

3. FISCAL POLICY REFORM FOR GROWTH AND COMPETITIVENESS

3.1 Montenegro's euroization has limited its options for macroeconomic management to fiscal policy. Its high current account deficit (before grants), at about 12 percent of GDP at end-2004, remains unsustainably large. In the past such a large current account deficit was financed through high official grants, loans and privatization revenues. However, official grants have declined in recent years (from 7 percent of GDP in 2002 to about 3 percent in 2004) as have privatization revenues, while net foreign borrowing has increased. With declining grants and rising debt service payments, adjustment to a smaller current account deficit is necessary. With euroization, the main policy tool for such adjustment remains fiscal policy. For that reason, fiscal sustainability remains a serious concern. However, while restraining demand through prudent fiscal policy is necessary, it is equally important for the Government to ensure that the composition of expenditures is supportive of growth, through increasing expenditure allocation to investment in public goods, in particular to infrastructure.

3.2 The chapter is organized as follows. Section A provides a background on the evolution of general government expenditures and revenues in recent years. Section B examines Montenegro's current fiscal situation, in particular whether its fiscal position is sustainable. It provides estimates on the level of a long-term sustainable fiscal deficit for Montenegro and discusses the adjustment needed to regain fiscal sustainability and where that adjustment may come from. Section C considers the allocation of public expenditure across key spending categories, to identify where the spending level may be excessive or inefficient, and also where more spending may be needed. The section looks into both the economic and the functional composition of general government expenditures to draw conclusions on the extent to which the current composition of expenditures is supportive of growth. Section D looks at the legal and institutional processes for budget management and planning, and the improvements that the Government may make to strengthen the link between fiscal policy and growth, while Section E provides conclusions and recommendations.

A. BACKGROUND

3.3 Montenegro's consolidated general government expenditure accounts for about 42 percent of GDP (Figure 3.1).⁴⁶ Of this, Central Government accounted for 22.2 percent of GDP, the extra-budgetary social funds for 15 percent of GDP, and municipalities for about 4.2 percent of GDP. Further decomposition of expenditures by economic and functional classifications is provided later in this chapter.

3.4 Over the last three years, consolidated expenditures have declined from about 43 percent of GDP in 2002 to about 41.5 percent in 2004, which suggests that the role of the Government in the economy declined only marginally. Current expenditures, accounting for over 90 percent of total general government expenditure, declined from over 38 percent of GDP in 2001 to about 34 percent in 2004, while capital expenditures, net lending and general reserves, which together account for less than 10 percent of the total, remained more or less steady. On the revenue side, consolidated general government

⁴⁶ The IMF data on consolidated fiscal operations for Montenegro do not cover local governments/ municipalities. However, Montenegro has local government data available for 2002-2004, although the quality of the data may be weak. To provide a more complete picture of consolidated general government in Montenegro, we supplement IMF data with such data on local governments. Since by law and in practice, local governments cannot generate deficits, their revenues (net of central government transfers) are equal to their expenditures. In that sense, exclusion of local governments does not introduce material difference into the IMF fiscal targets.

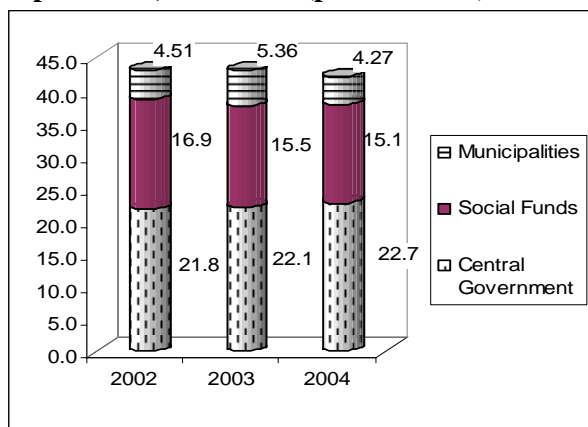
revenue **increased** from about 39 percent of GDP in 2002 to about 41 percent of GDP in 2004 (Figure 3.2), including revenues of local governments. Central government revenue and grants accounted for about 25 percent of GDP, social funds for about 11 percent of GDP; and local governments for about 4 percent of GDP. Consolidated general government in Montenegro is defined in Box 3.1.

Box 3.1. The Concept of Consolidated General Government in Montenegro

The concept of consolidated general government in Montenegro includes consolidated data for the Montenegrin Republican budget (central government), three extra budgetary funds--the Pensions Fund (PIO), the Health Insurance Fund (HIF), and the Employment Fund—and local governments. Local governments in Montenegro are represented by 21 municipalities, and their expenditure and revenue data are not always complete. Own revenues of the social funds and local governments are supplemented by transfers from the Republican budget.

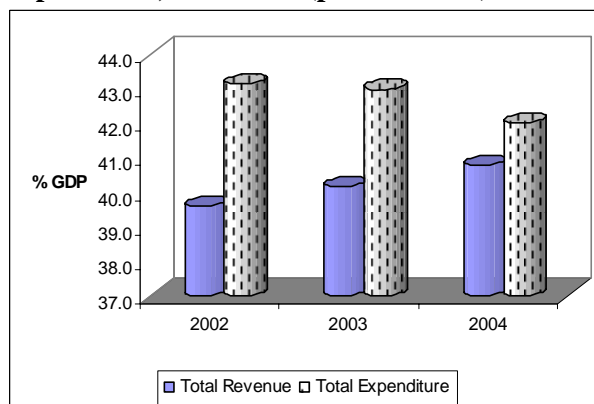
Fiscal data for the central government of Montenegro are based on the new GFS classification. However, data for the extra budgetary funds, reported directly by the funds, are not on a GFS basis and are generally compiled with delays. Montenegro’s budget for 2005 already contains tables with consolidated budgets for the central government and the social funds, but the municipalities have not yet adopted a new harmonized chart of accounts that would allow for the consolidation of municipal budgets into general government.

Figure 3.1. Consolidated General Government Expenditure, 2002-2004 (percent GDP)



Source: IMF; Montenegrin Ministry of Finance; USAID Urban Institute for Local Governments data.

Figure 3.2. Consolidated Public Revenue and Expenditure, 2002-2004 (percent GDP)



Source: IMF; Montenegrin Ministry of Finance; USAID Urban Institute for Local Governments data.

3.5 The composition of revenues has shifted significantly over the last three years, owing mainly to the revenue reforms undertaken by the Government. By composition, social security contributions and value-added tax (VAT) account for about 62 percent of the total tax revenue (Figure 3.3). Personal income tax revenue and the excise tax each account for an additional 12 percent of total tax revenue. International trade taxes account for 7 percent and corporate income tax accounts for only 3 percent of total revenue. The Government has introduced several tax reforms over the last three years. The *Personal Income Tax Law*, which came into force on July 1, 2002, replaced a proportional 19 percent income by progressive rates ranging from 0 to 25 percent. The *Value Added Tax Law* came into effect in April 2003. The sales taxes of 12 percent on services and 24 percent on most goods were replaced by the VAT rate of 17 percent. The *Corporate Profit Tax Law*, which also came into effect in July 2002, replaced a flat corporate profit tax rate of 20 percent by progressive rates of 15 percent for profits up to 100,000 euros and 20 percent for profits over 100,000 euros. This Law was further amended in the last quarter of 2004, which decreased the corporate tax rate from the prior progressive rates of 15 and 20 percent to a proportional rate of 9 percent. As a result, Montenegro now has the lowest corporate profit tax rate in

Southeast Europe. In large part because of these reforms, the composition of revenues has changed. Personal income tax revenues and revenues from international trade taxes have declined, while revenues from social contributions and the retail sales tax/ VAT have increased (Figure 2.3). Other revenues, including revenues from excises and corporate income tax, have remained more or less stable.

