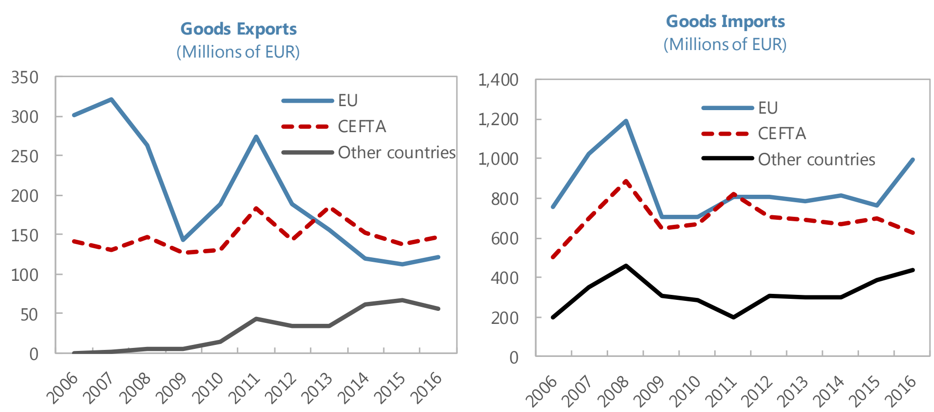
[1] Prepared by Jesse Siminitz.



Source: Monstat.

Source: Monstat.

2. **Goods exports have not recovered from pre-crisis levels, while goods imports are picking up.** Good export volumes increased more than 6 percent in 2016, after falling nearly 8 percent on average for the previous 4 years. Montenegro has lost half its goods exports as a percent of GDP since 2007, due to a loss in market share in Euro area countries and the shift of production to lower value-added goods. Montenegro's share of world exports has fallen in comparison to regional peers. Goods exports are highly correlated with commodity prices, which have declined in recent years. Also, the loss in aluminum production due to the closure of KAP is partly responsible for the fall.



Source: Monstat.

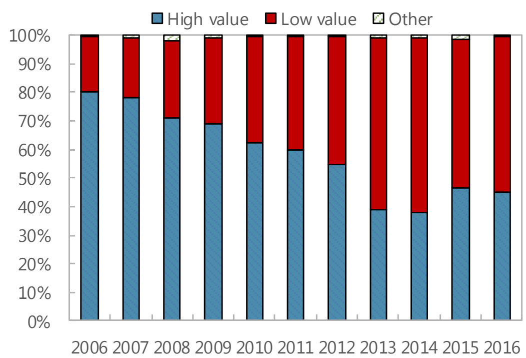
Source: Monstat.

3. **Goods imports growth is driven by construction equipment for large-scale infrastructure projects.** The volume of goods imports grew 12 percent in 2016, reflecting machinery imports for the highway and investments in tourism and energy projects. Machinery and transport equipment imports comprise the largest import category, growing almost

30 percent in 2016, and overtaking food imports for the second year in a row. The trade balance is dominated by goods imports, which average 5 times the value of goods exports. The fall in low-value goods imports is primarily due to the fall in oil prices, causing oil imports to half in value from their peak in 2011. Since overall goods imports have grown relatively little since 2009, Montenegro's share in world imports has fallen while other CEFTA countries have maintained their share of world imports.

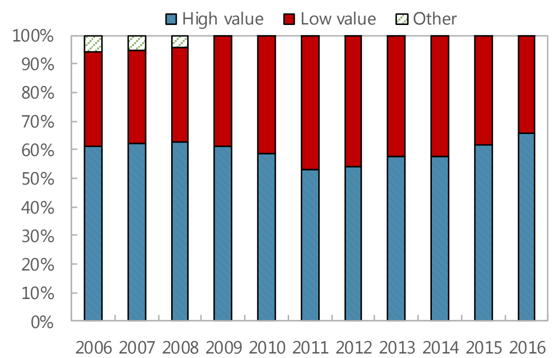
Figure 1. Merchandise Trade

Montenegro Goods Exports
(Percent of total)



Source: UN Comtrade.
Notes: Low value added goods are represented by a sum of SITC 0-4 categories including food, beverages, crude materials, mineral fuels, and animal oils. High value added goods are a sum of SITC 5-8 categories including chemicals, manufactured goods, machinery and transport equipment, and miscellaneous manufactured articles.

Montenegro Goods Imports
(Percent of total)



Source: UN Comtrade.
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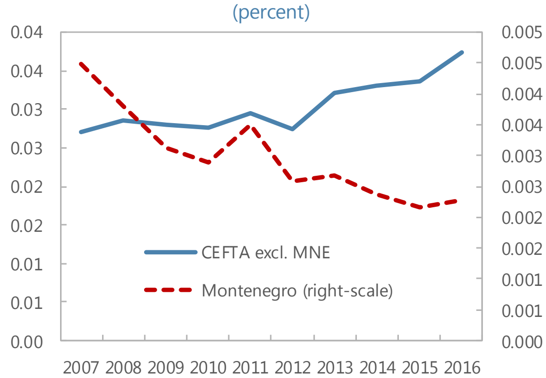
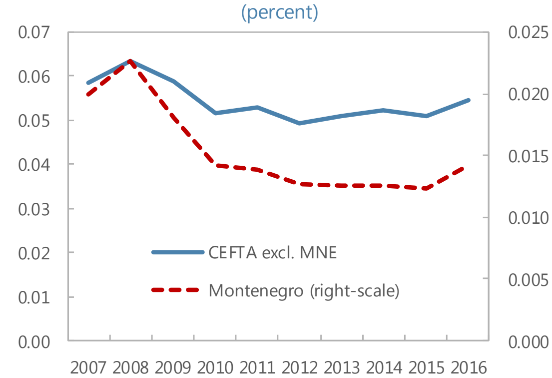
Share in World Exports
(percent)



