

4. PRIVATE AND FINANCIAL SECTOR REFORMS FOR GROWTH AND COMPETITIVENESS

4.1 The development of a competitive private sector, including a vibrant SME component, is essential for generating sustainable economic growth and employment. This chapter addresses three questions. First, in view of Montenegro's large informal private sector, it seeks to answer the question of why the informal sector is large and what the Government can do to expand the formal economy. The emphasis will be on the incentives and disincentives for operating in the informal economy, including the high burdens and the poor administrative and institutional capacity of the Government to enforce rules and operate in a transparent way. Second, the chapter will look into other key constraints that hold back private investment and growth, in both the formal and informal sectors of the economy. Consistent with the hypotheses laid out in Chapter 1, we will examine closely the extent to which enterprise restructuring, property rights and contract enforcement, bankruptcy and exit, and the cost of finance and financial intermediation constrain private sector investment and growth. Third, the chapter will identify policy priorities and suggest recommendations for private sector growth and competitiveness in Montenegro.

A. CHARACTERISTICS OF THE PRIVATE SECTOR IN MONTENEGRO

4.2 **Under the socialist system of the former Yugoslavia, socially owned industries and services generated most of the income (GDP) in the Republic.** During the socialist period, the Government made large investments in state-owned enterprises (SOEs)—notably aluminum production, steel production, ship -building and repairs and tourism—that served the captive former Yugoslav markets. With Montenegro's transition reforms, many of these socially owned enterprises have been privatized. According to the Montenegrin Privatization Council, more than 60 percent of the former socially owned or state-owned capital has been privatized. However, as of the start of 2005, controlling shares in the 17 or so largest companies still remain in the hands of the Government and social funds. Among these companies are the Aluminum Combine Podgorica (KAP) and the Power Company of Montenegro (Elektroprivreda Crne Gore), which continue to play an important role in terms of production and employment.

Table 4.1. Registered Businesses by Type, 2005

Businesses	Number
Joint Stock Companies	377
Limited Liability Companies	10,319
Limited Partnerships	627
General Partnerships	68
Entrepreneurs	13,090
Branches/affiliates of foreign companies	265
NGOs	226
Institutions	704
Other	99
Total	25,775

Source: Commercial Court Podgorica, January 2005.

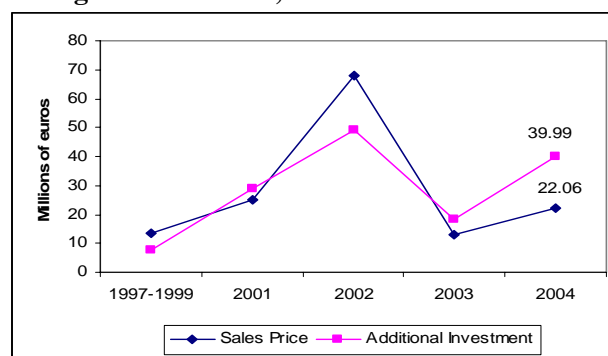
4.3 **In terms of employment, the public sector continues to dominate the Montenegrin economy.** According to the 2003 Labor Force Survey data, 59.2 percent of employment took place in the public sector (including the Government-provided public services, such as the civil service, the health and education sector, and social protection), 25.7 percent took place in private sector, and the rest was in mixed ownership. More than 64 percent of total employment is in the services sectors, and by the number

of employees, agriculture, trade and tourism-related services are the key branches in the economy (see Chapter 2).

4.4 The private sector's contributions to GDP and employment remain modest. Business registration data show that there are over 10,000 limited liability companies, over 300 joint stock companies, and over 13,000 entrepreneurs (Table 4.1). While it is very difficult to extrapolate from such data the extent of the contribution of the private sector to income and employment, most of the limited liability companies are likely to be SMEs in the private sector. In terms of employment, the emerging private sector, comprised of small firms, has not yet developed the critical mass to generate enough jobs to offset job losses in the public sector. The result has been a rise in unemployment over the last several years (see Chapter 2 for more details). Facilitating the entry of new firms and the growth of small enterprises is hence necessary to create more jobs and reduce unemployment.

4.5 Over the years, the Government's privatization program has clearly helped encourage private investment, including foreign direct investment (FDI), in Montenegro. During 1997-2004, total FDI in Montenegro amounted to 382 million euros. Of this, the largest amount was achieved through the privatization process. Over the same period, the total price of assets sold through privatization amounted to 141.4 million euros, while the new owners made a total additional investment in the amount of 144.09 million euros (see Figure 4.1). While Montenegro had the lowest total inflow of foreign investments in the region in absolute terms, FDI per capita (71 euros) remained close to the regional average.

Figure 4.1. Total FDI Achieved in Montenegro through Privatization, 1997-2004



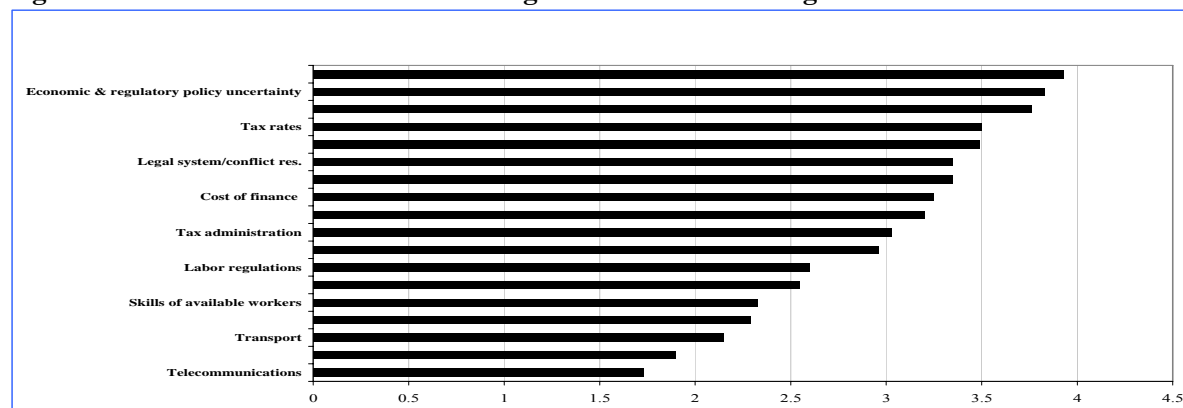
Source: Agency for Restructuring and Foreign Investments.

4.6 The privatization of Telecom Montenegro and KAP, completed as of early 2005, and the expected privatization of the remaining large strategic SOEs, mainly in the area of infrastructure and public utilities in 2006, are expected to bring further FDI inflows. Thus, in the short run the FDI inflow will depend predominantly on progress in privatization. However, in the medium to long-term, Greenfield investments in Montenegro will depend upon broader investment climate factors such as political stability, the protection of property rights, and contract enforcement (in particular, land property rights, regulations and governance) and financial intermediation and the availability of credit. These issues are discussed at length throughout the rest of this chapter.

4.7 The most highly visible feature of Montenegro's economy, however, is the large and persistent informal sector. It is estimated that the informal economy contributes about 30 percent of GDP and employs about 27 percent of the workforce (ISSP, 2004). A large number of firms (or entrepreneurs) do not participate in the formal sector because they seek to avoid taxes, and regulation and other administrative processes. Apart from purely gray economy firms, a significant number of registered enterprises under-report their business activities to avoid taxes and administrative hassles. Even formal sector enterprises try to keep their activities "blended" with informality in order to avoid the administrative and financial burdens of regulation. According to the Productivity and Investment Climate Survey of 2003 (PICS, 2003), firms in Montenegro perceived that their competitors reported on average only 70 percent of their business activities. Whether a firm is unregistered and entirely in the informal sector or is only partly outside the formal economy, it poses a threat to those firms that operate legally.

4.8 A large informal economy limits growth and competitiveness in a number of ways. First, by definition, the sector is beyond the realm of government control, and as such, does not contribute to government revenue. In turn, the sector does not receive property right protection and other services that formal sector businesses enjoy. Second, informal businesses pose an undue competition to those in the formal sector as they are not subject to tax and other government obligations. Indeed, in Montenegro a recent PICS survey shows that the uneven playing field posed by informal businesses is a major barrier to doing business (Figure 4.2). For these reasons, conversion of informal businesses into formal businesses through reforming the underlying policy, regulatory and administrative barriers affecting the former would be essential for growth.

Figure 4.2. Perceived Constraints to Doing Business in Montenegro



Source: PICS, 2003.