B. IS THE FISCAL POSITION SUSTAINABLE?

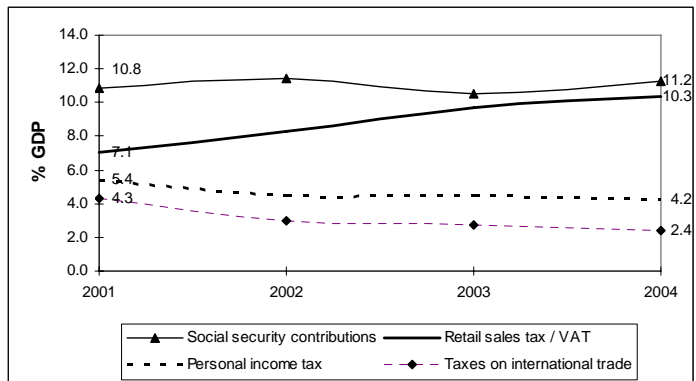
3.6 The general government deficit

after grants increased from about 1.6 percent of GDP in 2001 to about 3.1 percent in 2004 (Figure 3.4). By type of financing, net foreign financing steadily increased from zero in 2001 to about 2 percent of GDP in 2004 (with program aid increasing from zero to 0.9 percent of GDP and project aid increasing from zero to 1.2 percent of GDP); privatization receipts declined from about 5 percent of GDP in 2002 to about 0.5 percent in 2004.⁴⁷ Domestic borrowing, including the issuance of short-term securities (Treasury bills), fluctuated, in part depending on the Government's privatization revenues. In 2004, domestic financing accounted for about 0.6 percent of GDP. The recent increases in deficits after grants pose a risk to fiscal sustainability and macroeconomic stability.

3.7 Fiscal sustainability requires that the present value of the government's primary balance must equal the current debt-to-GDP ratio. At the end of 2004, Montenegro's estimated debt-to-GDP ratio was 43.8 percent of GDP. Under the simplifying assumptions that the economy grows at a constant real rate of 4 percent per year, and that the real interest rate is constant at 5 percent, a recent analysis by the World Bank finds that a primary budget balance of 0.4 percent is needed for Montenegro to achieve long-run fiscal sustainability.⁴⁸

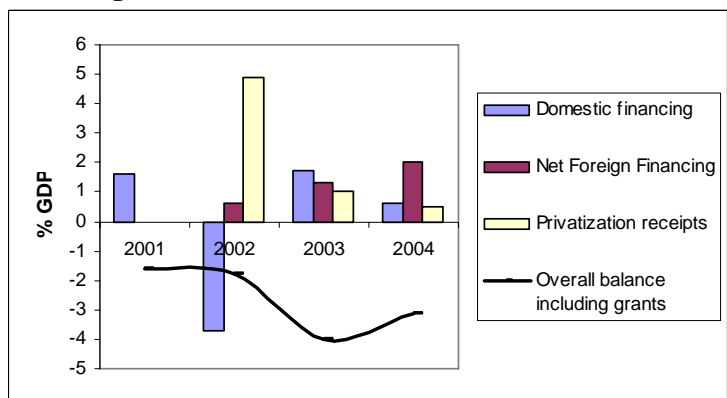
3.8 **Montenegro is thus currently very far from achieving a sustainable fiscal balance.** In the past two years, estimates of the primary fiscal balance in Montenegro put it at close to a deficit of 2 percent of

Figure 3.3. Trends in the Composition of Revenues, 2001-2004 (percent GDP)



Source: IMF; Montenegrin Ministry of Finance; USAID Urban Institute for Local Governments data.

Figure 3.4. Sources of General Government Deficit Financing, 2001-2004



Source: IMF; Montenegrin Ministry of Finance.

⁴⁷ The government expects to receive a much larger amount—about 10 percent of GDP—in privatization revenues in 2005. Whether the government uses these receipts to reduce deficit spending instead of increasing it will have important implications for fiscal sustainability and macroeconomic stability.

⁴⁸ This is based on an internal World Bank document: “Debt Sustainability in Serbia and Montenegro”, June 2005.

GDP. Current projections for the primary balance suggest a deficit of just over 1 percent of GDP in 2005. This is well short of the surplus of 0.4 percent of GDP needed for fiscal sustainability. Currently the effective nominal interest cost of Montenegro's debt is a little below 3 percent of its stock of debt. If one were to assume that real interest rate is 1 percent (rather than 5 percent as assumed above) in the long-run, a primary deficit no greater than 1.3 percent of GDP would be needed to maintain a stable debt-to-GDP ratio. Regardless of the level of interest rate assumed, the analysis suggests that, a substantial fiscal tightening—in the order of 1 percent of GDP-- is needed to achieve fiscal sustainability. While a higher growth rate and access to concessional financing can supplement such effort, fiscal reforms would take center stage. The next section highlights where such adjustment may come from.

C. IS THE COMPOSITION OF EXPENDITURE SUPPORTIVE OF GROWTH?

3.9 While further fiscal tightening is needed to ensure sustainability, it is equally important for the Government to ensure that the composition of expenditures is supportive of growth by ensuring adequate investment in public goods such as infrastructure.

The Economic Composition of Public Expenditure⁴⁹

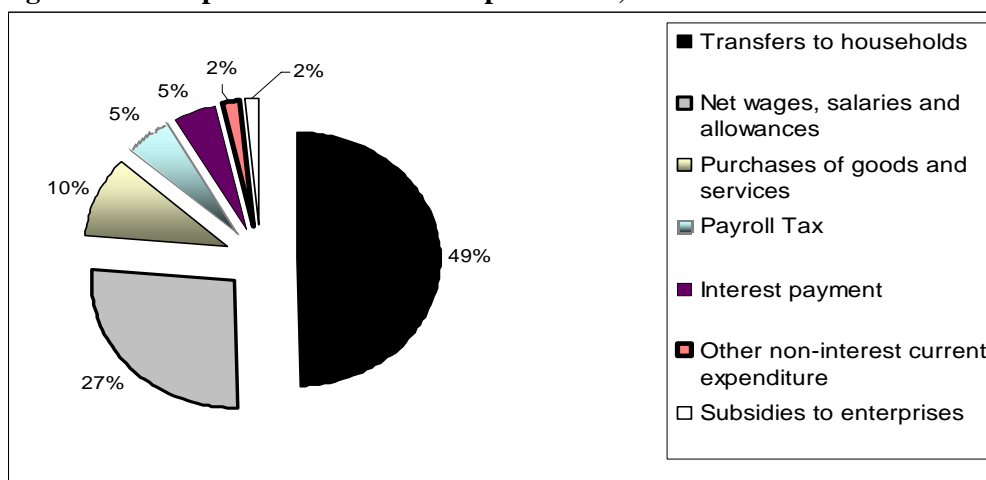
3.10 **Two key conclusions emerge from an analysis of the economic composition of expenditures.** *First*, Montenegro spends about three-fourths of its expenditure on wages, and various social benefits to households. A comparison with regional states shows that Montenegro's wage bill both as a proportion of total government expenditure and as a proportion of GDP is far above the average. On the other hand, capital expenditure is much below the level for other countries in the region (see Figure 3.6). In particular, the high wage growth has crowded out spending on public investment and operations and maintenance—expenditures that are essential for growth. *Second*, subsidies and lending to public enterprises have been progressively reduced over the last three years, but a lot remains to be done to impose a full hard budget constraint on public enterprises. Combined, direct enterprise subsidies and loans to enterprises accounted for about 1.6 percent of GDP in 2004. Despite several years of efforts at privatization and enterprise restructuring, incomplete reforms across the economy feed into the budget via enterprise subsidies and net lending. State-owned enterprises still lack hard budget constraints and budgetary discipline and therefore take resources away from other priority areas of expenditure, such capital investment in infrastructure. The scope for further fiscal tightening, as well as reallocation to public investment, lies in reducing expenditures on the wage bill, transfers to households, lending to public enterprises, and interest payments.