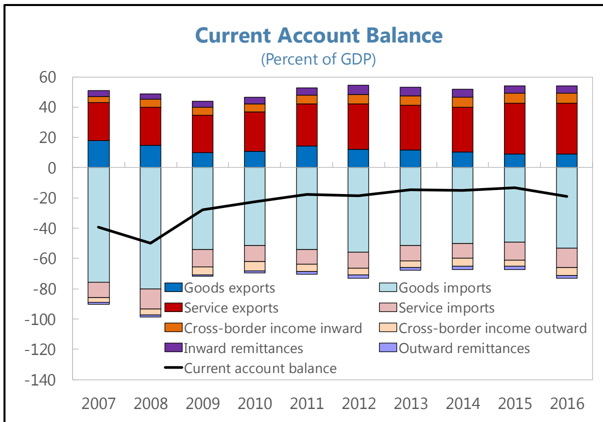
Source: IMF, DOTS.

Share in World Imports
(percent)



Source: IMF, DOTS.

4. Large current account deficits have persisted for years. The strong tourism-driven service trade surplus has not offset the continuing deterioration of goods exports and the steady importing of construction goods for large-scale infrastructure projects. Meanwhile, net remittances and cross-border compensation have grown and are becoming an increasingly important source of current account financing. The current account deficit widened to 19 percent of GDP in 2016, which was due mostly to investment, which grew 4.4 percent of GDP from 2015, while nongovernment savings fell 1 percent of GDP. The deficit is forecast to increase to 22 percent of GDP by 2018, when construction-related imports and commodity prices are expected to peak with investment projected to grow 6 percentage points of GDP.



Sources: CBM and IMF staff estimates.

5. Persistent deficits suggest competitiveness problems. The EBA-lite model for the current account estimates a CA Gap of -9.7 percentage points of GDP for 2016, with a cyclically-adjusted CA norm of -9.2 percent of GDP. Staff believes that the model may systematically over-estimate the current account norm of Montenegro compared to the average country of the EBA-lite sample due to additional country-specific factors not captured in the model, unavailable data (such as capital control index), and the limited history of data. In addition, several factors overstate the weakness of the actual current account: (i) data uncertainties related to very large errors and omissions in the BOP (revisions have improved to an average of 4 percent of GDP, but tourism receipts are likely still underestimated); (ii) the relatively high FDI inflows of Montenegro, and the one-time highway construction project (which partly explains the large deterioration in the CAD in 2016). Taking into account the uncertainties in the model-based estimates, staff assesses the CA gap to be in the range of -3 to -4 percent of GDP for 2016, instead of the model-determined value of -9.7 percentage points. This would better reflect a small economy with large investment needs, which fuel imports of around 50 percent of GDP.

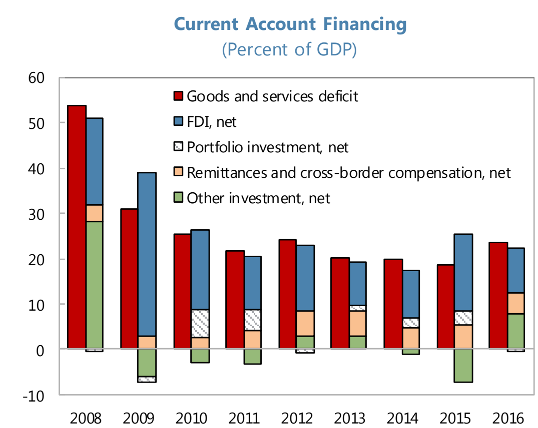
Exchange Rate Assessment using EBA-lite CA methodology

CA-Actual	-19.0%	CA-Fitted	-7.8%
CA-Norm	-9.2%	Residual	-11.2%
CA-Gap	-9.7%	Policy gap	1.4%
		Cyclical Contributions	0.1%
Elasticity	-0.49	Cyclically adjusted CA	-19.1%
Real Exchange Rate Gap	19.7%	Cyclically adjusted CA Norm	-9.3%

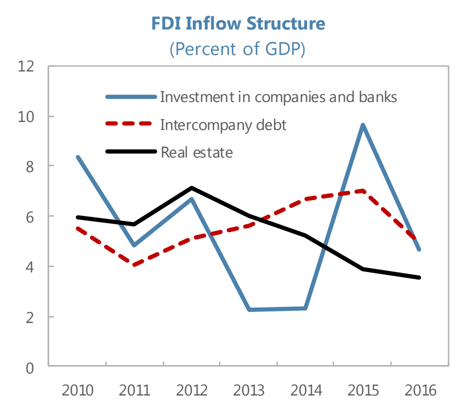
Source: IMF staff calculations.

B. Financial Account and External Debt

6. FDI inflows mostly finance the current account deficit. Financing from several countries is used to purchase imports in the construction of large-scale infrastructure projects. After a large inflow in 2015, foreign direct investment moderated in 2016 to 10 percent of GDP, which covered around 50 percent of the current account deficit. This is despite a one-off dividend payment in 2016 accounting for 50 percent of FDI outflows, meaning net FDI would have been 5 percentage points of GDP higher if not for this payment. Since 2012, FDI inflows related to real estate purchases have almost halved to 3.5 percent of GDP in 2016, while intercompany debt and investments in companies and banks have increased, which are likely channeled to more productive investments. Remittances and cross-border compensation, though not part of the financial account, are growing and helping to finance the large goods and services deficit. Also, large government Eurobond issuances have increased net portfolio investment, as government financing needs have grown. Montenegro continues to rely on debt flows, including government external borrowing, to meet external financing needs.