B. WHY IS THE INFORMAL SECTOR LARGE?

4.9 **Businesses compare the costs and benefits of operating in the formal sector against those of the informal sector to make decisions about whether to operate formally or informally.** On the one (incentives) hand, there are often regulatory and administrative costs involved in complying with formal sector government rules, including registration and licensing, level of taxes and other contributions required of formal sector businesses, and other operational costs associated with being in the formal sector. On the other hand, businesses also take into account the extent to which they can continue to operate in the informal sector without facing negative consequences for failing to comply with Government rules, and the question of whether they would face legal actions by the Government.

4.10 **According to the EBRD's Transition Report 2000, incentives for participation in the informal sector differ depending on the country's stage of reform.** In economies at a mature stage of reform (e.g., Central and Eastern European countries), the motives tend to be more "market-related" and guided by a desire to evade taxes and avoid other bureaucratic constraints. In economies at an initial stage of reform, informal activity may be driven by poor opportunities in the formal sector and could be providing a "coping strategy" for survival. In Montenegro, the key reasons for the large informal economy seem to be the high regulatory and administrative burdens on businesses on the one hand, and the poor administrative and institutional capacity and the relatively poor opportunities in the formal sector on the other.

The Regulatory and Administrative Burden

4.11 **Montenegro has recently simplified its business registration system.** Heavier regulation of

entry is generally associated with greater corruption and a larger informal economy.⁷¹ Since end-2002, Montenegro has had a much reformed new business registration system in place. A burdensome registration procedure which had involved 38 steps and 45 days was streamlined to 4 steps and 3 days.⁷² The new Company Law has lowered the minimum capital requirement for limited liability companies to 1 euro. Table 4.2 compares the indicators for starting a business in Montenegro with the region and the OECD countries. The outcome has been a reported doubling of business registrations over a period of one year, most of which have been drawn from previously unregistered businesses engaged in the gray economy. Notwithstanding other remaining regulatory and administrative deficiencies, business registration reform clearly demonstrates how the removal of the regulatory burden could help enterprises move from the informal to the formal economy.

Table 4.2. Starting a Business

Indicator	Montenegro	Regional Average	OECD Average
Number of procedures	9	9	6
Time (days)	11	42	25
Cost (% of income per capita)	NA	15.5	8.0
Min. capital (% of income per capita)	0.1	52.8	44.1

Source: World Bank, *Doing Business in 2005: Removing Obstacles to Growth*, Washington, DC, 2004; CEED using the Doing Business methodology.

4.12 Despite the simplified registration process, licensing and inspection problems remain cumbersome and slow, and deter formality and private investment. Recognizing this problem, the Government prepared the draft Law on Licensing, prescribing a faster and more efficient registration at the municipality level and listing the business activities that do not need a license. However, the simplified procedure has not yet been implemented. According to the Law on Local Self-Government, the 21 municipalities in Montenegro are responsible for urban planning, including zoning and building permits, general licensing of businesses and related permits, the provision of utility services (waste collection, water, sewerage and electricity distribution), and also various inspections. However, as a recent FIAS study shows (FIAS, *Montenegro Investment Environment Diagnostics*, 2004), business operating licenses take a long time to be issued, if they are issued at all. Licensing and inspection activities are not conducted in a fair, professional way. While visible and legal businesses are extensively inspected, there is no noticeable effort to crack down on illegal businesses that operate without a license, avoid tax and social security payments, and/or establish the business premises without building permits. Local land use plans are not adjusted to accommodate the needs of business expansion. These factors are regarded as key impediments to doing business in the regulatory jurisdiction of local governments.

4.13 Payroll taxes and social contributions are still high in Montenegro, discouraging formal sector operation. Several taxes apply to formal sector businesses in Montenegro. The most important of these are the value-added tax (at 17 percent), the corporate tax (at 9 percent)⁷³ and the personal income tax (ranging from 0 to 23 percent, with the maximum rate applied to personal income over €4,572). While these taxes are not out of line with the regional rates, and, indeed, the corporate tax rate is one of the lowest, the high payroll taxes raise the cost of labor, thereby creating incentives for hiring workers informally.

⁷¹ See Djankov S., R. La Porta, F. Lopez de Silanes and A. Schleifer. "The Regulation of Entry", *Quarterly Journal of Economics*, 117, 1-37, (2002)

⁷² CEED, 2003, "Montenegro business registration process analysis"; and, CEED "Starting a business".

⁷³ Amendments to Montenegro's Corporate Tax Law in the third quarter of 2004 decreased the corporate tax rate from the prior progressive rates of 15 and 20 percent to a proportional rate of 9 percent, one of the lowest corporate taxes in the region.

4.14 **Recent reforms have helped reduce the payroll tax and contributions burden.** Table 4.3 shows the total labor cost as a percentage of gross salary for employees and employers in recent years. In April 2003, in response to widespread avoidance and non-compliance, the Government of Montenegro reduced the overall income tax, and social contributions (pensions, health and unemployment insurance) by the employer for newly registered labor, effective for one year until May 2004. The effective rate tax wedge on labor, which takes account of tax deductions, different social contribution levels by sectors, and non-compliance, was thus reduced to about 48 percent in 2003. At the same time, fines were increased for employing unregistered labor and inspections were strengthened as part of the 2003 reforms. According to Ministry of Labor officials interviewed, the policy resulted in 14,300 new registrations by the end of June and a claimed 26,000 by the end of September.

Table 4.3. Income Taxes, Social Contributions and Other Fees and Surtaxes on Wages in Montenegro (percent of gross salary)

Contribution	Employed before April 2003	Newly employed between April 2003 and December 2004	Employed in 2004 and hired before April 2003	Employed since January 2005
1. Employees' share of contributions				
Pension-invalid insurance – PIO Fund	12.00%	12.00%	12.00%	12.00%
Health Fund	7.50%	7.50%	7.50%	7.50%
Unemployment	0.50%	0.50%	0.50%	0.50%
2. Employers' share of contributions				
Pension-invalid insurance	12.00%	0%	10.8%	9.6%
Health care	7.50%	0%	6.5%	6.0%
Unemployment	0.50%	0%	0.5%	0.5%
Compensation for use of public goods	3.00%	-	13-15% of PIT	13-15% of PIT
Housing allowance	-	-	0.7%	0.7%
Allowance for annual leave	€150.0	€150.0	€150	€150
Meal allowance	€25.0	€25.0	€25	€25
Montenegrin Chamber of Commerce	0.32%	0.32%	0.32%	0.32%
Yugoslav Chamber of Commerce	0.125%	0%	0%	0%
Alliance of Independent Trade Unions	0.20%	0.20%	0.20%	0.20%
3. Total taxes and contributions	43.6-68.6%	20.5-44.5%	39-63% plus	37 -60% plus

Source: ISSP, 2003, 2005.

4.15 **Despite the recent reforms, the labor taxes (or payroll taxes) are still perceived as too high and as one of the major factors discouraging operation in the formal sector.** There are two alternative indicators of the wage tax burden: the non-wage labor cost and the tax wedge on the labor market.⁷⁴ By our calculations, in 2004 the tax wedge—taking into consideration all the social contributions (pension, health insurance and employment contributions) as well as fees and surtaxes established according to the General Collective Agreement, the Law on Communal Taxes and Compensations and other laws—is estimated at 52 percent of the labor costs.⁷⁵ Non-wage labor costs were estimated in 2004 at 35 percent. In OECD countries, the total burden on the labor market is 51.8 percent among European member countries and 37.3 percent for non-European member countries. (ISSP Montenegro Economic Trends,

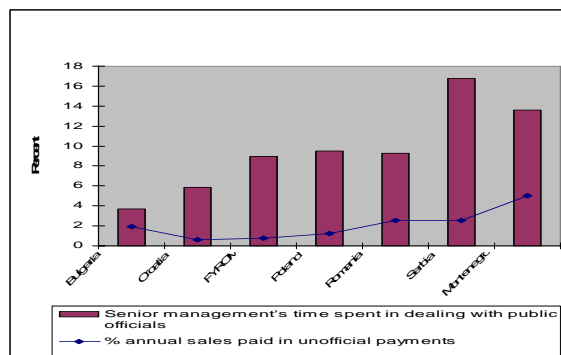
⁷⁴ Non-wage labor cost is defined as the ratio between payroll taxes and gross wages. The tax wedge on labor is a difference between the labor cost to the employer and the take home pay (net wage) expressed as a percentage of total labor cost.