3.11 **Two economic items--social welfare and transfers to households⁵⁰ and the wage bill--account for over 75 percent of total current expenditures** (Figure 3.5). The other expenditures, including expenditures on the purchase of goods and services, the payroll tax, interest payments, subsidies to enterprises, and other non-interest current expenditures, account for only about one-quarter of total expenditure. Transfers to households principally include government-funded social protection benefits for children and families, and for war veterans and maternity benefits, benefits to pensioners through the Pension Fund, benefits to the unemployed through the Employment Fund, and medical protection and health insurance through the Health Fund.

⁴⁹ Analyses of both the economic and functional composition of expenditures do not include data for local governments/ municipalities.

⁵⁰ Transfers to households includes transfers and social benefits, transfers to individuals, transfers to humanitarian organizations and NGOs, transfers to the three social funds, transfers to other units of government at a lower level (i.e. local governments), and social insurance and protection. Transfers to the social funds are netted out in the consolidated general government expenditure.

Figure 3.5. Composition of Current Expenditures, 2004



Source: IMF; Montenegrin Ministry of Finance.

3.12 **Montenegro's public sector wage bill is high as a proportion of general government expenditure, although it is less than the average for the EU-15 countries.** (Figure 3.7). In 2004 the total public sector wage bill expenditure represented about 9.1 percent of GDP (or 27 percent of total expenditure). However, this substantially underestimates the true level of the wage bill, since it does not include the wage bill in the health sector (financed under contractual arrangements through the Health Fund) and other wage bills concealed under transfers to semi-autonomous institutions, such as higher education. In comparison to other countries in the region,⁵¹ Montenegro's wage bill is substantially higher as a share of GDP (over 9 percent against about 7 percent for most other countries in the region).

3.13 **The high level of the wage bill is due mainly to the over-employment in the public sector.** Average gross monthly wages in Montenegro increased from about 150 euros in 2000 to 302.6 euros in 2004—a cumulative growth rate of 103 percent in just four years. The public sector continues to be the prime employer in the Montenegrin economy, accounting for about 60 percent of total formal employment (according to the 2003 Labor Force Survey).

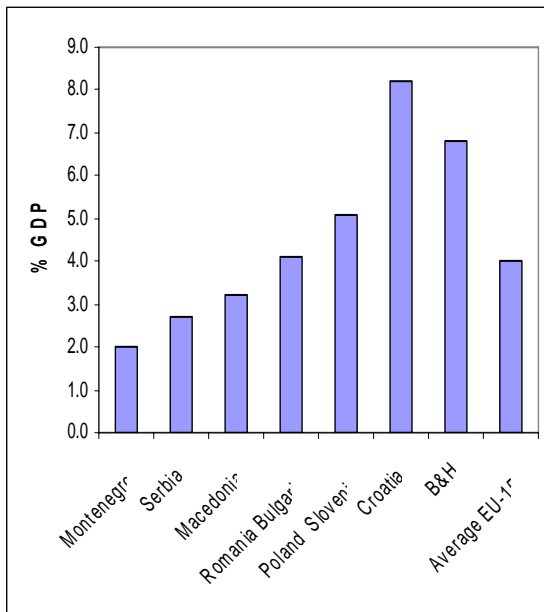
3.14 **The high and growing wage bill and transfers to households have crowded out essential public expenditures on operations and maintenance and capital investment.** Budgetary spending on operations and maintenance declined from around 6 percent of GDP in 2001 to about 3.5 percent in 2004. Montenegro's *capital expenditure* has remained not only low but also volatile. Capital expenditure decreased from 2 percent of GDP in 2001 to 1.5 percent in 2002, but increased to about 2 percent of GDP again in 2004. The volatility seems to arise from treating capital spending as a residual spending in the event of revenue shortfalls and other budgetary pressures. Montenegro's capital expenditure is also one of the lowest in the region, accounting only for less than one-half of the average regional spending as a share of GDP (2 percent in Montenegro versus 5 percent in most other countries) (Figure 3.6).

3.15 **Subsidies and net lending to enterprises stood at about 0.6 percent and 1 percent of GDP, respectively, in 2004.** Direct subsidies to public enterprises declined from about 1.2 percent of GDP in 2001 to about 0.6 percent in 2004. Still, this is not only lax but it also understates the real magnitude of subsidies in the economy, since state-owned enterprises also receive subsidies through the local

⁵¹ Wage bill data for countries in the region represents three-year averages covering mostly the period 1999-2001. For Montenegro the figures represent three-year averages covering the period 2002-04.

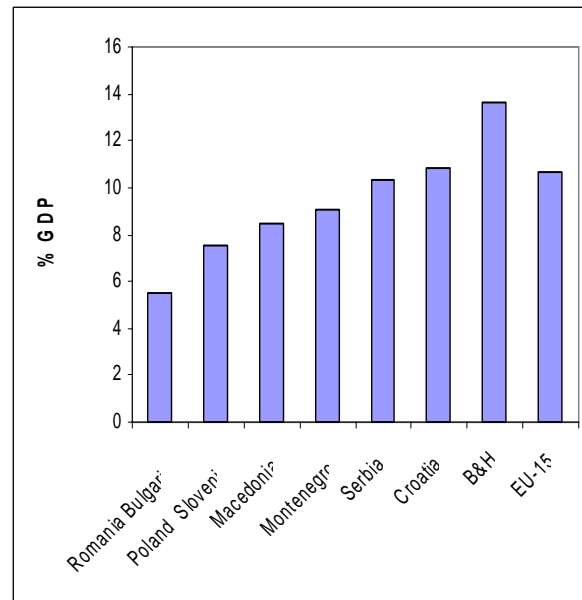
governments (municipalities). *Net lending* by the Government, which includes loans to public enterprises, has fluctuated in recent years but remained significant at about 1 percent of GDP in 2004. There is no adequate transparency surrounding the lending to state-owned enterprises, including the terms and repayment conditions.⁵² Finally, *interest payments* increased from 0.1 percent of GDP in 2001 to 1.6 percent in 2004.⁵³

Figure 3.6. Capital Expenditure, Comparison with Other Countries in the Region, 2003-2004 (% GDP)



Source: IMF; Montenegrin Ministry of Finance; Funck 2002.

Figure 3.7. Wage Bill, Comparison with Other Countries in the Region, 2003-2004 (% GDP)



Source: IMF; Montenegrin Ministry of Finance; Funck 2002.