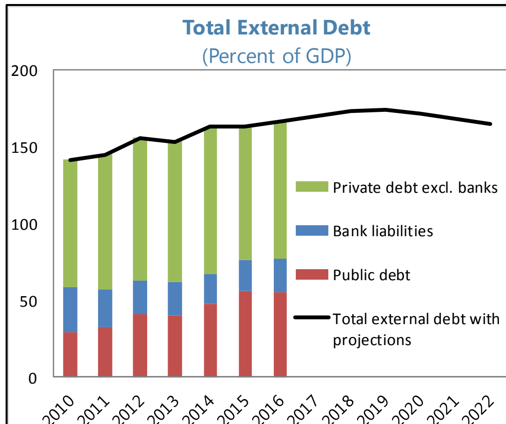


Sources: CBM and IMF staff estimates.



Source: CBM.

7. External debt has reached a new high. At 167 percent of GDP at end-2016, external debt is projected to reach a peak of 175 percent by 2019, before declining to 165 percent in 2022. One-third of the external debt is government debt (which grew 25 percentage points of GDP since 2010) and one-half falls into the non-bank private sector (inter-company debt to a large extent). Short-term debts of the private sector that mature in less than one-year account for only 4 percent of total private external debt. High external debt could become burdensome if interest rates rise or the euro depreciates. Foreign asset and liability position data are insufficient to build a comprehensive account of



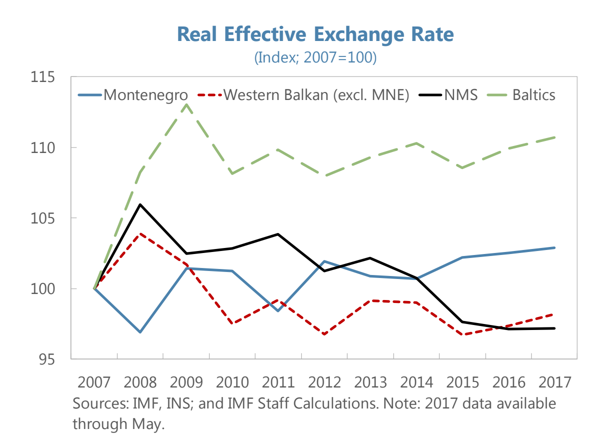
Source: CBM and IMF staff estimates.

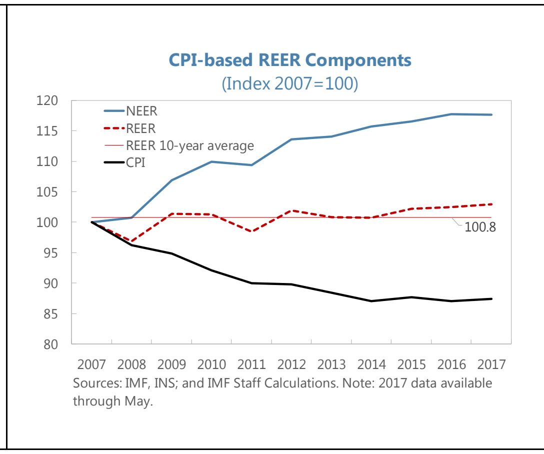
Montenegro's International Investment Position (IIP). The authorities are in the development stages of constructing IIP statements and TA missions are planned for this year for this objective. In the absence of comprehensive IIP data, staff cannot assess the underlying vulnerabilities resulting from foreign assets and liabilities, nor whether there is a mismatch between currencies and maturities. Given the high level of external debt and regular current account deficits, IIP data would be crucial for accessing external sustainability.

8. The authorities' fiscal consolidation plan should reduce government financing needs and could improve the sovereign credit rating. Government external debt should begin declining after 2019, as projected fiscal surpluses reduce gross financing needs. The implementation of the authorities' fiscal adjustment strategy should place debt on a downward path and bolster market access. If the authorities are vigilant in managing finances carefully they might be able to obtain a sovereign credit rating upgrade. In addition to controlling public debt, the government's priority should be to improve the investment climate, which could attract additional investments and strengthen growth prospects.

C. Real Effective Exchange Rate

9. Montenegro has no independent currency. The country adopted the euro as its currency, which provides a strong monetary anchor, but external shocks put a premium on competitive wage levels. Reducing external debt stock levels, opening the labor market to more flexible wage outcomes, and further EU integration would alleviate the constraints from adopting the euro as the domestic currency.





10. The REER has appreciated modestly since 2007. Stagnant productivity and rising labor costs have resulted in a modest 3 percent appreciation of the CPI-based real effective exchange rate (REER) since 2007, which recently registered a new high of 2 percent above its 10-year average. A comparison of price-based indices suggests the appreciation has exceeded that of the other Western Balkan states and new member states averages by 5 to 6 percentage points. The low inflation differentials have kept the appreciation in check while the nominal effective exchange rate weighted by trading partners has been the driver of appreciation. The more recent depreciation of the euro in conjunction with quantitative easing has eased the appreciation of the REER.

Exchange Rate Assessment using EBA-lite REER methodology

ln(REER)-Actual	4.62	ln(REER)-Fitted	4.78
ln(REER)-Norm	4.76	Residual	-0.16
REER-Gap	-13.4%	Policy gap	0.03

Source: IMF staff calculations.

11. Competitiveness has suffered from a moderately overvalued REER. The EBA-lite REER regression model estimates the REER to be undervalued by 13 percent, while the CA regression model suggests the REER is overvalued by 20 percent.[2] Data limitations are the main impediment to an accurate estimation of the REER for Montenegro. On balance, staff believes that the real exchange rate is overvalued by about 10 percent, due to the persistently large current account deficits and unit labor costs that continue to grow while productivity stagnates. A real depreciation through wage constraints and structural reforms to strengthen competitiveness would help reduce economic imbalances in the medium-term.