⁷⁵ In 2005, this legal basis for compensation (tax) for use of goods of common interests of 3 percent of gross wages was replaced by the Law on Local Self-Government Financing which allows the municipalities to introduce a surtax of 13-15 percent of the calculated personal income tax.

2004).⁷⁶ Labor taxes lower labor demand by raising labor costs. But they also lower labor supply by reducing the real consumption wage. The high wage tax burden has contributed to lower employment, higher informalization, and higher (long-term) unemployment.

4.16 Administrative and bureaucratic costs are also high (Figure 4.3). The cost and time tax⁷⁷ of administrative processes and bureaucracy is high in Montenegro. According to PICS 2003, senior management spends an average of 13.6 percent of its time in dealing with requirements imposed by government regulations such as taxes, customs, labor regulations, licensing and registration. The PICS data also shows that the procedures for obtaining licenses, permits and certificates required for business operation in Montenegro are not sufficiently transparent, which results in corruption. Together with Serbia, Montenegro appears higher on the bribe tax. Among surveyed firms, over 5 percent of total annual sales were paid in unofficial payments in Montenegro, more than twice the regional average, excluding Serbia. Yet Montenegrin firms perceive corruption to be a less severe obstacle to their business relative to other impediments, such as the cost of finance, regulatory uncertainty, and contract enforcement and the judicial system.

Figure 4.3. Montenegro's Costs of Administrative Barriers Compared to Regional Countries



Source: PICS 2003 for Montenegro and Serbia, BEEPS II for other countries.

Governance and the Institutional Capacity to Enforce Rules

4.17 Governance and the institutional capacity to enforce rules are weak. Administrative and regulatory burdens, while providing incentives to being in the formal economy, are not the only reason for the thriving informal sector. The lack of effective and consistent application of rules by the public sector contributes equally to the problem.

4.18 The regulatory process is characterized by inconsistency in the application of rules. According to the law, public servants shall effect the issuance of permits, licenses and certificates in compliance with the law on General Administrative procedure, and a complainant is secured the right to take his case before the Administrative Court. In practice, public servants use wide discretionary powers in making decisions that affect, for example, the issuance of permits, licenses and certificates, and tax collection (FIAS, 2004). Visible and legal businesses are extensively inspected, but no noticeable effort is made to crack down on illegal businesses that operate without a license, avoid taxes and social security payments or establish a business premises without building permits. Such inconsistency provides

⁷⁶ In addition to personal income tax, PIO contribution and contribution to the Health Fund, the employees also have to pay from their wages an unemployment contribution of 0.5 percent of gross wages, the employers, in addition to PIO contribution and contribution to the Health Fund, have to pay an unemployment contribution of 0.5 percent of gross wages, a fee to the Chamber of Commerce - 0.32 percent of gross wages; fee to the Confederation of Independent Trade Unions - 0.20 percent of gross wages; payment to the housing fund for employees - 0.7 percent of gross wages; compensation for use of public goods - 3.0 percent of gross wage (replaced in 2005 by 13-15 percent of personal income tax (PIT); meal allowance of 50 percent of the minimum wage (EUR 25), and transport allowance 25 percent of the price of gasoline per km. (See Table 4.15 for details).

⁷⁷ The time that senior managers have to spend dealing with government officials and regulatory activities provides a measure of the burden (so called "time tax") that regulation places on firms.

opportunities for bribe taxes and corruption. Improvements in the quality of regulation through greater transparency and a more consistent application of rules, and an improved tax administration capacity to support rule-based tax collection, are needed.

4.19 The enforcement of rules is weak because of lack of skills and poor institutional capacity in the public sector. Although an adequate legal framework has been put in place for public administration reforms, the Government has yet to fully implement the reforms. In March 2003 the Government approved a Public Administration Reform Strategy, which sets out the key objectives of public administration reform and puts forward an ambitious structural and legislative reform agenda for the reorganization and re-orientation of the state administration. The Strategy seeks to introduce new forms of administrative accountability based on more flexible, result-oriented contractual models, including competition mechanisms in the provision of public services. It also emphasizes the principles of client-orientation and the importance of a modern information system for enhancing the efficiency and quality of public services. The Strategy divides the process of administrative reform into three main stages: the first stage, from 2003 to 2004, concentrates on the development of a legal framework; the second and third stages, from 2004 to 2006 and 2007 to 2009, are devoted to the implementation of the Strategy and the adoption of new rules and procedures. In accordance with the reform phases, a set of key public administration laws—such as the Law on the State Administration, the Law on the Ombudsman and Law on Inspection Control, the Law on Administrative Procedure and the Law on Administrative Dispute — were approved by Parliament in 2003. A further set of laws, including the Law on Civil Service and the Law on Salaries, was adopted in 2004.

4.20 Yet Montenegro is only in the beginning stages of the more difficult phase of implementing the public administration reforms. Agency heads are typically political appointees, which undermines effective administrative coordination and the continuity of skills and knowledge. The public sector is overstaffed and under-productive. Low rates of public sector pay contribute to the problem of attracting and retaining competent professionals. Whatever the underlying factors, a modern public administration system, characterized by transparent, non-discretionary processes, and efficiency--although within reach in the medium term-- is yet to be created in Montenegro. This would require the putting in place of appropriate incentive and accountability systems and significant institutional capacity building through education, training, and the application of information technology, as well as a coordinated action from a number of key players to avoid the risk of administrative fragmentation.

4.21 Further, implementation of the new laws and regulations governing the private sector requires stronger institutional and administrative capacity. In the past three or four years, Montenegro has overhauled much of its legal and regulatory framework regarding the private sector but implementation is lagging behind (see Table 4.4). It was only in 2003 and 2004 that the Parliament of Montenegro adopted 45 laws and 67 laws, respectively, out of which roughly 35 are related to the business environment or the financial sector. It is hard to find an area that is not covered by a new law or by a law being drafted, particularly in regard to the activities of business and commerce (Table 4.4). While the new laws provide an adequate legislative framework for the development of a well-functioning market economy, significant implementation gaps are emerging. Many of the new laws have not yet been fully applied by the administration, the judiciary and the municipalities. In most cases, implementation of legislation aimed at improving the business environment (contract enforcement, access to finance, corporate governance, and business exit) has not yet begun. Because of the country's history, most of the professionals do not have the experience, skills and motivation required for this kind of work. One consequence has been that new legislation is not broadly understood and is not implemented with any effectiveness.

Table 4.4. Recent Business Law Reforms in Montenegro and their Status of Implementation

Group	Business law	Legislative Status	Legislation Date	Implementation Status
Fiscal/Tax laws	Tax Administration Law	5	Enacted Dec 2001	improved
	Personal Income Tax Law	5	Enacted Dec 2001	improved
	Corporate Profit Tax Law	5	Enacted Dec 2001	improved
	Excise Tax Law	5	Enacted Dec 2001	improved
Budget/Treasury	VAT Law	5	Enacted Dec 2001	improved
	Budget Law	5	Enacted Aug 2001	improved
	Law on Assumption of Debt	5	Enacted Oct 2003	improved
	Public Debt Law	5	Enacted Feb 2004	improved
Anti-Corruption Initiative Laws	Law on State Auditing Institution		Enacted early 2004	started
	Public Procurement Law	5	Enacted Aug 2001	improved
	Anti-Corruption Practice Law	4		
	Anti-Money Laundering Law	5	Enacted Oct 2003	improved
Privatization	Law on Participation of Private Sector in Delivery Public Services	5	Enacted Jun 2002	weak
	Digital Signature Law	5	Enacted Oct 2003	not implemented
	E-commerce Law	5	Enacted Dec 2004	not implemented
	E-communications Law	0		
Business Law	Telecommunications Law	5	Enacted Dec 2000	complete
	Energy Law	5	Enacted Jun 2003	improved
	Tourism Law	5	Enacted Jun 2002	improved
	Restitution Law	5	Enacted Mar 2002	replaced (new)
	Restitution Law, New	5	Enacted Mar 2004	ongoing
	Business Organization Law	5	Enacted Jan 2002	weak
	Secured Transactions Law	5	Enacted Jul 2002	improved
	Accounting Law	5	Enacted Jan 2002	(new draft)
	Mortgage Law	5	Enacted Jul 2004	started
	Revision – Real Property Law	0		
Contract Enforcement	Anti-Monopoly Law	3		
	Unfair Competition Law	3		
	Law on Licensing	2		
	Consumers Protection Law	3		
	Law on Foreign Trade	5	Enacted Apr 2004	ongoing
	Law on Enforcement Procedure	5	Enacted May 2004	weak
	Litigation Law	5	Enacted May 2004	weak
Banking Sector	Law on Expert Witnesses	5	Enacted Dec 2004	weak
	Bankruptcy + Cross Border Insolvency Law	5	Enacted Jan 2002	weak
	Central Bank Law	5	Enacted Nov 2000	complete
	Law on Banks	5	Enacted Nov 2000	complete
Pension/Social Sector	Bank Bankruptcy and Liquidation Law	5	Enacted Oct 2001	complete
	Insurance Law	3		
	Pension Law	5	Enacted Sep 2003	ongoing
Capital Markets	Securities Law	5	Enacted Dec 2000	weak
	Securities Law Amendments	1		
	Investment Funds Law	5	Enacted Jul 2004	weak

Status: 0 in preparation; 1 draft – working group; 2 draft – general review; 3 final draft submitted to GRM; 4 in Parliament; 5 enacted.