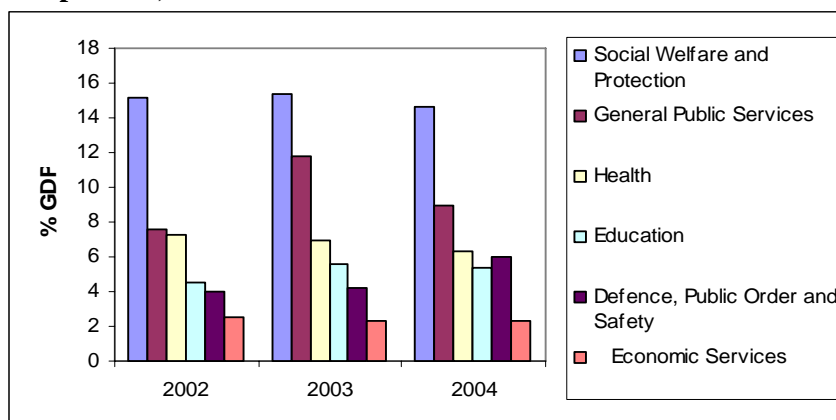
⁵² Loans to public-owned companies have very favorable conditions – 2 percent interest rate, 1 year grace period, and a 3- year repayment period.

⁵³ Besides debt repayment, interest payment has been the only expenditure where budget outturn has been higher than planned.

The Functional Composition of Public Expenditure

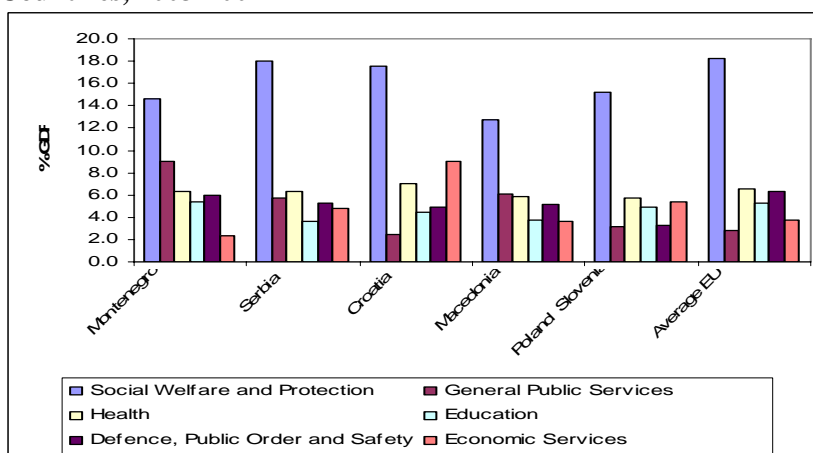
3.16 A look at general government expenditure by functions⁵⁴ suggests where some of the priorities for expenditure reform might lie. Four conclusions emerge from such an analysis. *First*, general government services (public administration, public order and safety, and defense) and social protection each consume about a third (33 percent) of total general government expenditure. Education and health combined account for another 25 percent of the total spending. The rest goes to economic services, and housing, sports and recreation (about 5 percent). *Second*, compared with other countries in the region, Montenegro spends substantially more on almost all of these functions--general public services, defense and public safety, education, and health in that order (Figure 3.8).⁵⁵ *Third*, despite the fact that Montenegro started public sector reforms a couple of years ago, the reforms have not yet resulted in a reduction in the costs of public administration and public order and safety. Instead, the costs of these functions have continued to grow. *Fourth*, although spending on social protection is more in line with other countries in the region, the dominance of spending on pensions and veterans' benefits means that a relatively small proportion of spending is targeted towards poverty related programs.

Figure 3.8. Montenegro's Functional Spending by Major Components, 2002-2004



Source: IMF; Montenegrin Ministry of Finance.

Figure 3.9. Montenegro's Functional Spending Compared to Other Countries, 2003-2004



Source: IMF; Montenegrin Ministry of Finance; Funck (2002).

⁵⁴ Due to lack of data, the table does not include municipal spending by functions. Public and economic services and education are financed primarily through the central government budget; health services are financed through the Health Insurance Fund and pensions through the Pensions Fund. General public services do not include interest payments.

⁵⁵ Montenegro data are average for 2002-2004, and do not include municipal expenditures and part of the externally financed projects, and exclude interest payments. Comparator country data refer to three-year averages for 1999-2001 except for Albania (2000-2002) and Hungary (1999-2000), and exclude interest and amortization charges.

General Government Services

3.17 **Montenegro spends substantially higher amounts than other countries in the region-- about 9 percent of its GDP-- on general public services (i.e., public administration)** (Figure 3.9). Despite the high spending, the general view is that public administration is poor, as standards within the public administration are not optimal and staff are often poorly trained and equipped for the functions that they are required to perform. In view of this, it remains essential for the process of public administration reform, which has begun recently, to provide budgetary space by not only reducing the very high level of spending on public administration but also by improving standards and service delivery (see Box 3.2).

Box 3.2. Public Administration Reform and Budgetary Space

Public administration reform remains critical to creating budgetary space in Montenegro. So far, some basic steps have been undertaken. A new Civil Service Agency has been established, a new Law on Salaries for public administration employees has been approved, and a new systematization of working posts is expected to lead to the rightsizing of the public sector.

The basic reason why the wage bill is so high is because of the excess staff in the public sector as well as a generous salary and wage increase in recent years. Public administration reforms are fundamental to addressing this problem. The reforms to date have not effectively addressed the excess staffing and the issues of the different types of allowances (hot meals, transportation, annual leave grants) that continue to burden the wage bill. While the Government has recently taken some steps to bring public sector employment and wage bill spending more into line with European norms (e.g., by reducing excess staffing in the education sector by almost 700 employees thus generating savings in the wage bill of around €3 million), there is a need to extend such steps to other sectors, such as public administration, with its excess staffing and inefficiencies. The Government plans to reduce employment in the public sector by 4,200 by the end of 2005, which is expected to generate an estimated savings of about €10 million⁵⁶, but it remains to be seen whether this reform will be implemented.

In addition, future elements of public administration reform will need to be planned and executed within a realistic budgetary resource framework. Where proposals lead to additional costs, it will be necessary to show how these costs are to be covered from elsewhere within the public service wage bill.

3.18 **Defense and public order and safety, at about 6 percent of GDP in 2004, was higher than the average levels in CEE countries, driven primarily by spending on the police service.** Reforms are needed to bring staffing progressively in line with norms in the region in order to control spending on this particular component.

Community and Social Services

3.19 **Spending on social welfare and protection, by far the largest functional component, accounting for 14.6 percent of GDP, is comparable with the spending levels in other countries in the region** (Figure 3.9). As elsewhere in the region, pensions and pension related benefit spending dominates, accounting for 80 percent of this spending. The level of spending on poverty-related social assistance programs has been among the lowest for countries in the region.

3.20 **Expenditure on health care services accounts for about 6 percent of GDP. Anecdotal evidence suggests that health spending in Montenegro is not efficient.**⁵⁷ In the health care system,

⁵⁶ The government is planning to reduce defense staffing by 3,200; the rest of the redundancy is expected to come from the public administration, which if completed should generate significant budgetary savings.

⁵⁷ See, World Bank, Serbia and Montenegro, Montenegro PEIR, Volume 3.

large inefficiencies, distorted incentives, and a lack of accountability have resulted in substantial resource waste and poor service delivery. Improving the efficiency of health services delivery is therefore essential to containing costs without sacrificing services. This could be achieved through improvements in the management of public health funds, prioritization in resource allocation towards preventive programs and priority treatment programs, and improvements in public procurement procedures in the sector.