D. Labor Market and Productivity

12. Labor market rigidities cause high levels of long-term and youth unemployment and disincentives for open-ended employment (Figure 2). Unemployment has been stubbornly high despite large fluctuations in business cycles. Firms constrained by firing restrictions are reluctant to hire in the first place, increasing long-term unemployment, which accounts for three-fourths of total unemployment. Montenegro also has one of the highest rates of temporary employment in Europe, which disproportionally affects young workers. High tax burdens on low-income workers and the relatively high minimum wage[3] drive a quarter of the workforce into informality.[4] Public sector employment is a high one-third and pays more than the private sector, thus reducing overall productivity.

13. Improving labor market flexibility and encouraging job creation for the long-term and youth unemployed should be an immediate priority. Allowing firms to adjust their workforce would encourage them to hire more workers with open-ended contracts. Reducing the tax burden on low-paid individuals would encourage hiring and lessen informal employment. The level of the minimum wage should be reviewed carefully as it is currently relatively high and

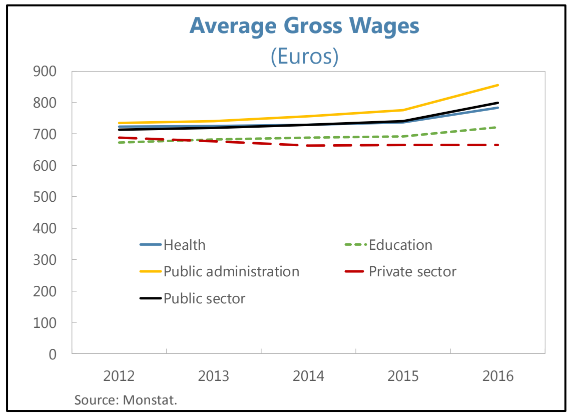
[2] The External Stability (ES) approach cannot be calculated in the absence of the International Investment Position (IIP).

[3] The national minimum wage for Montenegro is determined by the Government upon a proposal from the Social Council of Montenegro, every six months. The minimum wage cannot be set lower than 30% of the average wage in the previous six months. Currently, the minimum wage is set at 288 euros per month (38% of average 6 months of previous gross wages). This amount has not changed since 2013, when it was increased by 30%.

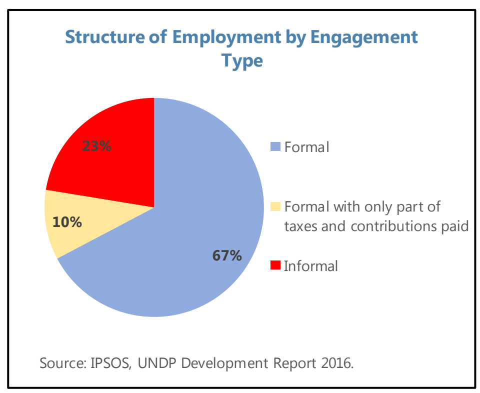
[4] See UNDP Report "Informal Work: From Challenges to Solutions" (2016).

likely binding for a significant share of young workers. The impact of active labor market policies (ALMPs) has been limited, due to inadequate funding. Additionally, most funding in recent years has been allocated to university graduate programs, which targets a group with the lowest unemployment rate. The authorities should review ALMPs to reallocate resources to the most promising programs, in line with successful EU programs. They should align curricula of education and training programs with current labor needs to reduce skill mismatches, particularly for low-education workers. They should also enforce active job-search verification and participation in activation programs to receive unemployment benefits.

14. The authorities should seek to reduce the public-sector workforce. Montenegro's public sector employs one-third of workers and the public wage bill is high compared to regional peers. Average gross wages of the private and public sector have diverged since 2012, with average private sector wages declining by 3 percent, while public administration wages have increased by 17 percent. This wage difference provides workers an attractive alternative to private sector employment, particularly for less-qualified workers. While the authorities intend to keep public sector wage growth in check, a possible civil service reform would present an opportunity to reform salary structures and reconsider the appropriate size of the public-sector workforce.



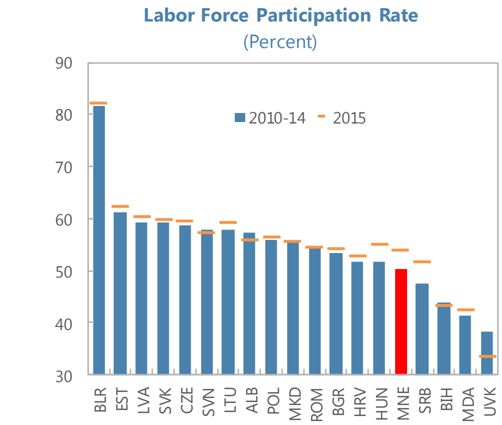
15. The tax burden on low-income workers and the relatively high minimum wage are the primary reasons for a high informal employment of 22 percent.[5] In addition, 10 percent are employed formally but pay only a fraction of taxes and contributions they should pay. Self-employed face incentives to join the informal labor market, due to the high tax burden particularly on earnings below the minimum wage. Informal employment is highest among the young, the elderly, and those with lower levels of education. However, if not for these informal jobs, the number of unemployed would be much higher and more would face the risk of poverty. The current labor market regulations have increased the size of the grey economy because of high costs of dismissal, the minimum wage, and regulations on wages. Average informal wages are at the level of the minimum wage. Therefore, individuals joining the formal labor force would be voluntarily forgoing income now for the prospects of a pension in the future, which is unlikely for lower-income households.



