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**COMMISSION STAFF WORKING DOCUMENT**

**ECONOMIC REFORM PROGRAMME**

**OF**

**MONTENEGRO**  
**(2017-2019)**

**COMMISSION ASSESSMENT**

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## 1. EXECUTIVE SUMMARY

**Montenegro experiences a gradual economic upturn driven by large investment projects** in the energy and tourism sectors and debt-financed public infrastructure works. GDP growth is projected to average 3.4 % in the period 2017-2019, largely driven by the strong investment cycle. However, the need for fiscal consolidation is set to restrain public and private consumption. The narrow production base and the high import content of investments result in large external imbalances.

**Public debt is on a steep upward trajectory and fiscal sustainability is a serious concern, set to further weaken given Montenegro's high and increasing refinancing needs as of 2019.** Despite substantial underspending in the capital budget, the fiscal position weakened in 2016 as a result of strong expenditure pressure in the pre-election period. Montenegro's economic reform programme (ERP) introduces a set of corrective measures for the 2017 budget, but a full-fledged medium-term fiscal policy strategy still needs to be developed.

**Tackling macroeconomic imbalances and rebuilding fiscal policy buffers would make the country more resilient to adverse external shocks and return the public finances to a sustainable path.** At the same time, implementing structural reforms is key to achieving high rates of sustained economic growth beyond the current cycle expansion. The main challenges in these respects include the following:

- **Debt-related vulnerabilities are rising and there is little room for manoeuvre of fiscal policy.** Montenegro's public debt remains high and is set to become more exposed to rollover and exchange-rate risks. The country's fiscal adjustment plans are incomplete, with most of the budgetary measures concentrated in the short term and several tax exemptions still in place. Implementing a sound medium-term fiscal consolidation strategy would support fiscal credibility and underpin investors' confidence.
- **Although slowly declining, non-performing loans burden banks' balance sheets and impede the functioning of the bank lending channel.** Overall, banks present robust capital buffers and liquidity ratios. However, there are still weaknesses with collateral execution and provisioning of non-performing loans (NPLs).
- **Enhancing the growth potential is crucial to reducing external imbalances.** Strong investment activity will help in this regard when new facilities and infrastructure are completed; however, at this juncture the key challenge Montenegro is facing is to find new ways to increase productivity and become more competitive in foreign markets. This would enable the country to boost exports and become less reliant on imports.
- **Network infrastructure investments need to be complemented by regulatory reforms.** Good progress has been made in opening the energy market, but continued efforts are needed to ensure rail market opening through strengthening the capacity and independence of the rail regulatory and safety authorities. Measures that facilitate the digitisation of the economy, including better broadband access, would support growth and innovation. Effective investment in broadband infrastructure will result in quality broadband connections in all the regions and boost the economy' digitisation.
- **Small and Medium Sized Enterprises' (SME) access to finance and a low level of internationalisation remain key barriers to increasing competitiveness.** The

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continued development of high quality public and private SME support services and the creation of a more level-playing field through strict implementation of EU competition rules are key. The latter requires ensuring the operational independence of the state aid authority as a first step. Continued efforts are needed to strengthen the rule of law, reduce the informal sector, and tackle corruption. This will ensure that regulatory improvements translate into an improved investment climate.

- **Main labour market imbalances stem from low labour market flexibility, the skills mismatch and ineffective employment support to the unemployed and inactive.** Employment opportunities of young people are limited due to oversupply of obsolete professions and insufficient practical learning. The ongoing modernisation of school programmes does not sufficiently address the root causes of the skills mismatch. High levels of inactivity point to the weak employment support and widespread undeclared work. Poorly targeted social assistance creates disincentives to work, which has recently resulted in negative labour market impacts for women. Labour law reform should bring about better functioning of the labour market; yet a comprehensive solution should encompass stronger employment support policies and linkages between employment and social protection.

**The policy guidance jointly adopted at the Economic and Financial Dialogue of 25 May 2016 has been partially implemented.** Some measures have been taken to restrain current spending, including the public sector wage bill, and to improve revenue collection. However, the plan for the correction of the deficit and public debt and a full-fledged fiscal strategy still need to be completed. Good progress was made in opening the energy market, but more needs to be done to ensure that the rail regulatory authorities have the capacity and independence to achieve this. Some initial efforts have been made to improve the financial and non-financial support for businesses and further steps are planned in the programme. The modernisation of school programmes is ongoing, but further efforts are needed. After a stall in discussions, the preparation of the new labour law has resumed. Active labour market policies were not strengthened, and they continue with low financing, coverage and targeting. Relevant actions have been initiated to establish cooperation between employment offices and social work centres and enhance the social protection information system. Overall, the structural reform measures planned in last year's ERP were only partially implemented.

The articulation between the ERP's macroeconomic and fiscal framework is broadly coherent to provide a basis for policy discussions. However, the macroeconomic assumptions could be better balanced between the negative spill-overs from fiscal tightening on consumption (larger than foreseen in consensus forecasts) and the rather optimistic underestimation of imports required for developing ongoing investments. Moreover, the fiscal consolidation measures appear barely sufficient to address the short-term policy objectives and challenges. The structural reform section of the ERP retains a strong focus on investments in transport and energy in terms of budgetary impact. Education reforms could yield more sustainable returns in the medium to long term if they addressed root causes of the inefficiencies, such as school-to-work transitions and creation of professions for which there is no longer demand. The envisaged labour market reform could help better translate economic growth into job creation. However, it needs to be accompanied by effective active labour market policies and well-targeted social assistance to reduce disincentives for work, including for women. More needs to be done to ensure that the reform measures are well-planned and implemented in a timely manner, given that several of the 2016 measures were delayed.

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## 2. ECONOMIC OUTLOOK AND RISKS

**The economic reform programme (ERP) projects accelerating growth in 2017-2018 and a slowdown in 2019.** Albeit decelerating, investment is expected to remain the main growth driver until 2018 and to stagnate –in real terms– in 2019. This should cause a slowdown of GDP growth in the same year. The programme does not expect domestic consumption to support economic activity. In fact, the need for fiscal restraint translates into consecutive real decreases in public consumption. Furthermore, fiscal consolidation is also seen to limit the growth of disposable household incomes. As a result, private consumption is expected to contract in 2017, before picking up mildly. The ERP expects both exports and imports to decelerate substantially following strong growth in 2016, with imports contracting slightly in 2018-19. On the production side, the ERP projects all branches of the economy to contribute positively to growth, especially construction and tourism-driven services. The planned completion of new power plants should lead to the energy sector contributing more to growth. Agriculture and manufacturing would also grow, but only modestly contribute to overall GDP growth.