3.21 **Montenegro's spending on education, at about 5.4 percent of GDP in 2004,⁵⁸ is above that of other countries in the region** (Figure 3.9). This is comparable to the OECD standards (5.5 percent for the OECD and 5.4 percent for Montenegro) as well as the standards of other countries.⁵⁹ The structure of education spending may suggest some degree of inefficiency in the sector (Box 3.3). Out of the total recurrent expenditure on general education, 94.6 percent was spent on the wage bill, while only 5.4 percent of total recurrent expenditure was spent on non-staff items. The OECD average for the share of non-staff cost in total recurrent expenditure is 19.7 percent. Furthermore, the match between vocational skills produced by schools and skills demanded by the private sector seems poor in Montenegro. There are a number of vocational profiles currently being offered in schools for which little or no demand exists in the labor market (Montenegro PRSP).⁶⁰ Further efficiency gains can be obtained by reducing the disproportionate staffing costs in education, as well as streamlining the vocational training programs to bring them into line with the skills demanded by the labor market.

Box 3.3. Is Public Expenditure in Education Efficient?

Regional comparisons demonstrate higher levels of public spending in Montenegro on a number of key functions and indicate that there is probably a substantial scope for increasing the efficiency and effectiveness of many programs within existing resource allocations. One such sector appears to be education.

Out of 455 active elementary school units, one-third of the total number (148) have 10 or fewer students; 337 units (including 42 mother schools or a quarter of these units) have fewer than 80 students, which would be 4 classes of 20 students. The student/teacher ratio is very low in many cases. There are 14 satellite (elementary) schools with only 1 student per class and 93 school units (13 mother schools and 80 satellite schools) with fewer than 5 students. In addition, there are many large urban schools with small classes, contributing to the number of employees and directorship or supervisory positions. To address this problem, the MES has recently produced new Norms and Standards, linked to the number of students rather than the number of classes.

Economic Services

3.22 **Economic services absorbed only about 2.3 percent of GDP in 2004** (Figure 3.9). This represents less than half of the average level of spending for other countries in the region. Spending on economic services as a share of total expenditures has remained volatile in Montenegro. Within economic services, spending on agriculture has remained constant as a share of total expenditures in the last three years, while spending on tourism-related economic services has been increasing both in nominal terms and as a share of total expenditure.

⁵⁸ This includes spending by social funds as well.

⁵⁹ Only Malaysia, Tunisia and Mexico have similar proportions of education spending.

⁶⁰ According to Montenegro PRSP, there are about 3,953 different vocations in Montenegro (based on data from the Employment Fund), of which there is demand in the labor market for only 750 of them. On the other hand, there are 262 vocations for which demand exists but the school system does not produce adequate trainees. The MES has recently initiated a »tracking« project that would monitor secondary school graduates until they find a job, which should help to better link education with the needs of the labor market.

Is Montenegro's Fiscal Policy Growth-Enhancing?

3.23 A large body of economic literature is concerned with whether (and what kinds of) public expenditures enhance growth.⁶¹ The recent theoretical literature emphasizes that, in evaluating the impact of fiscal policy on growth, the structure of both taxation (i.e., financing) and expenditures should be taken into account.⁶² One way to do this is to divide the government budget into four categories: distortionary or non-distortionary taxes and productive or non-productive expenditures (see, for example, Kneller, Bleaney and Gemmell, 1999). Shifting the revenue stance away from distortionary to non-distortionary taxation has a growth-enhancing effect, whereas switching expenditure from productive to non-productive forms is growth retarding. In this framework, income and corporate taxes are treated as distortionary,⁶³ while taxes on domestic goods and services are treated as non-distortionary. On the expenditure side, those expenditures with a substantial physical or human capital component are treated as productive,⁶⁴ while expenditures on social security and welfare, recreation, and economic services are regarded as unproductive (see Table 3.1).

Table 3.1. Theoretical and Empirical Aggregation of the Government Budget into Distortionary and Non-distortionary Taxation Productive and Non-Productive Expenditures, 2002-2004 (percent GDP)

Theoretical classification	Functional classification	2002	2003	2004
Distortionary taxation	Taxation on income	4.4	4.4	4.2
	Corporate income tax	1.0	0.9	1.1
	Social security contributions	11.5	10.6	11.2
	Taxation on payroll and manpower			
	Taxation on property			
Non-distortionary taxation	Taxation on domestic goods and services	12.6	13.7	14.3
Other revenues	Taxation on international trade	3.0	2.7	2.4
	Non-tax revenues	2.3	2.2	1.7
	Other tax revenues	0.4	0.3	1.5
Productive expenditures	General public services expenditure	7.5	11.8	9.0
	Defense, public order and safety	4.0	4.3	6.0
	Educational expenditure	4.5	5.6	5.4
	Health expenditure	7.3	7.0	6.3
	Housing expenditure	0.1	0.1	0.1
	Transport and communication expenditure	0.8	0.4	0.8
Unproductive expenditures	Social security and welfare expenditure	15.1	15.3	14.6
	Expenditure on recreation	1.2	1.0	0.7
	Expenditure on economic services	1.7	1.9	1.5
Other expenditures	Other expenditure (unclassified)	0.1	0.1	0.0

Source: Kneller, Bleaney and Gemmell (1999) for the framework; IMF and the Montenegrin Ministry of Finance for the data.

3.24 We apply this framework to the case of Montenegro for the period 2002-2004⁶⁵ to see whether the composition of fiscal policy has shifted in favor of or against growth. We will use the framework to answer two basic questions. First, on the financing side, have distortionary taxes increased

⁶¹ See, for example, Barro (1990), Barro and Sala-i-Martin (1992), Barro and Sala-i-Martin (1995), Devarajan et al. (1996), Easterly and Rebelo (1993), Glomm and Ravikumar (1997), Kneller et al. (1998).

⁶² Levine and Renelt (1992) convincingly demonstrate that a framework that does not specify the full government budget constraint will lead to biased estimates of the impact of public expenditures on growth.

⁶³ See Barro (1990).

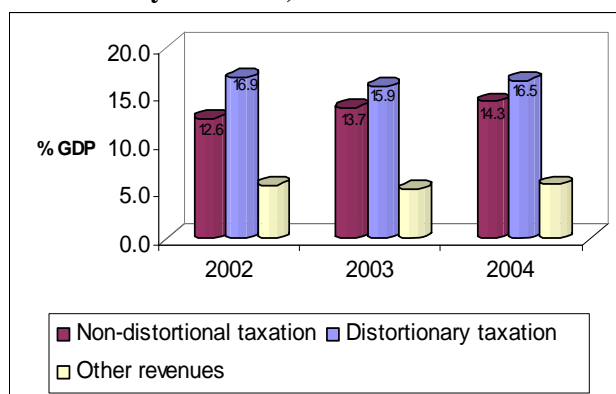
⁶⁴ See Barro and Sala-i-Martin (1995); and Devarajan et al., (1996).

⁶⁵ This framework is more suitable for a long-term analysis, but Montenegro's public expenditure by functional composition is available only for the period 2002-2004.

or decreased over the last three years? Second, on the expenditure side, have productive expenditures increased or decreased over the last three years?

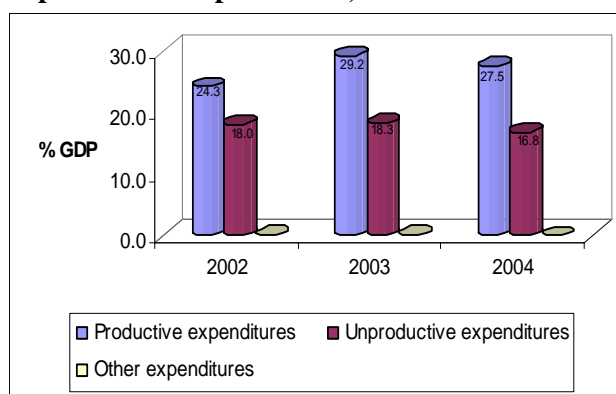
3.25 **On the financing side, Montenegro has slightly increased its non-distortionary taxation (from 12.6 percent in 2002 to 14.3 percent in 2004), while distortionary taxation has remained at about the same level (Figure 3.10).** Owing to the revenue reforms undertaken by the Government since 2001, the personal income tax and the corporate tax (both distortionary) have declined, while the retail sales tax and VAT (non-distortionary) have increased (see Figure 3.3). Social security contributions (distortionary) have increased but have been more or less off-set by the decline in personal and corporate income taxes so that distortionary taxation has remained more or less constant.