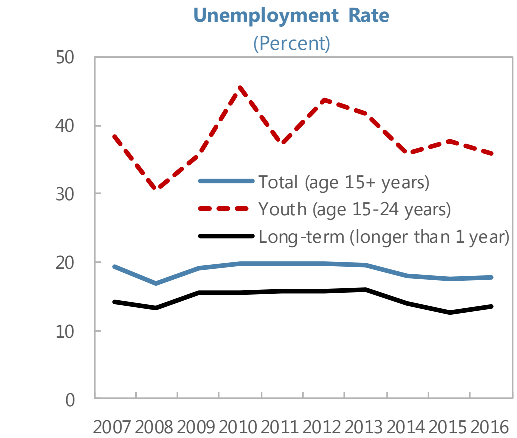
[5] See UNDP Report "Informal work: from challenges to solutions" (2016).

Figure 2. Labor Markets

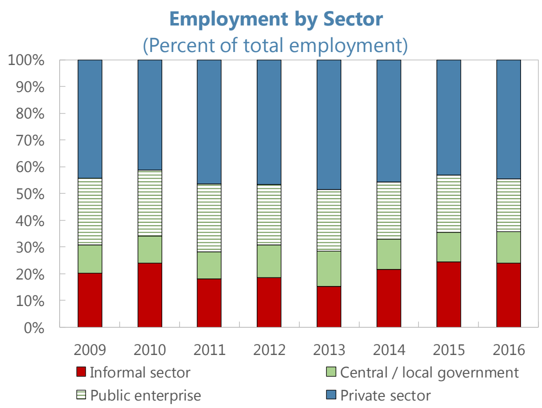
Labor force participation is low compared to peers, but has been rising recently...



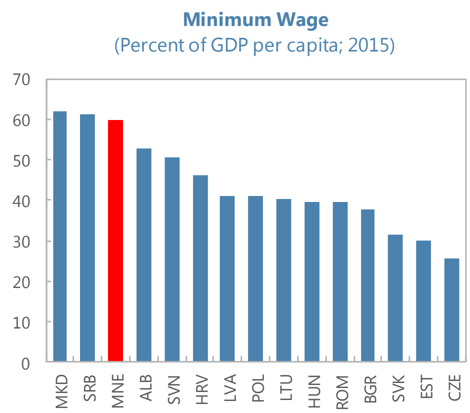
...despite persistently high levels of youth and long-term unemployment.



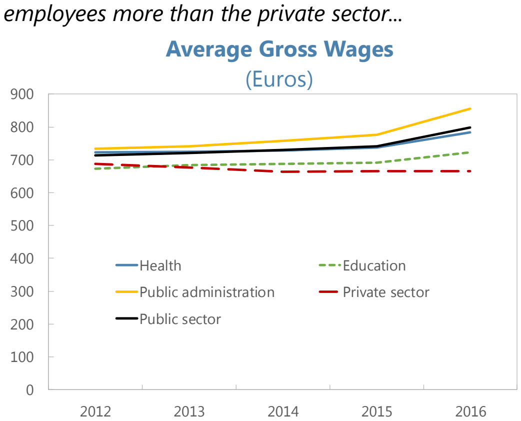
Informal employment is highest among the young and those of lower levels of education.



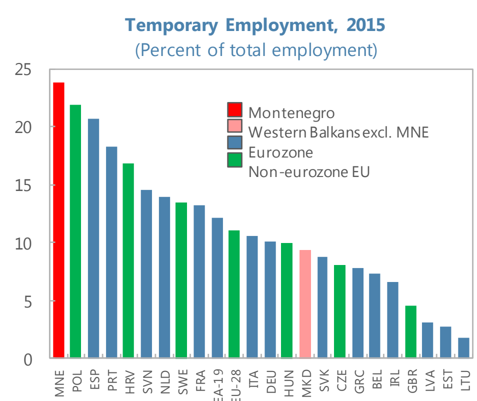
The minimum wage is relatively high and likely binding for a significant share of young workers.



The public sector employs one-third of workers and pays its employees more than the private sector...



...while employment protection is a large disincentive for employers to offer open-ended positions.

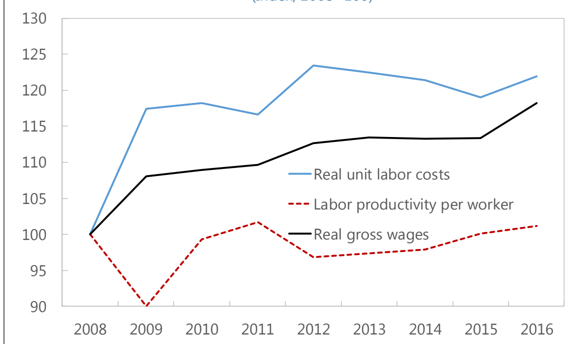


Sources: Monstat, Labor Force Survey; ILO; Eurostat; IMF, WEO database; and IMF staff calculations.

16. The authorities envisage approval of a new labor law in 2017/18. The present labor law is already in line with EU directives, but a new law would improve competitiveness and is envisaged for the World Bank PBG. The labor law working group includes many social partners, who are debating how to improve labor-market flexibility, improve sanctions for unregistered work, better target AMLPs, and increase market participation. The authorities plan to maintain discipline over public-sector wages as part of the fiscal adjustment strategy. They believe that their privatization program is on track.