**The GDP growth scenario is broadly plausible, but the projected sources of growth raise some questions.** The overall growth path and the expected strong investment activity in 2017 and 2018 remains consistent with planned large-scale public and private capital projects and with consensus and Commission forecasts. However, the programme presents a rather weak correlation between some of the macroeconomic variables. For instance, the link between gross fixed capital formation (largely driven by private<sup>1</sup> investment) on the one hand, and foreign direct investment (FDI) and construction activity on the other hand seems underestimated. Also, the strong deceleration of imports forecasted for 2017 does not appear fully consistent with investment dynamics. Ongoing investments may indeed be less dependent on imports than in 2016, when the construction of a windmill farm and the start of the highway<sup>2</sup> works required more substantial (one-off) imports of construction machinery and equipment. However, this does not fully explain the imports profile considering the still ongoing robust activity in other major import-dependent projects. The projected decline of household consumption in 2017 also seems at odds with underlying macroeconomic assumptions, in particular accelerating employment and robust wage growth. Historical data suggest that drops in private consumption usually appear in recession years. Similarly, the expected contraction of government consumption seems rather ambitious and does not appear to be fully explained by the corresponding fiscal programme.

The programme presents an alternative low-growth scenario, focused on the event of an 8 % year-on-year reduction in the level of gross fixed capital formation in 2017 compared to the baseline, followed by further marginal deceleration in the following two years. However, in this alternative scenario, private consumption growth is higher than in the baseline, despite the predictable negative impact from the slowdown on employment,

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<sup>1</sup> In the period 2017-2019, the total value of planned investments is EUR 3.14 billion, including 34.4 % in tourism, 21.5 % in energy, 15.3 % in a highway, 6 % other transport, and 2.7 % in agriculture.

<sup>2</sup> Unless otherwise indicated, the highway mentioned in this assessment refers to the priority section (Smokovac-Mateševo) of the Bar-Boljare highway which will connect the port of Bar with the Serbian border. The estimated cost of the 40 km of this priority section is EUR 810 million or 20 % of GDP in 2014. Due to exchange rate movements, the cost raised to EUR 1.01 billion in March 2017.

credit availability and rising unemployment. The main risks to the programme's macroeconomic projections are, apart from delayed implementation of investments and geopolitical risks, a deterioration of investors' confidence (resulting in more expensive external financing) and unfavourable weather conditions hampering agriculture (which could affect tourism and electricity output).

Table 1:  
Comparison of macroeconomic developments and forecasts

	2015		2016		2017		2018		2019	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	3.4	3.4	2.6	2.4	3.7	3.2	3.1	4.4	n.a.	2.6
<i>Contributions:</i>										
- Final domestic demand	4.4	4.4	8.4	9.2	6.5	3.6	3.8	3.3	n.a.	1.0
- Change in inventories	-0.7	-0.7	1.5	0.3	0.0	0.0	1.0	0.0	n.a.	0.0
- External balance of goods and services	-0.3	-0.4	-7.3	-6.8	-2.7	-0.3	-1.7	1.1	n.a.	1.6
Employment (% change)	2.4	2.5	1.6	1.0	2.9	2.0	2.9	1.0	n.a.	0.5
Unemployment rate (%)	17.5	17.5	17.9	19.4	17.4	17.8	17.1	17.0	n.a.	16.6
GDP deflator (% change)	1.4	1.5	0.7	0.4	1.3	2.0	2.3	1.9	n.a.	1.6
CPI inflation (%)	1.4	1.4	0.1	0.4	1.4	2.2	2.1	2.0	n.a.	1.7
Current account balance (% of GDP)	-13.3	-13.3	-19.5	-21.0	-22.7	-20.8	-23.4	-18.8	n.a.	-16.9
General government balance (% of GDP)	-8.4	-8.4	-3.8	-3.8	-6.6	-6.1	-6.0	-5.5	n.a.	-3.8
Government gross debt (% of GDP)	61.2	62.8	65.5	66.6	70.3	71.6	73.3	74.9	n.a.	77.5

Sources: Economic Reform Programme (ERP) 2017, Commission Winter 2017 forecast (COM)

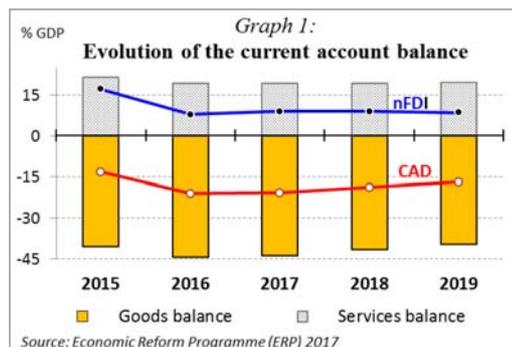
**Labour force supply remains a structural factor constraining growth.** Despite high unemployment rates, there is a scarcity of workers in key sectors of the economy (i.e. construction and tourism). This is due to skills mismatches, poor mobility and low labour participation (caused by early retirement and an ageing population). The ERP's analysis shows some deterioration in price competitiveness as unit labour costs (ULC) increased marginally in 2016 because of the 3.5 % overall increase y-o-y of Montenegrin salaries (which are relatively high by regional standards). Introducing life-time social benefits for mothers of three or more children also negatively affected labour market activity in 2016. There is evidence that many women opted out of the workforce to become eligible for the generous<sup>3</sup> benefits. Others –previously inactive– registered as unemployed. All of this resulted in further deterioration of labour statistics.

**Inflationary pressures are led by imported prices.** Overall, inflation trends are being led by the rebound of global oil and food prices through imports. After a mild increase in the final months of 2016, inflation is set to grow moderately, reaching an annual average of some 2 % in the period 2017-2019. This forecast also assumes weak inflationary pressures from private consumption as a result of high unemployment rates and modest wage growth. Moreover, the impact of unemployment and wages on overall price dynamics remains substantially lower than import prices. However, higher prices in restaurants and hotels (rising since June 2015) could nonetheless dampen the competitiveness of the Montenegrin tourism industry.