Figure 3.10. Trends in Distortionary and Non-distortionary Taxation, 2002-2004



Source: Kneller, Bleaney and Gemmill (1999); Montenegrin Ministry of Finance for the data.

Figure 3.11. Trends in Productive and Unproductive Expenditures, 2002-2004



Source: Kneller, Bleaney and Gemmill (1999); Montenegrin Ministry of Finance for the data.

3.26 **On the expenditure side, productive expenditures have increased while unproductive expenditures have declined slightly (Figure 3.11).** Productive expenditures—defined as the sum total of expenditures on general public services, defense, public order and safety, educational expenditures, health expenditures, housing expenditures, and expenditures on transportation and communications—rose from about 24 percent of GDP in 2002 to 27.5 percent in 2004. On the other hand, unproductive expenditures—consisting of social security and welfare expenditures and expenditures on recreation and economic services—declined from 18 percent in 2002 to 16.8 percent in 2004.

3.27 **On the whole, it appears that Montenegro’s fiscal policy over the last three years has shifted slightly in favor of growth. Still, it has a long way to go.** On the one hand, distortionary taxation and unproductive expenditures were reduced; on the other, non-distortionary taxation and productive expenditures were increased. These changes should generally bode well for growth. However, two points should be emphasized. First, the aggregation of the functional classifications into distortionary/ non-distortionary and non-productive/productive expenditures in Table 3.1 is not uncontroversial. In particular, productive expenditures in Montenegro rose in large part because the framework classifies general public administration and defense and public order and safety expenditures as productive expenditures. However, while a reasonable level of spending on basic law and order, police, and administration can rightly count as productive, it could be argued that these expenditures are not wholly productive in Montenegro in view of the excess staffing prevalent in public administration and in the police and public order sector. Second, even if there were no issues with aggregation, the conclusion would mean that, while progress has been made over the last three years, Montenegro still needs to reorient its fiscal policy towards growth by increasing productive expenditures and reducing distortional sources of financing.

Montenegro's Public Investment Program

3.28 **Montenegro's domestically financed capital expenditure in 2004 accounted for about 2 percent of GDP** (Table 3.2). Capital expenditures financed through program and project loans are not integrated into the Government data on capital expenditures, but are estimated to constitute slightly over 50 percent of total capital expenditures in Montenegro (Ministry of Finance). Data on donor-financed capital expenditure are neither regularly reported by donors nor collected by the Government. Similarly, although local governments/municipalities are involved in the provision of basic utilities, their capital investment is not tracked by the Ministry of Finance, in part because local governments are not yet integrated into general government reporting (charts of accounts for local governments are being finalized).

Table 3.2. Montenegro's Capital Expenditure by Function, 2004* (euros)

Functional classification	Capital expenditures	% of Total
Other economic affairs	6,335,000.0	22.68
General public services	6,016,972.0	21.54
Transportation	6,010,703.4	21.52
Health service	3,218,794.7	11.52
Public order and safety	3,086,264.8	11.05
Education	1,347,280.0	4.82
Military and civil defense with administration	1,000,000.0	3.58
Social welfare and social protection	502,000.0	1.80
Sports, cultural and religious activities	326,000.0	1.17
Housing and utility affairs and services	64,100.0	0.23
Agriculture, forestry, hunting and fishing	20,000.0	0.07
Other expenditures	5,000.0	0.02
Energy	0.0	0.00
Mining	0.0	0.00
TOTAL	27,932,114.9	100.00

Table does not include externally financed capital expenditure.

Source: Montenegrin Ministry of Finance.

3.29 **In 2004, over 85 percent of domestically financed capital expenditures went to five major functions**—economic affairs, general public services, transportation, health services, and public order and safety, in that order. Within economic affairs, by far the largest share—nearly 90 percent—of the capital investment went to development projects. Tourism received only 30,000 euros, or about 0.5 percent of the capital investment on economic affairs. Within general public services, capital investment was made in general services (about 67 percent) and executive and legislative bodies (about 32 percent). There was virtually no investment in research and development (only 2,000 euros). The bulk of capital investment in public order and safety went to police and firefighter protection (over 85 percent). Capital investment in health and in education accounted for about 11 and 5 percent, respectively, of total capital investment.

3.30 **Capital investment in infrastructure accounted for only about 20 percent of total capital investment, or about 0.4 percent of GDP.** Within infrastructure, most of the capital investment was made in land transportation, namely, construction and maintenance of roads (slightly over 50 percent), and railroad transportation (about 33 percent). The rest went to water transportation and communication (about 10 percent). Air transportation, pipelines and other transportation systems, and communications affairs received no capital investment. Montenegro would need to create budgetary space for capital investment in general, and, in particular, for well targeted infrastructure investment that would effectively support the development of its tourism industry – the main potential for growth.

D. BUDGET PROCESSES, MEDIUM-TERM PLANNING, AND GROWTH

3.31 Apart from tackling sustainability and allocation issues, Montenegro would need to strengthen its budgetary processes and institutions to ensure a more efficient and transparent utilization of existing public expenditures. Effective budget management, including medium-term sectoral plans effectively tied to the budget, is central to maximizing the impact of current public expenditure on growth and service delivery. While Montenegro has made progress in recent years, there are still challenges with respect to addressing the arrears problem (a symptom of both budget preparation and execution problems) as well as establishing a medium-term expenditure plan that effectively links sectoral development plans with the budget.

The Budget Formulation Process

3.32 **Montenegro's Organic Budget Law, adopted in 2001, provides a framework for budget formulation and execution.** The Law assigns responsibilities to the Ministry of Finance (MoF) to issue detailed subordinate regulations to guide the processes. The MoF is responsible for managing the budget preparation process for the central government. The budgets of municipalities and social funds are prepared by their respective bodies. Montenegro's budget for 2005 already contains tables with the consolidated budgets of the central government and social funds, but a new harmonized chart of accounts is being adopted that would allow for the consolidation of municipal budgets into the general government budget as well. The budget, however, is still not fully comprehensive as it does not include municipalities and, in some cases foreign-financed programs and projects.

3.33 **Montenegro's budget preparation process begins in June with the preparation of the macroeconomic and fiscal policy framework for the next fiscal year, which in turn defines the overall budget resource envelope.** The MoF then issues circular instructions, with expenditure ceilings for each spending agency and the formats for budget submission. Requests for funding would also include planned spending from the so-called "own revenues" of budget users. While the MoF is not responsible for funding those programs and activities planned to be financed from own revenues, all own revenues realized at the level above the planned figure become public revenues and cannot be used by budget users.

3.34 **The spending agencies then prepare their budgets according to the format provided by the MoF and submit their budgets to the MoF in September.** Budget planning at the spending agencies is based mainly on historical costs. Although the Government has recently developed a medium-term fiscal framework covering three years (2005-2007), very few budget users have started preparing programmatic budgets. The final budget allocation outcome would involve negotiations. After negotiations, budget analysts from the MoF work with the budget officer of the respective spending agency to fit demands within the approved level of spending. The consolidated draft budget is then approved by the Government and forwarded to the Parliament in November for voting. The voted budget is published in the official Gazette to inform budget users and citizens of budget allocations.