Source: USAID; <http://www.skupstina.cg.yu/>; World Bank staff assessment.

4.22 There is lack of administrative and institutional capacity at the municipal level as well. Important decisions at the municipal level are often perceived by businesses as driven by narrowly determined special political interests. Businesses feel that municipal decisions, taken or not taken, are ad hoc and non-transparent and do not reflect an appreciation of commercial realities (FIAS, 2004).

C. WHAT OTHER CONSTRAINTS LIMIT PRIVATE SECTOR INVESTMENT AND GROWTH?

4.23 Conversion of the large informal economy to the formal economy—although a major challenge for the Government of Montenegro—is not the only factor, nor perhaps even the most important constraint, affecting private sector investment and growth. Several other constraints that cut across the formal and informal sectors would need to be alleviated.

Privatization and Enterprise Restructuring

4.24 **Enterprise privatization and restructuring are far from complete.** Though significant privatization of socially owned enterprises has been accomplished over the years (see Chapter 1 for a summary), enterprise restructuring remains far from complete, and many companies privatized through the MVP continue to face significant economic and social problems. Although 12 foreign banks and investment funds took part in the establishment of six privatization (investment) funds, the privatization funds could not function well (e.g., as mutual funds operate in the West), in part because most of the shares owned by the voucher funds had no real market. The Montenegrin MVP program corporatized medium to large SOEs of almost any quality and issued their shares in return for vouchers. Thus, the funds ended up with a portfolio full of shares that were essentially illiquid at any significant price ("junk shares"). In addition, the trade in shares of so many diffused owners has been slow at consolidation, making it difficult to find majority owners quickly. Restructuring has progressed more slowly than expected, partly because of the much diversified ownership structure, which would require time to be concentrated in the process of free trade in shares. In the meantime, the transition costs to the shareholders of the companies and to the Government have been considerable.

4.25 **Most companies privatized through the MVP lack the capital injection necessary to re-equip them with new technology, equipment and practices, and thus improve their profitability and competitiveness.** By the nature of their privatization, these companies did not have a strategic foreign investor that could bring the necessary capital and technology. Furthermore, even if with a strategic investor, under the Business Organization Law a two-thirds majority is required to effect re-capitalization, and it appears that this is creating an obstacle. Citizens, workers and investment fund shareholders appear reluctant to see their positions diluted, even if that would lead to higher profitability. There have been cases where potentially interested foreign investors have walked away in the face of this obstacle (e.g., regarding investment in a shoe factory).

4.26 **There is a lack of management and restructuring skills, even in cases where the privatized companies have been placed under new management.** With diffused ownership and lack of majority ownership, the MVP has been fairly ineffective in inducing changes in management and corporate governance. Even where the MVP has led to management changes, the new management has continued to lack expertise in restructuring and developing viable business plans. In the absence of restructuring expertise the companies have continued to perform poorly, which further undermines profitability, shareholders' values, and the private sector's ability to generate employment and growth.

4.27 **Many of the "privatized" companies continue to be saddled with the high costs of excess labor and employment.** Restructuring plans to shed excess labor remain unimplemented to date for two main reasons. The first reason is that because the "privatization funds" lacked staff and resources, which rendered them ineffective in supporting company restructuring, including the shedding of excess labor. The second reason is that, the Government agreed to fund the (social) costs of restructuring in many companies but in many cases has not yet provided the funding or severance payments needed to complete the restructuring. Anecdotal evidence suggests that only 15 out of 32 companies for which the Government promised to meet the social costs have been restructured. A relatively small number of

significantly large companies continue to face the problem of severance payments expected from the Government which have not been made available to date.⁷⁸

4.28 Lack of restructuring in many of these companies has severely curtailed the growth of the formal private sector. In the absence of new investment and technology, and faced with the problem of excess labor, and lack of good corporate governance and management skills, many enterprise managers have performed poorly. The large unstructured companies not only maintain a large excess capacity but also continue to tie labor and capital. The rates of excess capacity among Montenegrin companies, as reported by the PICS 2003 data, average a high of about 55 percent. While producing under capacity, these plants continue to occupy buildings and land located next to infrastructure (electricity, water and sewage connections) that could be better used in other productive activities. A more vigorous implementation of restructuring and of the Bankruptcy Law (see below) would permit, among other things, a faster reallocation of assets and labor toward more productive activities.

4.29 However, there is hope that this is changing, if only very slowly. Currently, shares of companies and investment units privatized through the MVP are slowly being consolidated through trades in two stock exchanges, NEX Montenegro and the Montenegro Stock Exchange. This consolidation of shares into majority ownership may lead to management changes, the completion of the restructuring plans, the introduction of new capital and technology, and better profitability and shareholders' value of these companies.

Bankruptcy and Enterprise Exit

4.30 An effective bankruptcy regime promotes efficiency and productivity in two ways. First, it supports creditors' rights and facilitates lending to firms that are going concerns. Second, the bankruptcy/liquidation regime promotes efficiency by enabling bankrupt firms to be financially or organizationally restructured, or by shutting them down and disposing of their assets if they are not viable as going concerns. An efficient insolvency regime may also allow loan prices to remain low and facilitate access to credit.

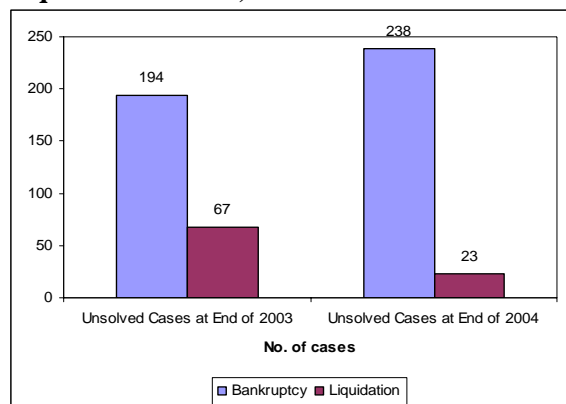
4.31 Montenegro's new Bankruptcy Law, enacted in January 2002 and effective since July 1, 2003, is not yet fully implemented. By the end of 2004, a bankruptcy procedure was initiated for 145 small enterprises, of which 85 have been completed and 60 are ongoing. The procedure therefore seems expeditious for small private companies, and lasts from 3 to 6 months.

4.32 While the new bankruptcy law⁷⁹ seems to function reasonably well for small private companies in financial distress, it has worked less well for large companies privatized through vouchers that continue to accumulate losses. Most of the unsolved bankruptcy cases as of the end of 2004 (238 cases)(Figure 4.4) are for medium and large enterprises. Of 194 bankruptcy cases started for medium and large enterprises before 2004, there are 134 still to be resolved (most of which are linked to former MVP companies). A strict interpretation of the Bankruptcy Law (Law on the Insolvency of Business Organizations), which mandates that a corporation that has been illiquid for 60 days shall enter the bankruptcy procedure, would have implied a larger number of bankruptcy cases, as there are many more illiquid companies. Furthermore, the duration of cases is much longer for medium and large enterprises, with the latter accounting for the bulk of cases lasting over one year (21 percent) (Figure 4.5).

⁷⁸ The 2005 republican budget contains no allocation for such restructuring and severance payments.