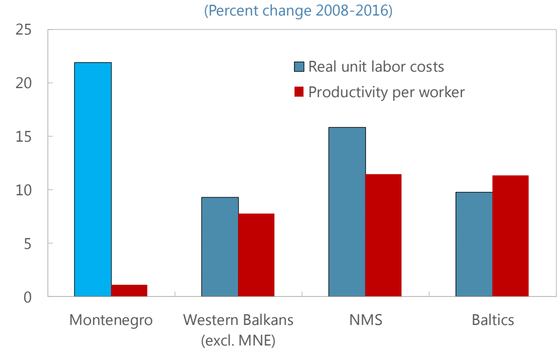
17. Labor productivity has stagnated as an inflexible labor market has driven up unit labor costs. High rates of youth and long-term unemployment and low employment and activity levels persist. Productivity gains have been limited by low levels of training and R&D spending. Unit labor costs—a key measure of competitiveness—increased by 22 percent during 2008–16, compared with an average 9 percent for other Western Balkan countries. Real gross wages grew 18 percent during this period, while productivity stagnated at 1 percent. Much like Eurozone countries, Montenegro cannot devalue in nominal terms and nor set interest rates independently. This means it needs to close its competitiveness gap by reductions in costs such as labor costs, until reforms to improve productivity produce results.

Productivity and Labor Costs
(Index; 2008=100)



Sources: Monstat; IMF, WEO; and IMF Staff Estimations.

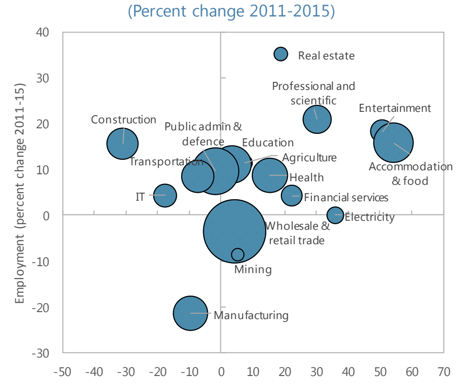
Productivity and Real Unit Labor Costs
(Percent change 2008-2016)



Sources: Monstat; IMF, WEO; and IMF staff estimates.

18. Labor productivity in some sectors raises concerns. The fastest growing sectors are the tourism-related sectors of entertainment, food, and accommodation, which also have the largest productivity improvements. Manufacturing and mining sectors have been scaling back employment since 2011 to boost productivity. In real estate, employment growth is twice output growth, indicating an overcapacity of firms may be driving down profits. Another concern is construction, which has seen the largest fall in productivity (-40 percent since 2011) and has responded to falling output by adding employment. However, according to the UNDP, an additional 36 percent of construction workers are unaccounted for through informal employment.

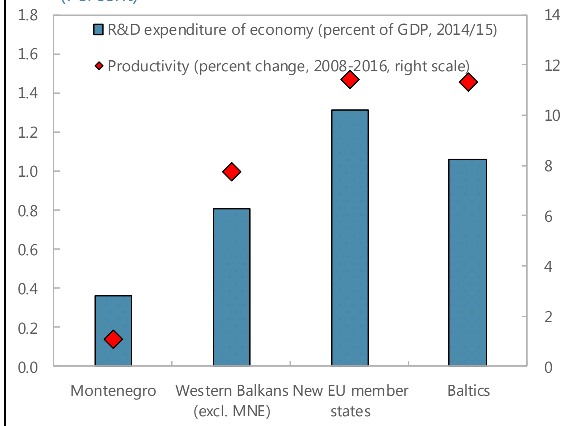
Sectoral Output and Employment
(Percent change 2011-2015)



Source: Monstat.
Note: Bubble size indicates sectoral economic output in 2015.

19. Investing more in education and training, infrastructure, and research and development (R&D) would boost productivity and economic potential. Fiscal policy can promote TFP growth through stimulating innovation, which is the key driver for long-term productivity growth.[6] Though R&D returns in emerging economies are on average smaller than advanced, returns depend critically on the human capital base of countries. However, the rate of return is also larger for countries further from the technological frontier, suggesting that R&D in emerging economies such as Montenegro could potentially yield high returns, provided there is a sufficiently educated work force. Given the need for fiscal adjustment, authorities will need to address underinvestment by designing the tax system to get the best value for money. The authorities have requested technical assistance in tax policy, which will help to address these challenges.

R&D Expenditure and Labor Productivity
(Percent)



Source: Eurostat; and IMF, WEO.

E. Business Environment

20. Structural reforms to improve the business environment are crucial for strengthening Montenegro's competitiveness (Figure 3). Montenegro's score in the World Bank's Doing Business survey has been improving along with its peers, but its ranking fell this year from 48th to 51st place. However, DB indicators may be outdated, given recent improvements in electricity and EU trade law convergence.[7] The latest DB's most noticeable improvement was in "paying taxes", where Montenegro reduced the number of tax payments a business must make per year. The 2017 report also indicates that "getting electricity" access is costly and burdensome for businesses, while supply reliability is low amongst peers. "Trading across borders" is reported administratively expensive for exporters and high compliance costs as damaging price competitiveness, contributing to weak goods exports.

21. With the caveats mentioned above, further development of the electricity infrastructure would improve the energy supply and lower costs of doing business. A business in Montenegro pays one of the highest costs (percent of income per capita) in the region to obtain an electrical connection. Also, businesses file more paperwork and wait a longer time before being connected to the grid. Power reliability is low, but recent and planned investments in electricity generation and distribution should improve measured outcomes and raise the productivity of firms that require a reliable electrical grid.

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[6] See Fiscal Monitor April 2016, Chapter 2: Fiscal Policies for Innovation and Growth.

[7] The authorities expect that the next DB survey will reflect these improvements and result in a better placement.