**The current account deficit is expected to narrow as a result of slowing growth in import-intensive investments.** A substantial trade deficit, caused by a narrow

<sup>3</sup> The law on Social and Children's care providing for this benefit was amended in December, reducing the level of benefits provided by around 25 % as of 2017. While the pension legislation foresees 40 years of work to acquire full pension rights (average EUR 284/month), the benefit for mothers registered 25 years in the employment office is EUR 264 (down from EUR 336 before the reform).

production and export base, is the main factor driving Montenegro's historically large current account gap. In 2016, the current account deficit broadened markedly to 19 % of GDP (from 13 % recorded a year earlier), reflecting last year's substantial surge in investment. Looking forward, the ERP expects imports to decline as a result of lower investment, weak private consumption, and a modest but sustained growth in exports, especially tourism-related services. The income balances surpluses are expected to remain stable but small. Overall, although investments are set to remain robust, the current account deficit would gradually narrow down to 17 % of GDP in 2019 according to the projected slowdown of investment in real terms in the baseline scenario.



**The large external imbalances reflect the weak competitiveness of the Montenegrin economy mainly due to non-cost factors, and the country's large investment needs.** Completion of the various types of infrastructure, tourism and energy facilities is expected to boost productivity and contribute to lowering external imbalances in the long run. However, structural reforms are necessary to sustain productivity gains and bring about substantial improvements in the business environment. FDI is expected to remain stable and cover half of the current account gap, while the financing of public works will mostly rely on long-term government borrowing. Downside risks to this outlook stem from political or financial stability risks which could hinder the access to, or increase the cost of, finance. For the first time, the ERP also provides an estimate of total external debt, including private sector, but with data coverage only until 2015. The external debt remained high but relatively stable at around 145 % of GDP during the period 2013-2015.

**The stability of the banking system is improving but lending growth remains weak.** Credit risk remains concentrated in a few domestic banks. Overall, banks present robust capital buffers, with regulatory capital to risk-weighted assets ratio at 16 % in 2016, well above the regulatory minimum of 10 %. Liquidity is increasing, with banks' funding shifting from external sources to more stable domestic deposits. However, there are still weaknesses present in collateral execution and the provisioning of non-performing loans (NPLs). To address the problem of impaired loans, the Central Bank of Montenegro is asking banks to prepare three-year strategies to deal with NPLs, and is extending the scope for banks to restructure loans under what is referred to as the Podgorica approach, which –so far– failed to yield results. Meanwhile, credit risk results in tight credit conditions and weak lending growth, in particular to domestic companies. In order to increase banks' liquidity and stimulate lending, the Council of the Central Bank of Montenegro cut in March 2017 the mandatory reserve requirement ratios by 2 pps (from 9.5 % to 7.5 % and from 8.5 % to 6.5 % for deposits with maturity up to or more than one year, respectively). Several banks used part of this additional liquidity to extent loans to the government.

Table 2:

## Financial sector indicators

	2012	2013*	2014	2015	2016
Total assets of the banking system, mEUR	2,808	2,959	3,136	3,472	3,791
Foreign ownership of banking system	81.9	83.5	82.7	80.4	79.4
Credit growth	-0.7	3.1	-1.9	0.8	1.3
Bank loans to the private sector %	93.3	91.4	93.2	93.8	93.6
Deposit growth	9.0	5.9	10.0	13.7	9.4
Loan to deposit ratio	1.2	1.2	1.0	0.9	0.8
<b>Financial soundness indicators</b>					
- non-performing loans	17.6	18.4	16.8	13.4	10.3
- net capital to risk weighted assets	14.7	14.4	16.2	15.5	16.1
- liquid to total assets	24.0	20.0	22.0	24.8	24.5
- return on equity	-18.3	0.5	5.4	-0.7	1.5
- forex loans to total loans %	1.9	3.9	3.9	8.2	6.4

Sources: National Central Bank, DataInsight

\* International Accounting Standards were introduced in 2013.

### 3. PUBLIC FINANCE

**A loosening of fiscal discipline prior to the elections and underspending on capital projects marked budget developments in 2016.** Substantial increases in wages and social benefits forced the government to ask the Parliament to revise the central government budget after the October 2016 elections. Current expenditure reached a record high of 46 % of GDP due to higher than planned increases in social benefits, public sector salaries and the need to pay the health fund debt. The budget revision reduced capital spending by 65 % compared to the plan because of delays in the implementation of the highway. As a result, the central government deficit in 2016 amounted to 3.5 % of GDP, compared to the original plan of 7.1 %, and the previous year's deficit of 8.4 %. Budget revenue increased by 12 % y-o-y thanks to the good performance of value added tax (VAT), personal income tax and concession fees boosted by the one-off auction of radio-frequencies.

**Fiscal imbalances are set to increase compared to 2016, despite some corrective measures in the 2017 budget.** The 2017 budget foresees a 4.4 % y-o-y increase in revenue, an overall freeze in current expenditure and a strong (113 %) surge in capital spending. On this basis, the budget deficit is expected to increase to 6 % of GDP. This deficit target incorporates the effect of a fiscal consolidation plan<sup>4</sup> that specifies measures to contain the increase of the fiscal deficit and is expected to yield budget savings equivalent to some 3.2 % of GDP (see box below). If the announced measures are not fully implemented, further consolidation may be necessary before the end of the year to cope with the high financing needs of the budget. The nature and impact of the 2017 budget measures are quite diverse, and to a large extent they do not qualify as durable consolidation measures. They partially reverse earlier increases in wages and social benefits, are of a one-off nature (e.g. restructuring of tax arrears), are not yet fully specified or rely to a large extent on broadening the tax base by reducing informality. When designing the 2017 budget, authorities sought a compromise between maintaining a competitive low-tax environment while investing in large infrastructure projects and

<sup>4</sup> This 'Plan for the correction of the budget deficit and public debt' was a legal requirement stemming from the fiscal rules enshrined in the law on budget and fiscal responsibility. However, despite being a five-year plan, the current version mostly presents consolidation measures for 2017.

preserving to a large extent disposable household income. A few tax measures may have a longer lasting effect on public finances beyond 2017. But the estimated overall fiscal impact appears optimistic, and a more complete medium-term plan is missing. As a result, there is a risk that the consolidation plan will yield less than 3 % of GDP.