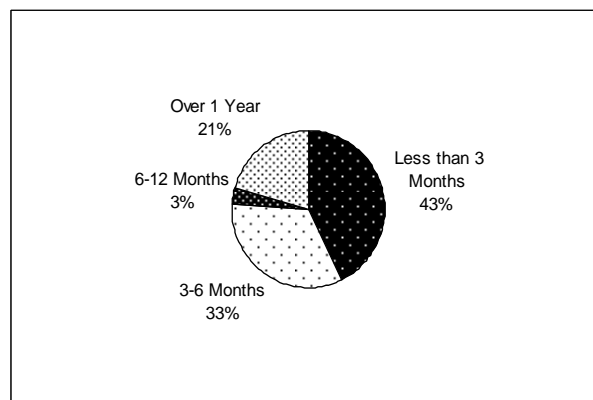
⁷⁹ A new Bankruptcy Law was enacted in January 2002 and took effect from 1 July 2003.

Figure 4.4. Unsolved Bankruptcy and Liquidation Cases , 2003–2004



Source: Commercial Court of Podgorica.

Figure 4.5. Duration of Bankruptcy Cases, 2004

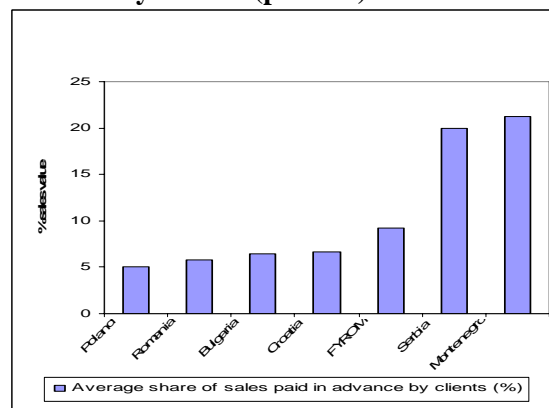


Source: Commercial Court of Podgorica.

Contract Enforcement and Property Rights

4.33 **Most businesses in Montenegro do not rely on the courts to resolve commercial disputes.** Evidence shows that firms depend extensively on informal practices and other institutions to enforce contracts and reduce uncertainty in transactions. In particular, they rely heavily on pre-payments and on building long-lasting relationships with suppliers and customers (Figure 4.6). In Montenegro, the average share of sales paid in advance by business clients is about 20 percent of the total sales value. This is not only high but is more than double the regional average, excluding Serbia.

Figure 4.6. Average Share of Sales Paid in Advance by Clients (percent)



Source: PICS and BEEPS.

4.34 **The pro-debtor bias in the system stems partly from the lack of capacity to enforce contracts in courts and from debtor provisions in key legislation.** Recently passed laws relating to contract enforcement⁸⁰ provide an improved legal framework for contract enforcement, through, among other things, shifting the burden of proof from courts to parties in dispute, setting deadlines for submitting evidence, introducing the obligation of the second instance court to reach a verdict and not to give a case back to the first instance court, etc. Nevertheless, the implementation of the new laws has been weak to date (Table 4.5).

⁸⁰ These laws include: Law on Civil Procedure or Litigation Law, Law on Enforcement Procedure, Law on Civil Lawsuit, Law on Criminal Procedure, Law on Courts, Law on Enforcement of Criminal Sanctions, Law on Executive Proceedings, Law on Assessors, and Law on Mortgage.

Table 4.5. Key Recent Contract Enforcement Legislation and Implementation Status

Law	Legislation Date	Implementation Status*
Law on Enforcement Procedure	Enacted May 2004	weak
Litigation Law	Enacted May 2004	weak
Law on Expert Witnesses	Enacted Dec 2004	weak
Bankruptcy + Cross Border Insolvency Law	Enacted Jan 2002	weak

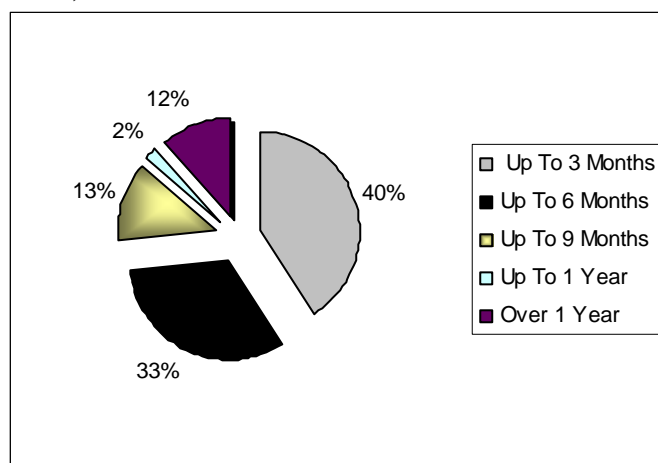
* Bank staff assessment.

Source: USAID and <http://www.skupstina.cg.yu/>

4.35 **In Montenegro, domestic and foreign investors see the poor functioning of the court system as a major impediment to doing business** (FIAS, 2004). Business people’s confidence in the independence of judges is low despite the judiciary’s formal independence. Corruption in the courts is a serious concern. Foreign investors perceive that preferential treatment is generally given to domestic investors in the courts. Investors hope that the new Law on Courts, which provides new procedures for judicial appointment, will create a pool of more independent judges capable of acting with greater independence and integrity. Also, many judges, particularly at the lower court level, appear to have difficulties in keeping abreast of the rapid rate of legislative changes and the associated new concepts being introduced in the transition to a market economy.

4.36 **The courts are too slow: it can take a year from the submission of a claim to the handing down of a judgment.** Enforcement of a title can take another 6 to 12 months (FIAS, 2004). Resorting to an appeals court could take a further 12 months. Overall, about 40 percent of the commercial court cases are resolved within less than 3 months; 33 percent take up to 6 months; and about 28 percent of the cases take longer than 6 months (Figure 4.7). The average duration is too long, with about 60 percent of cases taking longer than six months to resolve.

Figure 4.7. Estimated Duration of Commercial Cases, 2004



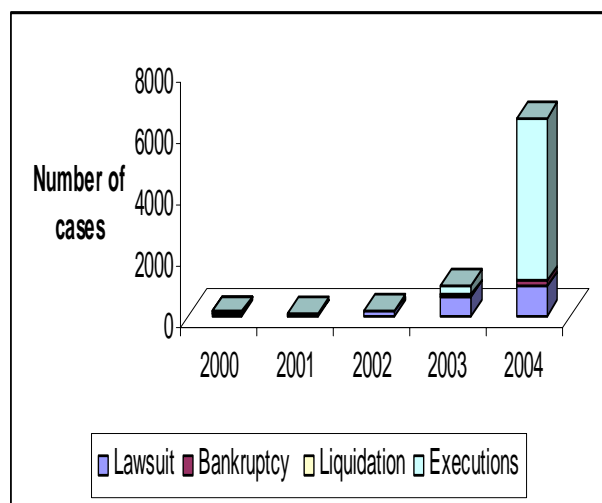
Source: Commercial Court of Podgorica.

4.37 **Yet, the courts’ performance has recently improved, in particular during 2004** (Figure 4.8). The introduction of new legislation coupled with accelerated enforcement procedures, has helped to reduce somewhat the backlog, especially of lawsuit and execution cases in 2004. While this reduction in the backlog of commercial cases is encouraging, commercial courts as well as courts in general are still overloaded with inactive or abandoned cases (Figure 4.9).

4.38 **To further reduce the backlog of commercial cases and to speed up contract enforcement, several institutional bottlenecks would need to be removed.** First, the Montenegrin judiciary has been under resources and personnel pressure for an extensive period of time, and this would need to be reversed. Second, the system lacks qualified judges, partly because the pay is low. Without qualified and independent judges it is difficult to win public confidence in the courts. Finally, there is a strong need for court personnel to be trained, evaluated and compensated adequately, and for the court system’s infrastructure to be upgraded, including the implementation of a strong Judicial Information System.