22. The authorities are addressing underdeveloped infrastructure with substantial investments in electricity generation and transport. They believe that the construction of an undersea cable with Italy, improving interconnections with Serbia, building a second thermal power plant block, and completing smaller scale hydro-stations will improve energy-network stability and help develop regional energy markets. They believe the Bar-Boljare highway will connect underdeveloped northern regions with the capital and alleviate transport bottlenecks. Other major connectivity infrastructure projects amounting to €1.1 billion over three years are in line with EU priorities under an agreed-upon connectivity agenda.

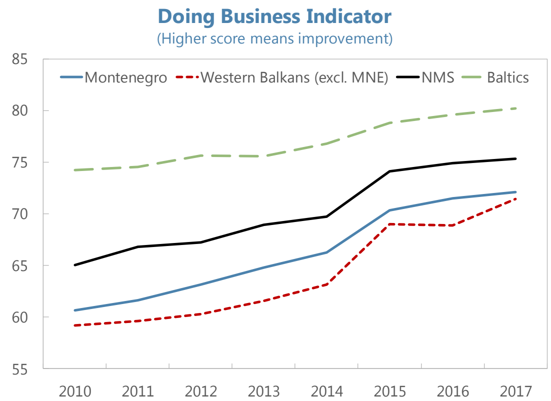
23. Increasing coal excises would encourage green energy investments and lower the impacts of pollution on public health and productivity. Carbon-emitting energy sources inflict additional costs on Montenegro, which are not currently reflected in prices. Burning coal for use in thermal power plants may appear to be a cheap source for electricity generation, but pollutant by-product emissions have negative impacts on the health of citizens. Increasing coal excises would incentivize energy firms to invest in cleaner and safer forms of energy generation, while providing a new source of revenues. Additionally, a cleaner local environment would lower the costs of the public health system, improve the productivity of current workers, and attract higher numbers of foreign tourists.

24. Simplifying compliance for exporters could incentivize productive firms to export and improve the cost competitiveness of current exporters (Figure IV.2). The indirect costs for firms to export goods from Montenegro are higher than for regional peers, both for border and document compliance. Similarly, it is time consuming for Montenegrin firms to file the necessary paperwork to export. Given that Montenegrin goods exports have been declining on average in recent years to EU countries despite efforts to converge with EU trade standards, structural reforms should be undertaken to address the difficultly in exporting goods. This would improve the cost competitiveness of current exporters and address the large current account deficit.

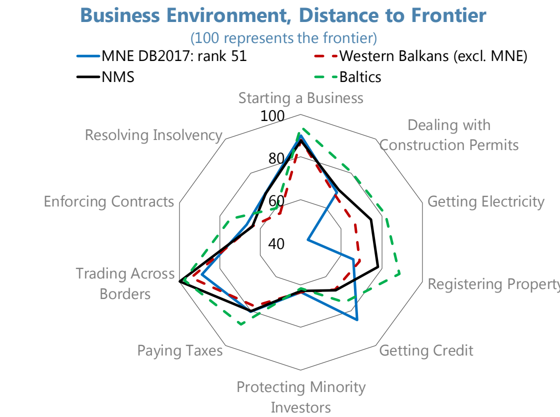
25. Some state-owned enterprises (SOEs) are a drag on public finances and productivity. The privatization process seems to have slowed recently. For example, the tender for the Port of Bar was cancelled without explanation. There are SOEs without public policy functions that are loss making and have significant tax arrears (Montenegro Airlines, Plantaže winery, etc.). Municipal SOEs are often the employer of first and last resort. Staff recommended reaccelerating the privatization process and merging some municipal SOEs to achieve efficiency gains. The pending exit of a minority foreign investor in EPCG, the electricity generation utility, means that the authorities will need to find a new strategic investor or purchase shares valued at €250 million (6 percent of GDP).

Figure 3. Business Environment

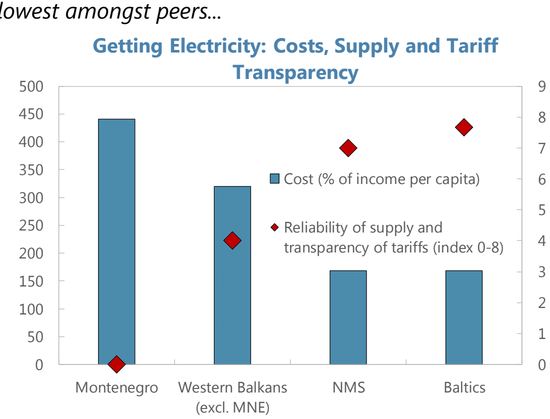
Business environment indicators are improving along with peers…



… though lag the region in getting electricity and trading across borders

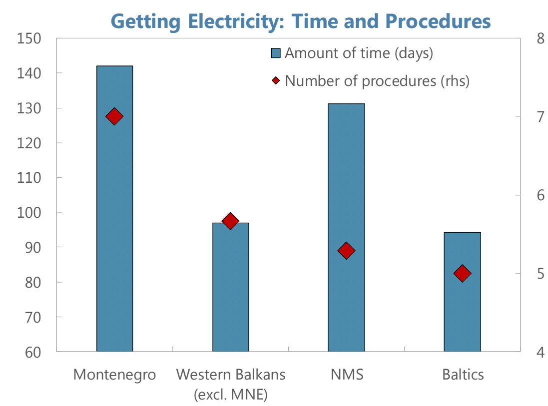


Electricity access costs are high and supply reliability lowest amongst peers…

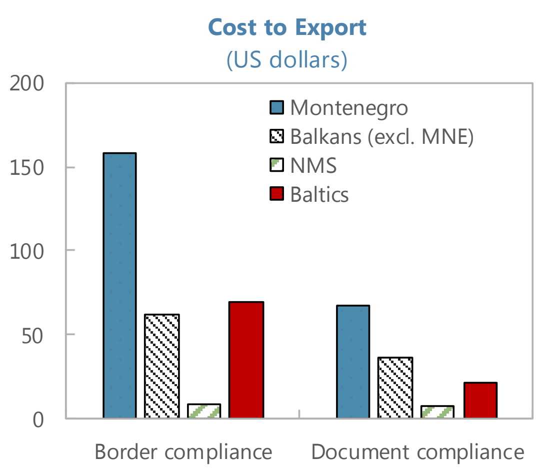


Source: World Bank, Doing Business Database.