**Box: The budget for year 2017**

- \* The budget was endorsed by the government on 18 December and adopted by the parliament on 29 December 2016.
- \* The general government deficit target is 6 % of GDP, basically because of the commitment of 5 % of GDP to build a highway (out of a total 8 % of GDP planned for overall capital spending).
- \* The macroeconomic scenario supporting this budget was slightly revised downwards, forecasting GDP growth of 3.2 % (compared to 4 % growth in earlier estimates) and an inflation rate of 2.2 %.
- \* The budget was accompanied by a recovery plan with measures totalling 3.2 % of GDP:

Table: Main measures in the budget for year 2017

Revenue measures*	Expenditure measures**
<ul style="list-style-type: none"> <li>• Amendments to the Law on excise tax ‡ Increase of excise on mineral oil (9 cts/lt) (0.8 % of GDP)</li> <li>• Collection of tax arrears (Law on rescheduling of tax claims) ‡ (0.3 % of GDP)</li> <li>• Increase of VAT rate (from 7 % to 19 %) on computer equipment ‡ (0.04 % of GDP)</li> <li>• Introduction of the electronic VAT system‡ (0.28 % of GDP)</li> <li>• Maintaining the higher personal income tax rate (PIT) of 11 % (until end of 2019) ‡ (neutral impact)</li> <li>• Increasing fiscal discipline (legalisation of employment and regular payment of liabilities) (0.4 % of GDP)</li> <li>• Legalisation of informally built structures (fiscal impact not available)</li> </ul>	<ul style="list-style-type: none"> <li>• Amendments to the Law on Wages of Public Sector employees ‡ a) Reduction of public sector wages (by 8 %) (0.1 % of GDP (+ additional 0.03 % in gov. savings on taxes and contributions)) b) Two-year suspension of years of experience bonus<sup>5</sup> in public sector salaries ‡ (0.07 % of GDP)</li> <li>• Amendments to the Law on Social and Children's care ‡ : a) reduction of the benefit for mothers of 3 or more children (0.4 % of GDP) b) postponing 6 months (to 1<sup>st</sup> July 2017) benefits for children with unemployed parents (0.02 % of GDP)</li> <li>• Reduction of the budget for financing political parties ‡ (0.04 % of GDP)</li> <li>• Reduction of the capital budget (0.25 % of GDP) ‡</li> <li>• Other discretionary measures (0.94 % of GDP)</li> <li>• Optimization of the number of public sector workers (fiscal impact not available)</li> </ul>
<b>Total from revenue measures: 1.5 % of GDP</b>	<b>Total from expenditure measures: 1.7 % of GDP</b>

\* Estimated impact on general government revenues.

\*\* Estimated impact on general government expenditure.

‡ Legislative measure or amendments adopted in December 2016.

Source: *Economic Reform Programme (ERP) 2017, Ministry of Finance*

<sup>5</sup> On 3 March 2017, the Ministry of Finance and public sector trade unions agreed to replace this measure by a 1 % decrease in the base salary (until end-2018) for wages with a coefficient above 4.10. The impact of this measure should be equivalent to the suspension of the years-of-experience bonus.

**The ERP lacks a complete medium-term fiscal strategy and does not sufficiently address fiscal sustainability concerns.** The set of fiscal measures presented in the ERP is expected to be complemented in the second quarter of 2017 by a medium-term fiscal strategy. The measures presented in the programme remain focused on intensifying investment in infrastructure and optimising current expenditure, with the aim of consolidating public finances and reducing the budget deficit and public debt (net of capital investment) during the programme period. Public investment, and in particular the highway works, will remain the main driver of public debt and deficit until 2019, when the work on the main section is expected to be completed. The next stages of the highway –later on– should not be considered unless considering a different financing scheme (for instance, including highly concessional or grant financing), to avoid hampering public finances.

**Key elements of a fully-fledged fiscal strategy are expected to be adopted in the second quarter of 2017.** Some preliminary ideas announced by the government are: First, a more through-through reform of the law on social protection (better targeted and means-tested) would significantly reduce the excessive cost of the current scheme. Second, the centralisation of fiscal cash registers (i.e. electronic fiscal invoices) is expected to come into effect in 2018, with an estimate impact of some EUR 10 million (or 0.25 % of GDP) in extra revenue. Third, a comprehensive reform of public administration could address low efficiency while contributing to the sustainability of public finances. Fourth, the legalisation of illegally built structures would improve the public finances of municipalities. Importantly, a sound fiscal strategy would require that legislative measures are not adopted without ensuring that adequate financial resources are available.

*Table 3:*  
**Composition of the budgetary adjustment (% of GDP)**

	2015	2016	2017	2018	2019	Change: 2016-19
<b>Revenues</b>	42.1	45.1	44.8	43.9	42.9	-2.2
- Taxes and social security contributions	35.3	37.0	37.5	36.7	36.0	-1.0
- Other (residual)	6.8	8.1	7.3	7.2	6.9	-1.2
<b>Expenditure</b>	50.4	49.0	50.8	49.4	46.7	-2.3
- Primary expenditure	48.0	46.8	48.2	47.1	44.3	-2.5
<i>of which:</i>						
Gross fixed capital formation	8.2	5.0	9.0	10.0	8.4	3.4
Consumption	14.7	16.3	15.6	14.7	14.3	-2.0
Transfers & subsidies	14.1	16.2	15.3	14.5	14.2	-2.0
Other (residual)	11.0	9.3	8.3	7.9	7.4	-1.9
- Interest payments	2.4	2.2	2.6	2.3	2.4	0.2
<b>Budget balance</b>	-8.3	-3.9	-6.1	-5.5	-3.8	0.1
- Cyclically adjusted	:	5.7	-3.0	0.9	3.4	-2.3
<b>Primary balance</b>	-5.9	-1.7	-3.5	-3.2	-1.4	0.3
<b>Gross debt level</b>	65.7	66.6	71.6	74.9	77.5	10.9

*Sources: Economic Reform Programme (ERP) 2017*

**Several risks could derail the fiscal projections.** The programme presents a detailed and realistic list of the risks in a SWOT<sup>6</sup> analysis matrix, and their impact is considered in an alternative scenario (see box on sensitivity analysis). These risks include: further delay or cost overruns in public investment, external shocks hindering public debt financing, political instability in the region, or simply a failure to achieve fiscal

<sup>6</sup> Strengths-weaknesses, opportunities-threats analysis.

consolidation goals. On the latter, the ERP highlights adverse spillovers from recent social benefit increases into the labour market and into public finances. It also considers the risk of a formal deterioration of fiscal parameters as a result of the implementation of the European system of accounts (ESA 2010) in government finance statistics. There are also some upside risks, like higher investments following the expected accession to NATO or higher budget revenue from implementation of the reforms agenda.

**Overall, improving the fiscal framework is key to supporting budget consolidation.**

The cash-based budget fails to reflect all budget commitments on time, and therefore remains subject to revision. Authorities are implementing an action plan to introduce accrual accounting in government financing statistics (compliant with ESA 2010). The restructuring of accumulated local-government arrears was accompanied by measures to prevent their re-emergence. These measures included improving checks on multi-year commitments and introducing more binding medium-term budgetary ceilings. In general, the medium-term budgeting process still needs improvement, not least because unrealistic expenditure allocations have undermined its credibility. To reinforce debt sustainability, a fiscal strategy needs to be adopted and the five-year plan for correcting the budget deficit and public debt completed with measures beyond 2017. In addition, implementing concrete policies to strengthen public finances and reinforce the fiscal rules would also help anchor expectations of budget discipline.