Budget Execution and the Arrears Problem

3.35 **All budget users, except for higher education and institutions of culture, pass through a central Treasury system.** The Treasury approves and sends a *monthly* spending schedule to each budget user. Also, it closely monitors revenue collection each month and pays the invoices sent by budget beneficiaries, according to available funds. A quarterly analysis of the compliance of execution with plans

is conducted. At year-end, the MoF prepares final accounts, which are then audited by an independent auditor.⁶⁶

3.36 Montenegro's overall budget execution has improved in recent years, but execution varies considerably across categories (Table 3.3). The overall index of budget execution—expressed as a ratio of the actual budget outturn to the planned budget—improved from about 90 percent in 2002 to 97.7 percent in 2004.⁶⁷ Yet there have been significant variations by economic and functional composition. By economic composition, debt servicing (with a persistent execution several hundred times higher than plan) and interest payments, and the wage bill, had the highest index of execution. The items with the lowest index of execution were capital investment (57 percent) and maintenance and operational costs (77 percent). By functional composition, actual spending on general public services has consistently exceeded plan, with an index of execution of over 100 percent. The lowest ratio of budget outturn to plan has been with regard to economic services, with only 52.2 percent of the planned budget actually realized in 2003.

Table 3.3. Budget Execution by Economic Items, 2002 - 2004

Economic classification	2002	2003	2004
Gross salaries	75.7	89.7	94.9
Allowances	88.4	77.6	95.4
Goods and services	78.5	84.6	77.1
Interest	72.2	55.7	135.3
Rent	72.2	84.1	91.8
Subsidies	74.1	87.2	92.2
Grants and social benefits	84.1	85.8	78.1
Other expenditures	71.9	80.9	88.7
Capital expenditures	69.0	59.4	57.1
Loans and credits	64.5	55.9	84.6
Reserves	99.3	85.6	123.8
Total	89.5	94.5	97.7

Source: Montenegrin Ministry of Finance.

3.37 Montenegro's large arrears, defined as the difference between accrued and paid expenditures, are symptomatic of continued budget formulation/execution problems. As at end-2004, total arrears of the central government⁶⁸ stood at 1.3 percent of GDP (€19.7 million). By functions, the largest arrears have been generated toward defense and police (31 percent) and the Health Fund (27 percent), followed by economic services (18 percent) and education (13 percent) (Figure 3.12). Within economic services, most arrears have been generated in the transportation and infrastructure sector. By economic items, the bulk of the arrears constituted unpaid social benefits and transfers (32 percent), unpaid maintenance and operational costs (26.6 percent) and unpaid health insurance contributions to the Health Fund (16.4 percent).

⁶⁶ Until 2005, Deloitte & Touche, a private auditing firm, has audited government accounts in Montenegro. For the first time in 2005, government accounts are expected to be audited by the new Supreme Audit Institution of Montenegro (which has just been established).

⁶⁷ This is a simple average of the ratio of actual budget to planned budget across all economic classification items.

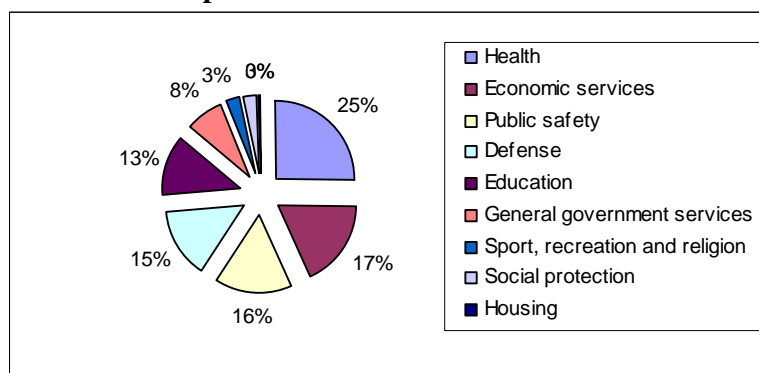
⁶⁸ General government arrears, inclusive of arrears generated by social funds and municipalities, are probably much larger but no complete data are available.

3.38 **Arrears seem to arise for several reasons in Montenegro. They arise first of all because revenue projections by the MoF often turn out to be more optimistic than actual revenues.** In the recent years there have been consistent shortfalls in revenue collection of 3 percent to 5 percent each year, in part because of recent tax cut measures by the Government. With revenue shortfalls, the Treasury takes expenditure measures to bring expenditures in line with resources, and advises spending agencies to adjust their spending accordingly.⁶⁹ However, this notification comes each time with several months' delay, thereby creating the conditions for the arrears to be generated by the spending agencies or budget users. The time gap between the points at which revenue shortfalls are identified and expenditure measures are adopted by the MoF and the spending agencies leaves a gap of months for budget users to create arrears. The following year, budget users have to first pay off the arrears before making any new commitments. However, while budget users are paying last year's arrears, new arrears in the current year would be generated that roll over to the next year, thereby perpetuating the cycle.

3.39 **However, not all of these arrears are due to poorly planned revenues. The problem arises in part because of lack of good commitment control at the spending agencies.** The Department of Internal Auditing was formed within the MoF only about a year ago. With the establishment of the Department, several internal controllers have been trained to review transactions related to the inflows, commitments and outflows of budget users in 2004. By the end of 2004, the Internal Control conducted budget reviews for seven minor budget beneficiaries. The preliminary findings of this assessment are: (i) all budget users do not properly plan their needs and often are forced to spend funds budgeted for one item on something else; (ii) there is a lack of budget officers and accountants in some institutions; (iii) the even existing budget officers are not well enough trained to perform all of the expected tasks; and (iv) there is a need to improve the quality of financial statements as well as transparency.

3.40 **Arrears undermine budget efficiency, effectiveness and growth for two main reasons.** First, arrears weaken the predictability of budget and planning by spending agencies/budget users. Budget users cannot plan in advance or focus on program effectiveness, efficiency, and improved productivity if they must spend most of their time fighting arrears or battling for funds to operate their program. Second, arrears may be costly, especially when they are owed to suppliers of goods and services and especially if interest has accrued on them. For these reasons, the Government of Montenegro would need to take two key steps to address the arrears problem. First, the Government would need to prevent arrears from arising by providing better and more realistic revenue projections as well as speedy expenditure decisions to be implemented by budget users in the event of revenue shortfalls and by strengthening the commitment control systems at the spending agencies through the upgrading of staffing, accounting standards, and transparency. Second, the Government would have to develop a serious plan to clear the current stock of arrears. Unfortunately, the Government has not yet initiated a systematic plan to audit and clear the arrears. Such a plan should identify the most costly arrears, and attempt to retire those first.

Figure 3.12. Central Government Arrears as at end-2004, by Functional Composition



Source: IMF; Montenegrin Ministry of Finance.

⁶⁹ In 2004 the MoF issued so-called "Saving measures" where it announced budget cuts of €14.9 million (proportionally across beneficiaries). Most of the cuts came from capital spending, maintenance and operational costs and subsidies to enterprises.

Medium-Term Planning and Growth

3.41 **The MoF has already taken the initial steps toward providing a Medium-Term Expenditure Framework.** In its current form, the framework consists of projections of revenues, expenditures by economic item and financing for the central government for the next three years. While this is a step forward, it is far from being a full MTEF. The framework lacks the consolidation of total public expenditures, in particular the budgets of municipalities, as well as bottom-up medium-term sectoral budgeting and analysis. Bottom-up costing and multi-year budget planning by budget users is critical to achieving an effective link between sector policies and budgets at the micro level, and between broad national policy and development priorities and the budget at the macro level.