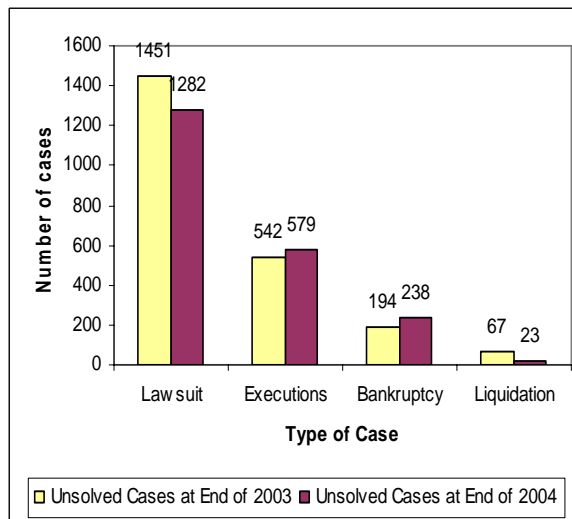
4.39 **With regard to property rights, land seems to be a key area in which further improvements are needed.** The lack of secure land property ownership is regarded as a significant problem for investors in Montenegro (FIAS, 2004). Montenegro's lack of good property rights over land arises from absence of good and readily available land titles information. Although land titles registration is computerized and not overly time consuming or costly, the Cadastral Office does not have adequate, reliable land information. This lack of transparency and discretionary public access to information makes land title transfers risky for investors, and complicates the planning and approval activities of municipalities.

Figure 4.8. Commercial Court Cases Solved, 2000-2004



Source: Commercial Court of Podgorica.

Figure 4.9. Unsolved Court Cases, End of 2003 and 2004



Source: Commercial Court of Podgorica.

4.40 **Uncertain property rights in Montenegro would be reduced considerably if the land title information was made available** by the Cadastral Office, and if it was required that land titles be accompanied by a certified site survey and pegging. In most developed countries, every parcel of land and every building is represented in a property document that can be used as collateral for credit. The single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur's house. In this way, life is injected into assets and they generate capital.

Financial Intermediation and the Cost of Finance

4.41 **Empirical evidence shows that the private sector obtains less external financing, especially less term financing, in countries with weak legal and financial systems.**⁸¹ The ability to finance activities through the sale of equity on the capital markets will not become available to firms until the institutions supporting such a system are adequately developed. In the absence of such finance, firms are forced to rely mostly on internal funds and retained earnings. This also means that financial sector reforms must extend beyond legislative reforms or bank restructuring and privatization, to the building of institutions that underlie firm transparency and accountability. In addition, the small size of the Montenegrin market poses a significant obstacle for the development of a well-functioning financial and banking sector.

⁸¹ Laporta, R., et al, (1998); Demirgüç-Kunt, A. and V. Maksimovic, (1999), Demirgüç-Kunt, A. and V. Maksimovic, (1998), Pagano, M (1993).

4.42 **In the past four years the Montenegrin authorities have taken steps to improve the functioning of the financial sector**, including privatizing state-owned banks and permitting the entry of foreign banks.⁸² While these measures have helped improve the performance of the financial sector, privatization and restructuring alone will have limited effects on the competitiveness of the banking sector because of the small size of the market. A process of further financial integration, in addition to having a positive effect on the development of the national financial market, could help attract intermediaries from the more developed markets and enhance the access of Montenegrin firms to financial markets, cross-border loans, and other financial services to the Montenegrin firms.

Table 4.6. Structure of the Banking System, End-2004

	State-owned Banks	Foreign-owned Banks	Local Private	Total
Number of banks	2	3	5	10
Total Assets (million euros)	72.8	137.8	233.8	444.4
<i>Share in Total</i>	<i>16%</i>	<i>31%</i>	<i>53%</i>	
Total Capital (million euros)	21.5	29.2	40.0	90.8
<i>Share in Total</i>	<i>24%</i>	<i>32%</i>	<i>44%</i>	
Total Funds-mobilized (million euros)	44.5	63.6	165.1	273.2
<i>Share in Total</i>	<i>16%</i>	<i>23%</i>	<i>60%</i>	

Source: Central Bank of Montenegro (2005).

4.43 **As of end-2004 Montenegro's banking system was comprised of ten banks, with 444 million euros in total assets** (about 29.1 percent of GDP)(Table 4.6). The total banking system assets increased by 95 million euros or about 27 percent in 2004. Similar to that of other transition countries, the financial system is centered on banks with the share of bank assets over total assets held by financial institutions (banks, insurance companies, pension funds, securities firms, investment funds, etc.) of over 90 percent.⁸³ The Government holds a majority interest in two banks and a direct or indirect minority ownership in five additional banks (about one-quarter of the capital is state owned). There is no apparent shortage of banks (compared to the other countries in the region, Montenegro leads in terms of banks per 100,000 inhabitants – 1.6), but the cautious entry of foreign banks into the Montenegrin market has thus far produced only limited gains: competition has increased slightly and some new products and services have been introduced.

4.44 **Nevertheless, confidence has begun to return to the Montenegrin banking system recently.** Progress in bank restructuring and the expansion in the market share of foreign-owned banks have provided confidence in the banking sector. In 2004, loan-loss provisioning grew by 43 percent. Montenegro's overall ratio of loan-loss provisions to non-performing loans (NPLs) now stands at 65 percent, in line with some better performing neighboring countries.⁸⁴ Reflecting the increasing confidence in the banking sector, total deposits increased by 29.5 percent in 2004 (reaching 273 million euros as of end-2004). The growth in deposits helped to produce the rapid increase in lending by commercial banks to private companies and natural persons (Figures 4.10 and 4.11). The credit growth appears to be linked

⁸² Other reforms in the financial sector included the establishment of the Central Bank and introduction of the euro as a legal tender, transfer of the clearing house functions to commercial banks and several legislative changes.

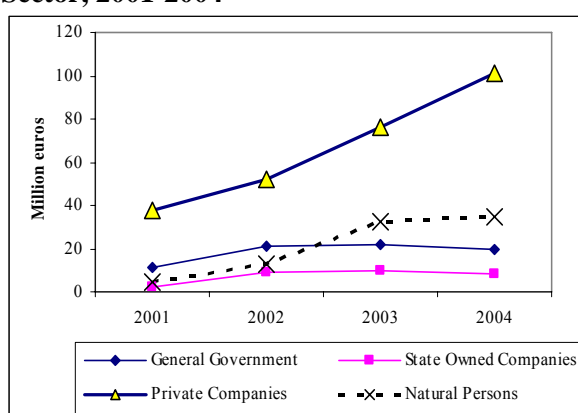
⁸³ In most CEE and SEE countries the share of bank assets over total assets held by financial institutions (banks, insurance companies, pension funds, securities firms, investment funds, leasing companies) exceeds 85 percent.

⁸⁴ However, as witnessed by the recent problems with Hipotekarna Banka, where significant roll-over of non-performing loans almost led to a bank run, further loan provisions are likely to be necessary as these new loans to private sector mature and some portion becomes delinquent.

to firms that generate high profits or to enterprises that have high revenue from partly informal operations.

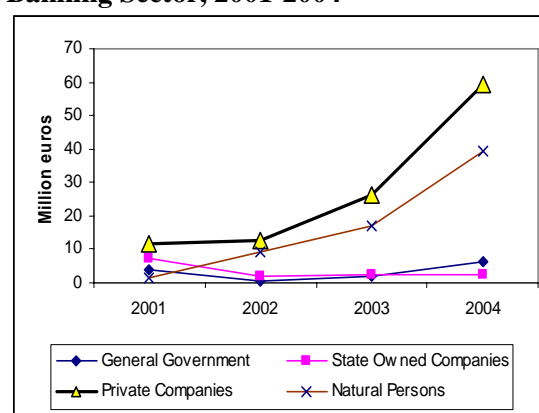
4.45 **However, total credits from banks to the private sector amount to only 11 percent of GDP.** This is quite low compared to the regional countries (42.3 percent in Bosnia and Herzegovina, 26.6 percent in Bulgaria, 57.3 percent in Croatia, and 42.7 percent in Hungary),⁸⁵ although credits to the private sector started to rise from fairly low levels in 2004. The ratio of domestic credit to GDP, however, is only a rough indicator of financial intermediation, not least because credit may include non-performing loans from the past. Directed loans to state and socially owned enterprises or firms that were privatized through voucher privatization may not be declared fully as non-performing even though many of these are overdue and are being rolled over.

Figure 4.10. Short-term Loans by the Banking Sector, 2001-2004



Source: Central Bank of Montenegro.

Figure 4.11. Long-term Loans by the Banking Sector, 2001-2004



Source: Central Bank of Montenegro.