**Box: Debt dynamics**

The ERP expects the debt ratio to further increase and come close to 80 % of GDP by the end of 2019 driven by high primary deficits fed by further withdrawals from the highway loan. The overall implicit interest rate is expected to remain broadly stable at around 3.7 %. The level of stock-flow adjustments will increase markedly in 2019, (although details are not explained in the programme). However, the expected debt trajectory appears rather conservative, and further slippages are not to be discarded. Moreover, the already high financing needs will surge in 2019 as, in addition to the highway loan and budget deficit financing, the government will also need to refinance maturing Eurobonds worth some 6.4 % of GDP.

*Table 4:*  
**Composition of changes in the debt ratio (% of GDP)**

	2016	2017	2018	2019
<b>Gross debt ratio [1]</b>	<b>66.6</b>	<b>71.6</b>	<b>74.9</b>	<b>77.5</b>
Change in the ratio	3.8	5.0	3.3	2.6
<i>Contributions [2]:</i>				
<b>1. Primary balance</b>	<b>1.0</b>	<b>4.0</b>	<b>3.7</b>	<b>0.5</b>
<b>2. "Snow-ball" effect</b>	<b>0.5</b>	<b>-0.7</b>	<b>-1.9</b>	<b>-0.6</b>
<i>Of which:</i>				
Interest expenditure	2.2	2.6	2.3	2.4
Growth effect	-1.5	-2.0	-3.0	-1.9
Inflation effect	-0.2	-1.3	-1.3	-1.1
<b>3. Stock-flow adjustment</b>	<b>2.3</b>	<b>1.7</b>	<b>1.5</b>	<b>2.7</b>
<i>Memorandum item</i>				
<b>Gross financing needs</b>	<b>15.7</b>	<b>12.5</b>	<b>10.8</b>	<b>17.2</b>
<b>Highway loan [3]</b>	<b>0.3</b>	<b>5.0</b>	<b>5.5</b>	<b>4.1</b>

**Notes:**

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on

[3] Includes loan and government own contribution.

Source: Economic Reform Programme (ERP) 2017, ECFIN calculations

**Fast growing public debt, coupled with considerable gross financing needs, remains a cause for concern.**

A considerable stock of Eurobonds maturing in 2019 and 2020 will boost debt refinancing needs up by an additional 6.4 % and 12 % of GDP, respectively. Montenegro's public debt, including guarantees, already exceeds 70 % of GDP. The share of external debt is predominant, accounting for 89 % of the total. Around half of it corresponds to Eurobonds, 29 % to international financial institutions and bilateral loans, 15.4 % to the highway loan, and 1.4 % (the most expensive and shorter maturity) to commercial banks. Montenegro is vulnerable to changes in market sentiment and to host country regulatory requirements that could influence debt holders' willingness to hold Montenegrin securities, as occurred with the emission of domestic bonds in November 2016. The exchange-rate risk is largely concentrated on the Chinese loan to finance the highway, issued in US Dollars at fixed exchange rates of 2014. A sound fiscal strategy is

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therefore essential to mitigate debt-related vulnerabilities and rebuild room for policy manoeuvre.

***Box: Sensitivity analysis and comparison with previous ERP***

Based on the macroeconomic low-growth scenario's lower level of investment, the fiscal position would weaken as a result of lower economic activity and budget revenue would contract by some 2 % annually. In this alternative scenario, the level of expenditure would (optimistically) remain at the same level as in the baseline, due to the high level of non-discretionary spending of the budget. This would result in a higher deficit, in particular in 2018 and 2019. This higher deficit would also feed into the public debt stock, to reach 84 % of GDP in 2019, up from 77.5 % in the baseline.

Compared with previous ERPs, revenue projections were conservative, but actual revenue was systematically higher than planned. However, for expenditure, the opposite was also observed. In 2016, there were systematic overruns of expenditure over the plan, except for capital spending.

#### **4. STRUCTURAL REFORMS**

**The ERP identifies key obstacles to growth and competitiveness, and outlines a number of relevant measures to address them.** The 2017-2019 programme is clearer than the 2016 ERP. The Commission's assessment last year was for the most part taken into account; however, the link between the diagnostics and the identified obstacles with the reform measures could be strengthened.

**The reform measures are appropriate to foster growth and competitiveness.** The majority of these measures represent a continuation or further development of the previous ERP. Where a measure from last year is not anymore presented as reform priority, the programme provides an explanation. However, several reform measures identified in the 2016-2018 ERP were delayed, underlining the need for realistic planning and close monitoring of the implementation of the structural reform agenda. Given the challenging fiscal situation and a rapidly growing public debt, fiscal consolidation and less costly regulatory reforms should be prioritised. Instead, the ERP retains a strong budgetary focus on investments in transport and energy. The business environment measures are relevant, but implementation has recently slowed down. Compared with other sectors, the budgetary allocation for industrial and SME support is comparatively low and depends on external funding sources. The envisaged restructuring of business zones should be pursued cautiously to ensure a positive return on related public investments and given incentives in the medium term. The envisaged labour market reform could help better translate economic growth into job creation; it needs to be accompanied by well-targeted social assistance to reduce disincentives for work. Implementing education, public administration and public finance reform could yield higher and more sustainable returns in the medium to long term.

**Structural reform needs remain essentially concentrated on the improvement of the labour market, and human and physical capital.** The labour market is characterised by high youth unemployment, low participation of women and high long-term unemployment. Labour market performance is poor and active labour market policies are ineffective. More progress is needed to align education and skills with the labour market needs. There are significant transport bottlenecks, but they need to be addressed in a fiscally sustainable and transparent manner, with due attention given to network

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maintenance and regulatory reform. Expensive and low availability of high-speed broadband access is not supportive of economic growth and innovation. Local companies are insufficiently integrated in regional and international production processes. Ensuring the operational independence of the State aid authority, as required by the Stabilisation and Association Agreement, would guarantee a more level playing field and bring benefits to consumers and businesses. Despite ongoing work, challenges remain in the area of rule of law. Corruption continues to be a serious problem and the informal sector is large, creating unfair market conditions. The policy guidance of the Economic and Financial Dialogue with the EU in May 2016 on structural reforms was only partially implemented.