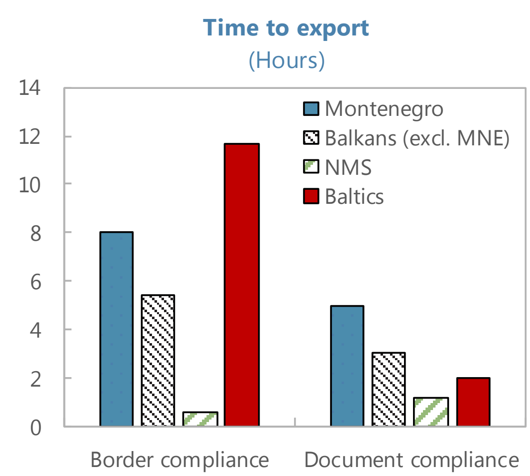
…while the number of procedures required causes long delays for business to gain access to electricity.



High indirect costs are worsening price competitiveness…



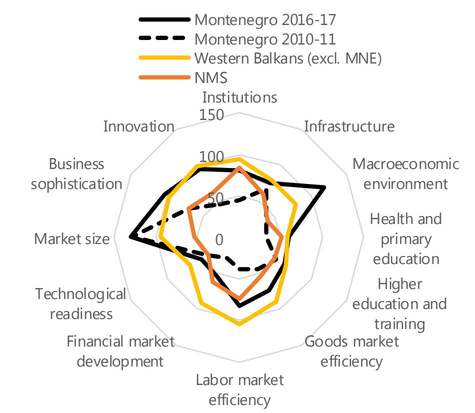
… while high administrative costs are burdening exporters.



Sources: World Bank, Doing Business Database.

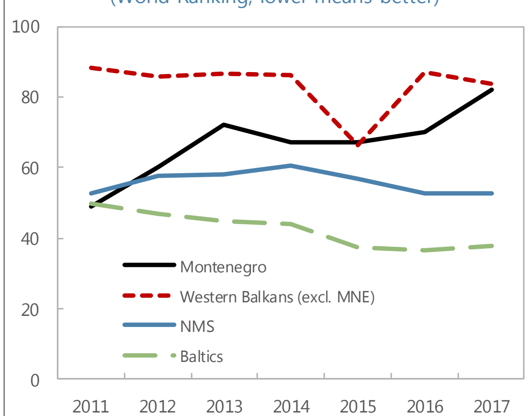
26. Montenegro has fallen in the Global Competitiveness Index (GCI) since the 2010–11 report. Out of 132 countries, Montenegro most recently ranked 82nd, a decline of 33 positions with losses in rankings in most category. Montenegro now ranks similarly to other Western Balkans states, whereas it was considered more competitive in the past. The macroeconomic environment has seen the largest decline, owing mostly to government debt accumulation. Innovation has seen the second largest drop, explained by a deterioration in research and development and in government procurement of advanced tech products. This could partly explain the stagnant productivity that many sectors are currently suffering from. Labor market efficiency has also fallen, with Montenegro's capacity to attract and retain talent continuing to fall. With regards to institutions, improvements are needed in property rights and in corporate governance.

Global Competitiveness Rankings
(World Ranking, lower means better)



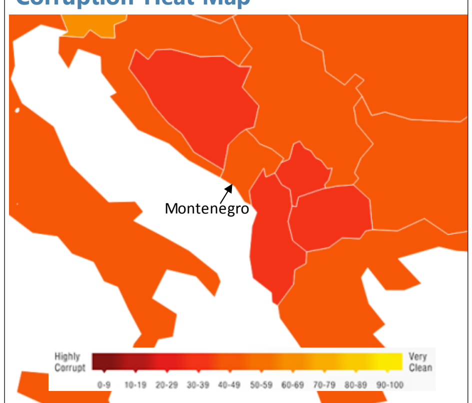
Source: WEF, Global Competitiveness Report.

Global Competitiveness Index
(World Ranking, lower means better)



Source: WEF, Global Competitiveness Index.

Corruption Heat Map



Source: Transparency International.

27. There is a perception of governance problems for institutions and individuals. Although governance indicators and ratings are subject to valid criticisms and uncertainties, even the perception of corruption is harmful for attracting investment. In the Transparency International ranking, Montenegro is tied for 64th place for corruption in the world, ranking slightly better than peers and most neighboring countries. Corruption (perceived and actual) undermines the public's trust in government, threatens market integrity, and distorts competition. The IMF and World Bank can support the authorities' efforts to improve governance by developing an anti-corruption framework.

28. There was an improvement in AML/CTF performance in 2016, but the effectiveness of measures to safeguard against the laundering of proceeds of corruption should be further strengthened. Montenegro has submitted updated information on AML/CFT regulations to MoneyVal, and a new MoneyVal report will be published later this year. Montenegro's AML legislation defines politically exposed persons (PEPs) in line with internationally adopted AML guidelines. However, the authorities should strengthen guidance to financial and non-financial institutions on identifying and reporting possible suspicious transactions related to PEPs, including when they are the beneficial owners of companies. Risk-based supervision should also be strengthened, with proportional and dissuasive sanctions enforced on entities for non-compliance.