4.46 **Interest rates remain high though spreads vary widely among banks in the Montenegrin banking system.** High interest rates, ranging between 11 and 20 percent, decrease the number of bankable projects with a suitable risk-return profile. Because of the high cost of capital, there is a high degree of dependence on internally generated cash flows among firms. Lack of access to credit limits businesses to using only their own funds, retained earnings, or money borrowed from friends and family and removes an important motive for businesses to formalize—thus contributing to the persistence of the informal economy.⁸⁶ The aggregate interest spread was about 7.6 percent in 2004 (down from 9.6 percent in 2003). The wide variability of interest rates within the system relates to the weak framework for creditor protection and contract enforcement, the high country risk, and low competition in the banking sector. It also partly reflects the different features and strategies of individual banks and their credit assessment skills and operational (in)efficiencies. The variability of interest rates does suggest that some competition exists and that interest rates are likely to be driven further downwards through greater competition.

⁸⁵ The data as of end-2002.

⁸⁶ The PICS survey indicates that dependence on retained earnings was well over 80 percent. While it is not unusual – even in developed economies -- for retained earnings to constitute a major source of enterprise finance, the absolute level in Montenegro was substantially higher than the corresponding figures in Croatia (52 percent), Hungary (63 percent), Bulgaria (66 percent), Poland (68 percent), the Slovak Republic (69 percent) and Romania (70 percent) and slightly higher than Serbia (85 percent).

Why Is the Cost of Capital High?

4.47 Among the main reasons for the high cost of capital are the following: the relatively large Treasury bills market, caused by the large domestic financing needs of the Government; the high risks and low creditor protection; the high overhead costs associated with small-scale operations; and the small size of the market and low competition among the banks.

4.48 **First, the Treasury bills market is relatively large and crowds out private sector credit.** The size and structure of the Treasury bills market is shown in Table 4.7. This market, measured by the amount of Treasury bills issued and sold, grew significantly in 2004. Indeed, only in 2004, the Treasury bills market grew by 117.8 million euros. The reasons for such large growth are increased budget expenditure in July and August of 2004 owing to the payment of the old foreign currency savings, and poorer collection of revenues. Only a slight reduction of interest rates was observed on all types of governmental bills.

4.49 **The demand for Treasury bills by banks significantly exceeds the level that the banks allocate to Treasury bills as part of the mandatory reserve funds with the Central Bank of Montenegro.** During 2004, the banks of Montenegro allocated on average some 6.5 million euros in obligatory reserve funds in the form of Treasury bills (both 28-day and 56-day bills), while the amount purchased of Treasury bills alone ranged between 10 and 15 million euros per auction. The demand by banks for Treasury bills is high because of the high interest rates and relatively low risk, although their liquidity is exceptionally poor (i.e., there is no possibility of converting Treasury bills into cash before the maturity date). The high demand by banks for these bills also continued because of the lack of quality alternative opportunities for the marketing of free financial resources. As a result, the amounts due from the previous issuances were mainly reinvested (that is, interests were capitalized).

4.50 **Second, banks face high risks in Montenegro as the institutional arrangements for collateral and creditors' rights are underdeveloped.** In deciding whether to extend credit and at what interest rates, lenders need to know what share of debt they can recover if the borrower defaults. The value of collateral depends largely on the ease of creating and enforcing security agreements, and in Montenegro this appears to be somewhat problematic. The reasons include weak institutional arrangements for valuing and enforcing collateral (especially mortgages) and lack of information on the credit history of the client. Since practically all lending to enterprises in Montenegro is backed by collateral, legislation that would facilitate the use of collateral is particularly important. However, the amount of collateral requested by banks varies widely, depending on the risk assessment of the client. It sometimes exceeds 200 percent of the loan principal.⁸⁷ While the Government has recognized the existing weaknesses and has made efforts to reform the legal framework and create the necessary institutions (e.g., the Secured Transactions Registry),⁸⁸ the risks that creditors face are high for a variety of reasons.

⁸⁷ The PICS survey reports that in almost all cases creditors required collateral or deposits for the credits (PICS average for 2003 was 135 percent). However, due to the very high number of missing values, this could be used just as a rough indicator.

⁸⁸ The Registry is situated at the Commercial Court in Podgorica. Registration takes place either directly on-line for registered users (currently limited to lawyers who are members of the Montenegrin Bar Association and commercial banks) or by submitting an application form in person or by fax to the registrar in Podgorica.

Table 4.7. The Size and Structure of the Treasury Bills Market, 2003-2004 ('000 euros)

	2003				2004			
	Issued	Sold	% sold	Interest rate (annual %)	Issued	Sold	% sold	Interest rate (annual %)
28-Day T Bill	108,500.0	100,709.5	92.8	10.0	179,800.0	174,633.5	97.1	10.1
56-Day T Bill	48,500.0	37,512.5	77.6	10.1	60,200.0	53,827.0	89.5	10.0
91-Day T Bill	--	--	--	--	43,100.0	20,100.0	46.6	9.1
182-Day T Bill	--	--	--	--	9,500.0	7,500.0	78.9	10.0
Total	157,000.0	138,222.0	85.2	10.1	292,600.0	256,060.5	78.0	9.8

Source: Central Bank of Montenegro.

4.51 **There is no central system or register for credit records in Montenegro.** Credit information registries and credit bureaus can serve as key institutions in improving access to finance and reducing creditor risk, but Montenegro has no such institutions (Table 4.7). Businesses are not able to obtain reliable data on the creditworthiness of a potential customer and depend therefore on their own judgment and on information obtained through other informal channels. An effective, broad-based credit information registry, with a full scope of credit information, is critically important for developing the means to control and price credit risk, thus making possible reduced screening costs of loan applicants, lowered risk, and increased repayment rates.

4.52 **Until recently, mortgages or real estate could not be effectively used as instruments for creditor protection in Montenegro.** There were many practical difficulties involved in the realization of mortgage rights in the banking sector under the old mortgage regulations. The main problem was that the creditor could realize the mortgage only after the credit term had passed. However, this was too risky for creditors and generally led to lower credit and higher interest rates. In view of these problems, the Government of Montenegro adopted the *Law on Mortgage* in July 2004. Under the new Law, creditors are granted more legal protection through mortgage.⁸⁹ However, as its implementation has just begun, the full impact of this Law remains to be seen. Given the size of the market and, the potentially low demand, the impact of the improved mortgage system may still be limited.

Table 4.8. Credit Information Sharing and the Cost of Creating Collateral

Indicator	Montenegro	Regional Average	OECD Average
Cost of creating collateral (% of income per capita)	2.47-5.75	7.7	5.2
Credit Information Index	0	2.0	5.0
Public credit registry coverage (borrowers per 1,000 adults)	0	6.3	76.2
Private bureau coverage (borrowers per 1,000 adults)	0	46.7	577.2

Source: Doing Business World Bank and CEED for Montenegro.

4.53 **Informal operations limit the ability of banks to assess real income and to lend.** Enterprises generate significant revenues from partly informal operations (e.g., cash payments on top of official salaries are common). In many cases tax evasion is the main source of financing investments. Although

⁸⁹ A list of all subscribed mortgages is to be collected and published on the website of the Agency for Real Estate within one year of the passage of the Law, which should facilitate notification of third persons on subscribed mortgages.

banks in Montenegro use various strategies to deal with customers in the informal sector operations,⁹⁰ the formalization of firms and the growth of the formal economy would improve the ability of the bank to provide good quality credit risk.

4.54 Third, banks' operational costs are high and competition is low because of the small size of the market. Operating expenses at the aggregate level are high and amounted to 25.5 million euros in 2003. In 2004 overhead expenses increased to 32.7 million euros, a growth of 28.4 percent in just one year. Operating expenses represent between 5 and 8 percent of average assets and increased in 2004. Overhead expenses to core earnings (net interest and fee income) amounted to 75.5 percent in 2004, up from 73.4 percent in 2003.

4.55 Finally, the small size of the economy limits economies of scale and competition. One way of increasing the competition is to have foreign banks establish their affiliates. According to the Law on Banking the affiliates of foreign banks are required to have a minimum capital of 5 million euros. Given the small size of the market, it is questionable whether such a high level of capitalization should be required. Nevertheless, this issue should be considered once the current bank privatization and restructuring plans are completed. More important, the development of leasing industries may be better suited to the small market of Montenegro. Leasing may be a superior option to secured lending in a system with weak creditors' rights and a small size. The passage of the Leasing Law laid the foundation for more rapid development of the leasing industry in Montenegro. At the moment there are four leasing institutions operating in Montenegro, three of which are banks. The potential demand for leasing services is large, and all of the leasing companies planned to expand their businesses in 2004. Through this system, many SMEs should benefit from the increasing competition and the availability of new leasing products.