### **Public finance management**

**Weaknesses in public finance management (PFM) continue to undermine Montenegro's fiscal position.** The diagnostic in this area is limited to public procurement and public internal financial control. A stronger reference to implementation of the PFM reform programme adopted in December 2015 would have been appropriate. In addition, the existing fiscal responsibility framework is weak, and the deficit and debt thresholds established by the fiscal rules are not met. Fiscal reporting also remains weak with successive fiscal data revisions, especially on the spending side. There is scope for improving reporting on municipal arrears. Other areas for reform concern medium-term financial planning and the management of public funds. A public investment management system which uses sound cost-benefit analyses to inform budgetary priorities would improve fiscal control and increase transparency.

**The measure to introduce e-procurement could have a positive impact on the level of competition on public tenders and transparency in the use of public funds, but implementation initially planned in 2016 has been delayed.** The ERP also recognises the need to regulate concessions and public-private partnerships in line with the EU *acquis*. This will help ensure a level-playing field, while stimulating further economic development. A law on concessions and public-private partnerships has been in preparation for several years and a further delay in aligning this with the *acquis* could hinder private investments.

**The measure strengthening managerial responsibility in the public sector is an important public internal financial control reform, but it is unlikely to become a key driver for economic development.** Economic benefits will be long-term and are difficult to quantify. Moreover, the measure needs to be further developed, notably by defining what managerial accountability means in line with Commission and OECD recommendations and by including detailed information on how managerial accountability will be implemented. A timeline is lacking, and there are no details on the extent of the training needs.

### **Transport, energy and telecommunications markets**

**High regional connectivity and infrastructure costs hinder economic growth.** Infrastructure development is constrained by the country's difficult topography, which results in high investment needs and maintenance costs. Despite the formal opening of the energy market, the entry of new firms is yet to materialise. The diagnostic section does not recognise the potential for improving energy efficiency and reducing the economy's energy intensity. In line with the 2016 policy guidance, Montenegro advanced its regulatory alignment with the EU energy policy framework, albeit implementing legislation is still pending. Montenegro also completed the legal unbundling of electricity distribution from energy generation. As for rail transportation, safety and interoperability

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remain to be improved through the strengthening of the capacity and independence of the rail regulatory body and rail safety authority.

**The importance of further facilitating the rollout of broadband for innovation and economic growth, including to rural areas, is not considered in the programme.** Less than 4 % of Montenegrins (1 % in rural areas) have access to broadband connections with a data speed of 10 to 30 Mbps, far below the EU average. Low investment in fixed-line broadband infrastructure results in the slowest broadband connections in the region, with connection costs above the UN International Telecommunication Union's affordability threshold of 5 % of disposable income.

**The measure to build a robust power interconnection with Serbia complements other efforts to strengthen regional interconnection, including the ongoing construction of an undersea electricity cable to Italy.** The undersea cable to Italy is foreseen to be completed by the end of 2018, and work to improve the interconnection with Serbia is expected to last until 2019. All of this will support network stability and complement ongoing efforts to develop a regional energy market.

**The measure aimed at the construction of Block 2 of the thermal power plant in Pljevlja is part of Montenegro's energy strategy to complement its hydro-power potential with coal.** It seeks to increase domestic energy generation, ensure network stability by balancing the less predictable renewables, increase employment in Pljevlja, and provide thermal district heating. The use of the existing coal power plant would be phased out after a few years of parallel operation. The public debate in Montenegro nevertheless points to some questions on the relevance as well as economic and social viability of this undertaking. Montenegro already ranks first in the Energy Community when comparing the estimated external costs of SO<sub>2</sub>, NO<sub>2</sub> and dust emissions. While the new block should comply with EU environmental standards by using the best available technology, there may be a negative impact on Montenegro's ability to meet its long-term climate change commitments. Using coal may also expose the sector to the volatility of allowance prices under the EU's Emissions Trading System, and financing conditions, yet to be finalised, need to comply with the applicable EU state aid rules.

**Scaling up the sustainable energy-efficiency programme could result in significant budget savings and reduce future energy consumption needs.** This would complement the installation of 23 wind turbines in Krnovo, which was completed in 2016 and accounts for approximately 8 % of national electricity output. There is also scope to further reduce the high energy intensity of the Montenegrin economy, which is due to outdated metal production technology and inefficient energy consumption in households and public buildings.

**The two measures on transport, both rolled over from the previous ERP, faced some delays in 2016, resulting in substantial underspending of the capital budget.** As for the measure to build a priority section of the Bar-Boljare highway, excavation works and bridge construction are ongoing on the most challenging sections, engaging approximately 1350 workers, out of which 30 % are of Montenegrin origin. The full benefits of the Bar-Boljare motorway and of the Bar-Belgrade rail network will materialise only when the entire corridor is upgraded, linking the port of Bar to Belgrade, via Podgorica. Due to the significant resources invested in one section of the motorway construction, other important transport bottlenecks and high maintenance needs may not be properly addressed. Montenegro also needs to revise its transport development strategy to ensure alignment with the regional agenda on connectivity.

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**The large public investments in roads, railway and power interconnectors are in line with the priorities agreed under the connectivity agenda but weigh heavily on public finances.** Investment planning needs to take into account the fiscal constraints, EU rules on public procurement, state aid, and environmental impact assessments and should be accompanied by sound cost-benefit analyses.

## **Sector development**

### **Agricultural sector development**

**Agricultural development continues to be constrained by a number of challenges.** These include the fragmented and small parcels with high production costs, limited export opportunities, weak sector organisation, limited access to credits and a lack of qualified labour and adequate technology and infrastructure. The ERP diagnostic recognises most of these challenges.

**The measure to invest in the food production sector to help companies achieve EU standards is welcome.** The level of public support provided is steadily increasing, but measures on access to credit for farmers should also accompany the support scheme to ensure its effective implementation. To export more, Montenegro is also encouraged to make faster progress in obtaining EU export accreditation for exports of animals, products of animal origin or food products.

### **Industry sector development**

**Low product diversification, low labour productivity and underinvestment in modernisation, as well as weak linkages between private companies and science and research are key bottlenecks for further development of the industry sector.** To support an increased diversification and industrial modernisation, Montenegro has adopted a comprehensive industrial policy. Nevertheless, the production of competitive higher value-added products remains limited and the local industry is characterised by marginal participation in global supply chains, as well as a low level of digitisation, including in the manufacturing and construction sectors. Given the current steel and aluminium production overcapacity on world markets, the objective as regards base metals should be to strengthen the manufacturing industry with a view to shifting towards higher quality and material efficiency, including metal recycling. Moreover, non-energy resource efficiency and circular economy policy aspects should be considered as part of Montenegro's efforts to support industrial modernisation.

