“You can’t always get what you want
But if you try sometimes you might find
You get what you need”

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

EXECUTIVE SUMMARY

The Macroeconomic Context

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

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

- **With a coastline of less than 300 kilometers, the supply of beachfront property is—*per definitionem*—finite**. This implies that purchases of Montenegrin-owned coastal real estate by non-residents (which represented more than one-half of total FDI in 2006 and 2007) cannot be maintained at current levels and will dissipate as a source of capital inflows.
- **Domestic banks will not be able to lend to the private sector as aggressively as they did during the immediate post-independence period.** Credit to the economy had grown at unprecedented rates and, in 2007, considerably faster than deposits, necessitating increased foreign borrowing by domestic banks. Because of the financial institutions’ rapidly increasing degree of external indebtedness, Standard & Poor’s rated Montenegro’s banking sector as the riskiest in the region. With the stock of external bank debt exceeding 20 percent of GDP at end-2007, and further increasing to 25 percent in mid-2008, the rating agency’s critical assessment, made in early August 2008, will make foreign banks more careful to extend

further credits to Montenegrin banks, especially in light of an economy that is starting to lose its growth momentum. As observed by other countries, once the economy has moved onto the downward-sloping portion of the business cycle, banks will find it increasingly more difficult to borrow externally to be able to lend domestically. Because of the fallout from the international financial crisis, this development could occur considerably more abruptly than currently foreseen, as liquidity in foreign markets tightens and banks become increasingly more risk averse. For endogenous reasons as well, the need for domestic banks to demand foreign loans will decline, largely because of the maturing of Montenegro's business cycle, which will be accompanied by a decrease in the demand for private-sector credits. In any case, banks have been precluded from increasing credits at rates comparable the immediate post-independence period, as the Central Bank of Montenegro (CBCG) adopted measures in late 2007 that aimed at strengthening prudential ratios, in the context of which policy the monetary authority defined quantitative credit limits in function of the respective banks' stock of outstanding credit. Thus, for both supply- and demand-side reasons, banks will find that they will neither need nor be able to borrow from banks abroad.

Resultant Fiscal-Policy Challenges

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

- **Montenegro's "competitive" tax regime adds an element of pro-cyclicality, obliging Government to increasingly rely on imports as a source of fiscal revenue.** Like many other countries in Southeastern Europe, Montenegro has been aggressively reducing its direct tax rates, having introduced a 9-percent flat tax for corporate income (the personal income tax rate will have been reduced to the same level in 2010). Concomitantly, Government eliminated capital gains taxation and kept social contributions at a minimum (rates are foreseen to be lowered even further). In terms of enhancing the relative attractiveness of Montenegro as site for (foreign) direct investment, this has been very beneficial. However, the flat tax has removed automatic stabilizers from the tax system, amplifying elements of pro-cyclicality. The low income tax rates, in particular, have made the budget more susceptible to external demand shocks and increased its reliance on imports as a source of fiscal revenue. This is especially significant as lower capital inflows from the unsustainable sources mentioned above will lead to an almost corresponding reduction in imports and, in turn, considerably lower tax revenues than during the boom period. Subsequently, Montenegro's policymakers will need to base decisions on permanent spending obligations, including those on the wage bill, on its "structural" tax base—that is, on tax revenues net of influences from temporary and unsustainable external demand stimuli.

- **A large-scale public investment program is being designed with a view to crowding in private investment and increasing the economy's growth potential.** Following the transition towards a functioning market economy, the demands on public infrastructure—weakened by decades of neglect—have increased considerably. Supply constraints have become increasingly evident and, in the absence of further investments, are threatening to asphyxiate the growth momentum. These supply constraints are particularly evident in (i) the energy sector, as evidenced in the growing energy deficit; (ii) the transport sector, with increasing traffic jams (during the peak season) and a very high incidence of accidents; (iii)

the water sector, including waste water, affecting principal tourist areas during the summer months; and (iv) sanitary solid-waste deposits, resulting in wild dumps, a spoiled tourism experience, and—ultimately—increased public health risks for Montenegrins. Of these, the former two investments are particularly expensive. As Montenegro aims at developing a high-end tourism sector, it is critical that the necessary investments—within the available fiscal envelope—are made to quickly eliminate these growth-retarding bottlenecks. Moreover, insufficient maintenance has led to an accelerating rate of capital depreciation, and Government has recognized the need to reverse this trend.