D. CONCLUSIONS AND POLICY RECOMMENDATIONS

4.56 Montenegro's high unemployment and low growth are in large measure a reflection of a business environment which is not conducive to investment and job creation. Montenegro's emerging private sector, comprised of small firms, has not yet developed the critical mass to generate enough jobs to offset job losses in the public sector. Facilitating the entry of new firms and the growth of small enterprises is, hence, necessary to create more jobs and increase growth and competitiveness. Government policies that would help increase private investment and the growth of small enterprises hold the key to higher employment, growth and competitiveness in the medium term.

4.57 The most highly visible feature of the Montenegrin economy is the large and persistent informal sector, which contributes about 30 percent of GDP and employs about 27 percent of the workforce (ISSP, 2003). The presence of a large informal sector is a symptom of a high regulatory burden and a poor public administration as well as poor opportunities in the formal sector. While Montenegro has simplified its business registration system considerable since end-2002 (a burdensome registration procedure which had involved 38 steps and 45 days was streamlined to 4 steps and 3 days, and a minimum capital requirement of 1 euro) other regulatory and institutional barriers continue to hinder the formalization of small businesses. The following measures deserve priority consideration to increase the formalization of small businesses:

- *Simplify and speed up the issuance of business licenses and inspections.* The 21 municipalities in Montenegro are responsible for the licensing of businesses and related permits, and zoning and

⁹⁰ One bank even indicated that they take into account the unreported income, as otherwise they would not be able to lend.

building permits, and in general the provision of utility services (waste collection, water, sewerage and electricity distribution), as well as various inspections. However, business operating licenses take a long time to issue, and licensing and inspection activities are not conducted in a fair and transparent way (FIAS, 2004). While visible and legal businesses are extensively inspected, there is no noticeable effort to crack down on illegal businesses that operate without a license, avoid tax and social security payments, or establish business premises without building permits. A draft Law on Licensing, prescribing a faster and more efficient registration and listing of business activities, should be implemented as quickly as possible.

- *Reduce the high rates of labor taxation to encourage formal employment.* Recent reforms have helped reduce the payroll tax and contributions burden. Yet the labor taxes (or payroll taxes) are still perceived as too high and as among the highest in the region. Montenegro's tax wedge, one of the most important indicators of tax burden (defined as the difference between the labor cost to the employer and the take home pay [net wage] expressed as a percentage of total labor cost) stood at about 52 percent of the labor costs in 2004, while the comparative burden for the regional non-European member countries was 37.3 percent of total labor cost. A further phased and well-planned reduction in payroll taxes (compensated by equivalent increases in other taxes, and with adjustments to compensate for the resulting lost income of the social funds) could be considered as soon as offsetting fiscal measures have been identified. To decrease such high rates in a fiscally responsible way, reforms of in the health and pension systems need to be pursued to make the systems more efficient and sustainable. In particular, a review of early retirement, disability, maternity leave and sickness benefit policies should be part of the reform agenda with the aim of tightening the eligibility criteria and eliminating the widespread abuse of the system.
- *Improve governance and consistency in the application of rules.* A modern public administration system, characterized by transparent, non-discretionary processes, and efficiency is yet to be created in Montenegro. This would require the putting in place of appropriate incentive and accountability systems and significant institutional capacity building through education, training, and the application of information technology. The presence of high discretionary power often creates an opportunity for corruption. Improvements in the quality of regulation through greater transparency, and a more consistent application of rules, including an improved tax administration capacity to support rule-based tax collection, are essential.

13. **Enterprise privatization and restructuring are not complete.** Many companies that were privatized through the mass voucher privatization (MVP) program still lack strategic investors to re-equip them with new technology and improve their profitability and competitiveness. They also continue to be saddled by the high costs of excess labor and employment. There is thus an urgent need to:

- *Speed up the restructuring of the mass-voucher- privatized companies* by: (i) making budgetary allocations toward covering the social costs of restructuring—including severance payments for shedding off excess labor—for those companies in respect of which the Government agreed to fund such costs; (ii) strictly enforcing the new bankruptcy law for medium and large enterprises privatized through vouchers, that have continued to accumulate losses; and, (iii) strengthening the capacity of courts to deal with such bankruptcy cases.
- *Speed up the consolidation into majority shares of the companies' shares being traded on stock exchanges.* With diffused ownership and lack of majority ownership, the MVP has been fairly ineffective in inducing changes in management and corporate governance. Even where the MVP has led to management changes, the new management has continued to lack expertise in restructuring and developing viable business plans. Currently, shares of companies and investment units privatized through the MVP are slowly being consolidated through trades in

stock exchanges. However, the speeding up of the consolidation of shares into majority ownership is needed to bring about management changes, good corporate governance, completion of the restructuring plans, and the introduction of new capital and technology to generate better profitability and shareholders' value, and employment.

4.58 The implementation of recently enacted business laws and regulations is lagging. In the past three or four years Montenegro has overhauled much of its legal and regulatory framework as regards the private sector, but implementation is lagging. It was only in 2003 and 2004 that the Parliament adopted 45 laws and 67 laws, respectively, out of which roughly 35 are business environment or financial sector laws. While the new laws provide an adequate legislative framework for the development of a well-functioning market economy, significant implementation gaps are emerging. The implementation of legislation aimed at improving the business environment—contract enforcement, access to finance, corporate governance, and business exit—has not yet begun in most cases. Speeding up the implementation of these laws will be critical to private sector investment and growth.

4.59 Contract enforcement and property rights are weak. Investors see the poor functioning of the court system as a major impediment to doing business (FIAS, 2004). The courts are too slow: it can take a year from the submission of a claim to the handing down of a judgment. Enforcement of a title can take another 6 to 12 months. Resorting to an appeals court could take a further 12 months. Overall, about 40 percent of the commercial court cases are resolved within less than 3 months; 33 percent take up to 6 months; and about 28 percent take longer than 6 months. Speeding up the resolution of cases that take longer than six months (which frequently include bankruptcy and liquidation cases) is urgent. As for property rights, land title registration is computerized and not overly time consuming or costly, the Cadastral Office does not have adequate, reliable land information. The lack of transparency and discretionary public access to land information makes land title transfers risky for investors, and complicates the planning and approval activities of municipalities. The specific measures that the Government can undertake to improve contract enforcement and property rights are the following:

- *Reduce the backlog of commercial court cases and speed up contract enforcement* through: (i) easing the resources and personnel constraints in the Montenegrin judiciary; (ii) ensuring that qualified judges are put in place, with better compensation; (iii) training court personnel; and (iv) upgrading the court system's infrastructure, including the computerization of case management.
- *Improve land title transparency and control illegal construction.* Lack of transparency on land titles and registration represents one of the greatest threats to the future prospects of Montenegro's tourism industry, particularly in the few remaining high-potential tourism sites (e.g., Ulcinj, and inland areas close to national parks and other natural attractions). The Government needs to vigorously enforce land property rights and control illegal construction.

4.60 The cost of capital is high and financial intermediation is low. Total credits from banks to the private sector amount to only 11 percent of GDP in Montenegro. This is quite low compared to the regional countries (42.3 percent in Bosnia and Herzegovina, 26.6 percent in Bulgaria, 57.3 percent in Croatia, and 42.7 percent in Hungary), though credits to the private sector have started to rise from fairly low levels in 2004. Interest rates as well as spreads remain high: the real interest rate has ranged between 11 and 20 percent in recent years. The aggregate interest spread was about 7.6 percent in 2004 (down from 9.6 percent in 2003). Given Montenegro's limited opportunities in Greenfield investments, most investors would be hard pressed to find a project whose real rate of return would exceed 11-20 percent. The high cost of capital and the wide variability of interest rates within the system relate to the weak framework for creditor protection and contract enforcement, the high country risk, and the low competition in the banking sector. Specific measures that the Government can undertake to reduce the cost of borrowing and improve financial intermediation are the following:

- *Reduce the need for Treasury bill financing through a tight fiscal policy.* This would help reduce the budgetary burden of interest payments on Treasury bills and would create the conditions for the lower cost of capital in the economy by reducing the crowding-out of Government.
- *Establish an effective, broad-based institution, with full credit information* on all borrowers, to address the problem of asymmetric information in credit markets.
- *Introduce more competition into the banking sector* through the completion of the privatization of government-owned banks (in particular Podgoricka Banka), and by promoting leasing operations in view of the small size of the Montenegrin market.