**The measures to boost investment in processing industries and industrial modernisation foresee an expansion of the available support instruments.** This is achieved through new credit lines and a new pilot programme launched in mid-2016 to support industrial modernisation. The scheme for supporting processing industries delivered its first results, creating 253 jobs at a total cost of €1.48 million in subsidies. By contrast, the pilot scheme on industrial modernisation has so far not seen any significant uptake.

### **Services sector development**

**Insufficient tourism infrastructure and accommodation structures, limited accessibility of destinations, high seasonality and the regional disparities are key bottlenecks to Montenegro's effort to become a high-end tourism destination.** The ERP does not contain an analysis of the services sector as a whole but only identifies obstacles in the tourism sector. Other services such as information and communication

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technologies (ICT), retail and wholesale trade and non-financial professional services are not mentioned.

**The measure that seeks to address seasonality by improving skiing facilities in the North of Montenegro relies on publicly financed construction activities.** It represents a continuation from last year. However, so far private investors seem to lack interest. Previous plans to develop public-private partnerships for this have not advanced.

### **Business environment and reduction of the informal economy**

**There is room to further improve the business environment.** The ERP diagnostic is narrowly focussed on areas with lower grading in the World Bank's Doing Business report, including company registration, the work of cadastral services, the issuing of construction permits and contract enforcement, as well as limited access to credit as regards SME development. It fails to mention other areas frequently identified by businesses as presenting weaknesses, such as access to electricity, cumbersome tax administration procedures, and a high level of informality. Another important reform in this area, albeit not mentioned in the ERP, is to make the state aid authority operationally independent and to ensure that it has the necessary powers and resources, which, however, has been delayed. There is a lack of transparency and conflicts of interest among the authority's staff, and it lacks enough qualified staff to cope with an increased workload to establish a good enforcement record.

**While Montenegro has been successful in attracting a steady high flow of foreign direct investments, further efforts are needed to strengthen the rule of law, to reduce the informal sector, and to tackle corruption.** Recent progress on further improving the business environment has been more incremental as shown by different rankings, including due to delays in implementing planned reforms. Businesses also continue to complain that the outcome of judicial proceedings is at times difficult to predict due to inconsistent case law, lengthy enforcement proceedings and the possible non-enforcement of court orders. However, the duration of enforcement proceedings has improved, following the introduction of a public bailiffs system. Efforts are also ongoing to strengthen SME non-financial and financial support in line with 2016 policy guidance. However, SMEs' limited access to finance and low level of internationalisation remain key barriers to increasing competitiveness. Being frequently family-run, SMEs often face weak internal capacities, poor investment readiness and financial literacy, as well as a lack of professional management expertise.

**The measure that introduces e-services to the land registration system seeks to accelerate the issuance of cadastre documents.** However, while the ERP also identifies the parallel use of land-based and inventory-based registries as a related obstacle, the reform does not include plans to improve the data quality and coverage.

**The measure that introduces e-fiscal invoices was rolled over from the previous ERP, as the coverage of the mobile phone networks needed to be tested first.** The measure remains relevant for reducing the informal economy and has the potential to create a better level playing field for registered businesses and improve revenue collection. Montenegro expects a revenue increase of some €10 million in 2018.

**The two SME measures represent ongoing efforts to further expand the available financial and non-financial support.** While SME financial support has increased in recent years, only limited budgetary resources are dedicated to non-financial support. On the latter, the ERP envisages mentoring services, targeted training courses and conferences for stakeholders including on financial literacy, as well as the development

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of a database on private consultancy services among others. With regard to financial support, the Investment and Development Fund's (IDF) activities continue to largely depend on external funding from international financial institutions. It is recommended that the performance and effectiveness of the IDF's activities are externally reviewed.

### **Research and innovation**

**The ERP recognises the importance of research and innovation as a driver for competitiveness and the diagnostic highlights key bottlenecks.** These include insufficient integration of private sector support through cooperative projects between the public research sector and industry, and a fragmented research landscape. There is also a low level of cross-border synergies. The number of domestic innovative and internationally competitive enterprises is low. Montenegro is in the process of upgrading its statistical capacities for this sector. This could also allow for eventually providing greater incentives for private spending on R&D. In this context, the foreseen development of a Smart Specialisation Strategy could help identify key measures to support competitiveness and growth.

**The measure to establish a Science and Technology Park (STP) at the University of Montenegro in Podgorica is a further step in the right direction to enabling technology development and innovation.** A first Innovative Entrepreneurship Centre "Tehnopolis" was opened in Nikšić in 2016 to help boost technology transfer and innovation, as foreseen in last year's programme. While operations have commenced, the laboratories remain to be equipped. The current measure presents a balanced approach to developing incubators and start-ups in different geographical areas and establishing connections between local and regional business centres. However, construction alone is not enough, as investment in technology and skills development is needed. The programme does not provide a clear timeline and lacks relevant statistics and indicators. Negotiations on securing funding are still ongoing. Montenegro should consider ways to mobilise private investment to ensure sustainability of the STPs. Private sector companies could be involved to give non-financial support to aid start-up capacity building, in return - for example - for shares, benefits, or intellectual property rights.

### **External trade and investment facilitation**

**The export sector is hampered by a narrow export base, a low level of export diversification and a predominance of low added-value products with only a few companies that trade internationally.** The diagnostic section further recognises the interlinkages between trade facilitation and the ability to attract investment, as well as the need to address weaknesses in the general business environment. Further regional economic integration was achieved under Montenegrin chairmanship of the Central European Free Trade Agreement, when negotiations on a Trade Facilitation Protocol were completed in 2016. Swift implementation could significantly reduce related transaction costs. Montenegro could also promote a more service-oriented organisation culture in its customs service through, for example, ensuring that its authorised economic operators programme is more widely used and simplifying customs procedures to increase the efficiency of the clearance process.

**The measure to restructure existing business zones aims at attracting direct investments and technology transfer.** While such zones may help attract investments, experience in other countries suggests that they have to be carefully designed to be financially and economically effective and to ensure strong linkages with domestic suppliers. In addition to the cost for the zones' establishment and infrastructure, there is the potential loss of income depending on the incentives provided.

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## Education and skills

**Poor educational outcomes represent structural bottlenecks on the labour market.** Insufficient coverage of preschool education negatively affects labour market participation of women. Low preschool enrolment rate and low quality of the basic education system result in a high share of low achieving students, which affects performance at higher levels. Enrolment in vocational education and training (VET) is high, but so is the transition to higher education, creating an oversupply of higher education graduates which the labour market cannot absorb. Practical learning and future skills anticipation need to be ensured as an essential part of the reform measures. The ERP diagnostic includes some of these aspects, but not all.