3.42 **The link between policy priorities and the budget is weak in Montenegro.** Many sectors and spending agencies lack medium-term planning and budgeting, which weakens not only the link between policies programs and the budget but the link between public expenditures and growth. A good example is provided by the tourism sector. Tourism is indicated as a priority sector for development in virtually all Government papers, including the Economic Reform Agenda. The Ministry of Tourism has a very detailed strategy (called Tourism Master Plan) for tourism development, which indicates programs and activities that would need to be undertaken in the medium term to long term. However, the strategy has not been translated into a programmatic budget, and the Government remains uncommitted to any medium-term budget for tourism development even though the sector is regarded as the main source of growth. This lack of an effective link between the medium-term tourism development strategy and the budget in turn undermines medium-term growth in Montenegro.⁷⁰ Similarly, Montenegro's PRSP remains unimplemented to date in part because it has not been well linked with the budget.

3.43 **Finally, a functioning MTEF could be an effective way to capture the various sources of funding for public investment, including investments by municipalities.** Municipal spending is very important in infrastructure, as many of the investments are undertaken at this level of government. Again, to take tourism development as an example, most of the programs are likely to be multi-year and multi-sectoral (involving different institutions at the same or different levels of government). Short-term budgeting is not an optimal arrangement for ensuring the financial commitments of various implementing agencies in guaranteeing program sustainability and growth.

E. CONCLUSIONS AND POLICY RECOMMENDATIONS

3.44 **Montenegro's current fiscal position is not sustainable.** At the end of 2004, Montenegro's estimated debt-to-GDP ratio was 43.8 percent of GDP. Under the simplifying assumptions that the economy grows at a constant real rate of 4 percent per year, and that the real interest rate is constant at 5 percent, a recent analysis by the World Bank finds that a primary budget balance of 0.4 percent is needed for Montenegro to achieve long-run fiscal sustainability. Yet, Montenegro's primary fiscal balance over the past two years was close to a deficit of 2 percent of GDP, and current projections for the primary balance suggest a deficit of just over 1 percent of GDP in 2005. This is well short of the surplus of 0.4 percent of GDP needed for fiscal sustainability. A substantial fiscal tightening—in the order of 1 percent of GDP-- is needed to achieve fiscal sustainability. While a higher growth rate and access to concessional financing can supplement such effort, fiscal reforms would take center stage.

3.45 **The scope for further fiscal tightening as well as reallocation to public investment lies in reducing expenditures on the wage bill, transfers to households, lending to public enterprises, and interest payments.** Montenegro spends about three-fourths of its expenditure on wages and various social

⁷⁰ This of course assumes that money allocated to tourism development would be used effectively.

benefits to households. A comparison with regional states shows that Montenegro's wage bill as a proportion of total government expenditure and of GDP is far above average. On the other hand, capital expenditure is much below the level for other countries in the region. In particular, the high wage growth has crowded out spending on public investment and operations and maintenance—expenditures that are essential for growth. Subsidies and lending to public enterprises have been progressively reduced over the last three years, but much remains to be done to impose a full hard budget constraint on public enterprises. Combined, direct enterprise subsidies and loans to enterprises accounted for about 1.6 percent of GDP in 2004. The large, yet-to-be-privatized state-owned enterprises (e.g., KAP, EPCG) still lack hard budget constraints and budgetary discipline and therefore take resources away from other priority areas of expenditure such as capital investment in infrastructure.

3.46 A more vigorous public sector reform is fundamental to creating a budgetary space for capital investment and rationalizing the state's functions, and also reducing the role of the state in the economy. The following measures deserve priority consideration in order to ensure fiscal sustainability and macroeconomic stability, create a budgetary space for capital investment, and improve the delivery of social services.

- *Reduce/control expenditures on the wage bill, transfers to households, and interest payments*, which have risen significantly over the last three years. In particular, the high wage growth has crowded out spending on public investment and operations and maintenance—expenditures that are essential for growth. The high wage growth should be controlled through public administration reforms that would eliminate employment redundancies as well as through the controlling of wage and salary increases (see chapter 2 for other measures).
- *Eliminate/reduce subsidies and lending to public enterprises by imposing a complete hard budget constraint.* Government subsidies and net lending now account for about 1.6 percent of GDP. State-owned enterprises still lack hard budget constraints and budgetary discipline. This problem could be overcome through (i) increasing the transparency around which state-owned enterprises receive subsidies and transfers from the Government; (ii) completing the privatization of these enterprises where privatization is an option; and (iii) where privatization is not feasible, by improving the management of such enterprises and defining strict financial performance criteria that would phase-out subsidies and budget transfers.
- *Develop a sound public investment program that will support tourism development and growth.* At 2 percent of GDP, Montenegro's domestically financed capital expenditure is much below the level of other countries in the region. Capital investment in infrastructure in 2004 accounted for only about 0.4 percent of GDP. While the low numbers may indicate the need for more capital investment, in particular infrastructure investment, such a decision is best guided by two prior conditions: (i) that there is a trade-off between a public infrastructure investment program and macro stability/fiscal sustainability, and whatever investment in public infrastructure needs to be made within the broader macroeconomic and fiscal constraints; (ii) that a rigorous public investment project appraisal and screening system is put in place to rank public investment projects, and fund only those which are strongly growth-oriented and whose economic and social returns are high enough. In Montenegro, there is a need to do both a strategic assessment of what infrastructure investment may be needed, and which of the many potential infrastructure projects warrant investment based on their economic and social returns. There is no doubt that increasing capital investment, in particular in infrastructure, is necessary. The challenge would be to do this in a way that does not compromise fiscal and macroeconomic sustainability (i.e., create budgetary space), and to carefully evaluate and fund only those infrastructure investments that are strongly linked to tourism development and growth (i.e. well-targeted investments).

- *Increase the productivity of current expenditures on education and health care services.* Compared with other countries in the region, Montenegro spends more on education and health. In the health sector it is important to improve the management of public health funds, continue the reform of primary health care, including preventive programs and priority treatment programs, and improve public procurement procedures by passing new regulations. In education the disproportionate staffing costs should be reduced through school consolidation, and vocational training programs should be realigned to suit those demanded by the labor market.

3.47 Furthermore, the Government would need to strengthen institutional and budgetary processes, in terms of both controlling arrears and strengthening the link between budgets, plans and programs. The following specific steps are necessary to increase the effectiveness of the Government budget and its link with growth:

- *Prevent arrears from arising through the following:* (i) providing better and more realistic revenue projections as well as speedy expenditure decisions to be implemented by budget users in the event of revenue shortfalls; (ii) strengthening the commitment control systems at spending agencies through better staffing, the upgrading of accounting standards, and transparency.
- *Develop a serious plan to clear the current stock of arrears.* Unfortunately, the Government has not yet initiated a systematic plan to audit and clear the arrears. This plan should identify the most costly arrears and attempt to retire those first.
- *Strengthen the link between policy priorities and the budget, especially in tourism development and PRSP implementation.* There is a need to develop a comprehensive medium term expenditure framework as a basis for public expenditure planning. This should comprise the central government, the social funds, and local governments, and should reflect fully the policy commitments of the Government. The Government budget generally, and public investment particularly, should support the realization of the growth potential of tourism. The Ministry of Tourism should move toward multi-year budgeting and program implementation, with specific milestones and monitorable targets.