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

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

- **Fiscal policy stays within the constraints of the Stability and Growth Pact,** a direct consequence of the unilateral euroization decision made in 1999. As Montenegro seeks to join the EU and eventually formalize the use of the euro as the country's legal tender, policymakers are bound—implicitly, at least—by the fiscal-policy constraints as defined by the Stability and Growth Pact (SGP). These were adopted in 1997 to maintain the Economic and Monetary Union (EMU), aimed at achieving a balanced budget over the span of a business cycle. For any given fiscal year, these fiscal criteria limit (i) the overall budget deficit of general government to 3 percent of GDP; and (ii) public debt to 60 percent of GDP. Given Montenegro's end-2007 debt-to-GDP ratio of about one-half the SGP limit, committing to the deficit criterion implies that—under moderately pessimistic assumptions of nominal growth rates and budget deficits—the debt-to-GDP ratio should not increase beyond the current level. Since 2004, fiscal policies have remained consistently within SGP limits. In a worst-case scenario, with the aforementioned unsustainable external capital inflows dissipating abruptly, Government will have to curtail public investments as well to stay within the limits spelt out in the SGP.
- **Tax revenues (net of those derived from temporary factors) finance current expenditure,** implying that Government can only borrow to finance investments. This

"modified golden rule" should help to prevent policymakers from committing to recurrent expenditures during boom periods that it cannot be maintain during economic downturns. A similar rule—applied permanently—constrains fiscal policies in many other European countries, facilitating a more medium-term approach to the design of fiscal policies and supporting governments to achieve both macroeconomic stabilization and public investment objectives. Fiscal policies since 2005 have been consistent with this principle, as general government posted a (gradually increasing) *current* structural surplus as budgetary revenues net of temporary factors exceeded public spending net of capital expenditures.

- **The ratio of recurrent expenditure to GDP declines gradually**. In this document, for illustrative purposes, the related benchmark keeps recurrent spending constant in real terms, at least during the implementation phase of the aforementioned priority investments. Given existing pressures for increased expenditure on the wage bill and on goods and services, this principle appears to be the most difficult to attain (and maintain). In 2006 and, more tangibly, in 2007, the ratio of recurrent expenditure to GDP has increased, and it will do so again in 2008. As a result, with more binding budget constraints for recurrent expenditure, Government will have to raise the effectiveness and efficiency of related spending, which should help to achieve the delicate balance between increased demands on the public sector (EU integration and decentralization) and gradually tighter budgets for recurrent expenditure.

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

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

Public Investment Priorities

8. **In the energy sector, major investments are required to ensure both a sufficient availability of reasonably priced energy and a sustainable financial position of the power utility.** Reflecting decades of negligence, the recently adopted energy strategy foresees investments of about €1.8 billion (more than 70 percent of 2007 GDP) until 2025 are very high. But the *status quo* is not an option either. Since 2002, the power utility (EPCG) has reported annual losses of about 1 percent of GDP. New investments have been very limited and its assets have deteriorated due to a lack of maintenance and

replacements. To improve its physical and financial conditions, EPCG is launching a major investment program, while seeking to address its fragile financial position. Both objectives are interlinked, as an improvement in EPCG's financial situation can only be achieved if the power utility is able to (i) maintain electricity production from local generation plants; (ii) improve its collections; and (iii) reduce its losses. Increasing energy-generation capacities presuppose the diversification of energy sources and active private-sector participation. To this end, Government has adopted a long-term energy-sector development strategy, specifying new investments, with private-sector participation, in generation capacity, including a second thermal power plant, new hydro power plants, and the development of wind and solar power plants. Among various financing options, and given existing investors' interest, Government might want to consider the full privatization of the power utility (also in light of competing public investment priorities elsewhere) as an alternative to the potential downsizing of investment projects and/or the lengthening in the implementation periods, which might otherwise be required.

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

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

Implications for the Wage Bill

11. **To create the needed fiscal space for these public investments, it is critical that the wage bill—the single-largest component in the current budget—be curtailed as a share of general government spending.** Current levels are very high, even by regional standards. At 11.8 percent of GDP in 2006, the wage bill exceeded levels observed in neighboring countries and most of the new EU member states. However, Government is exposed to increasing pressures to raise salaries in the public sector, which are partly motivated by the objective to remain competitive with the private sector. As a result, the wage bill is continuing to increase—with the 2008 ratio likely to exceed the outcome of 12.7 percent of GDP in 2007, for principally two reasons:

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

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

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