**The two measures covering development of new occupational standards for VET and aligning higher education with the labour market needs are ongoing and appropriate.** The implementation of the revised curricula and a new higher level studies model are foreseen in the 2017-2018 school year. A working group has been tasked to assess and improve the professional training programme for university graduates. However, no activity is mentioned on monitoring and evaluation mechanisms to assess quality and impacts which would provide a sound basis for future policy planning and skills forecasting.

**The root causes of the skills mismatch should be better targeted.** Reinforcing basic and transversal skills, introducing work-based learning and stronger career guidance are essential to improve the transition from school to work. Addressing high enrolment in programmes not relevant to the labour market and rationalising entry from VET to higher education need further attention. A rapid and responsive institutional mechanism to adapt qualifications and curricula is a pre-condition to ensure the reform's success. Continuous teacher training is fundamental and tracing students after they complete education should remain an accompanying measure.

## Employment and labour markets

**Labour market imbalances stem from high inactivity, low labour market flexibility, a skills mismatch and ineffective employment programmes.** High unemployment and low employment concern particularly youth, women and the long-term unemployed. Undeclared work, a lack of job opportunities and inefficient linkages with the social protection system further contribute to high inactivity. Active labour market policies (ALMPs) are weak and lack monitoring and evaluation. Employment offices manage passive programmes and do not provide adequate services to meet the needs of job seekers. Serious concerns remain about the social benefit for mothers with three or more children. This social benefit has had a negative impact on labour market participation of women and on social spending. Social protection and activation measures should be better balanced. The ERP diagnostic in this area includes main employment indicators.

**There is a need to incentivise work and offer strong employment support measures, while targeting social assistance at those in need.** There have been efforts to improve activation by establishing a system of cooperation between employment services and social work centres. This is a relevant step in bringing more people to the labour market, while better ensuring social protection for those who need it most. Actions to improve the social protection information system could include further linkages with benefits at the local level.

**The ERP measure aims to improve labour market participation and employability through new legislation.** While the planned activities are relevant, priority should be

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given to timely and effective implementation. The preparation of the labour law reform has just begun after a long pause in discussions and given that this represents a major labour market reform, it is essential to reach a comprehensive solution and undergo consultations with all relevant stakeholders. While labour market flexibility is important in raising employment levels, the solutions should be evidence-based and avoid the risk of labour market segmentation.

**The activities to strengthen the linkages between the labour market and the social protection system are well designed but have not yet produced significant results.**

Plans to improve labour market participation include giving employment offices a stronger intermediary role, better designing ALMPs and redefining provisions on unemployment benefits. It is essential to provide sufficient support and come up with a comprehensive solution that meets the needs of job seekers and helps them integrate into the labour market. On the other hand, it is essential to ensure sufficient financial support for those who need it. The activities should result in a better functioning labour market and more efficient employment services and programmes.

**Social inclusion, poverty reduction and equal opportunities**

**Poor labour market performance is coupled with a social protection system that does not fully respond to the needs of the population.** The ERP diagnostic in this area focuses on the recent introduction of the life-long benefit for mothers of three or more children, which has negative impacts on labour market participation of women and the sustainability of the social protection system. There is a need for a wider approach to address poverty and social exclusion. More has to be done to improve social integration and fight regional differences.

**The social protection system provides little access to its services, particularly for the most vulnerable parts of the population.** The strategic framework to bring advancements in livelihoods of the population is in place, but there have been little concrete outcomes. The social protection system needs to support activation, while providing help to those most in need. Monitoring implementation of the reforms is a challenge. The planned analysis of the social situation and the ongoing project to establish an integrated social welfare information system should help to identify relevant measures to pursue. Priority should be given to improving the quality of services provided by social welfare centres to activate those able to work.

**The measure to reduce the social benefits for mothers with three or more children does not provide a comprehensive solution to the negative impacts of this scheme.**

The benefit was introduced without an impact assessment and it continues to be dealt with in the same way. It has led to significant fiscal, labour market and legal problems. The effect of reducing the benefit seems inconclusive and will not address the current challenges. More should be done to tackle labour market participation of women through additional support measures, such as childcare services and preschool education, and ALMPs targeted specifically at women who left the labour market to benefit from this law. On the other hand, it is essential to identify socially vulnerable segments among the beneficiaries to ensure they receive adequate support. There is a need for a more strategic reflection on prolonging working lives, through retirement provisions and a long-term care system. While the need for a reflection on pension reform is mentioned, there are no concrete plans yet.

**ANNEX 1: IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2016**

2016 policy guidance	Summary assessment
<p><b>PG 1:</b> Stabilise the debt-to-GDP ratio net of debt related to capital investments already underway in 2016, and then reduce it over the remainder of the programme period.</p>	<p>Montenegro has <b>partially implemented</b> PG 1:</p> <ul style="list-style-type: none"> <li>• The ERP measures comply (at least formally for the year 2017) with last year's policy guidance. According to the ERP2017, projections on the debt-to-GDP ratio (net of debt related to capital investments already underway in 2016), would decline over the programme period. However, the effectiveness of the fiscal performance still needs to be assessed in practice, and the Plan for the correction of the deficit, and public debt needs to be completed with measures until 2021.</li> </ul>
<p><b>PG 2:</b> Take immediate measures to restrain current spending, including on pensions and the public sector wage bill. To generate budgetary savings and improve revenue collection, conduct a comprehensive review of tax expenditure as well as exemptions, and implement tax increase in a growth-friendly manner.</p>	<p>There has been <b>limited implementation</b> of PG 2:</p> <ul style="list-style-type: none"> <li>• Measures were taken to restrain current spending, including on the public sector wage bill, and to improve revenue collection. However, measures are mostly corrective of the expansionary fiscal policy pursued in 2016, and with a short-term focus.</li> <li>• The comprehensive review of tax expenditure and tax exemptions remains pending, as does the new government's fiscal strategy.</li> <li>• The implementation of a tax increase in a growth-friendly manner appears insufficient.</li> </ul>
<p><b>PG 3:</b> Develop a comprehensive strategy to further foster the disposal of non-performing loans by banks, including participation by all relevant stakeholders, while establishing a bank lending survey to better gauge underlying credit dynamics.</p>	<p>There has been <b>limited implementation</b> of PG 3:</p> <ul style="list-style-type: none"> <li>• The Central Bank of Montenegro drafted amendments to the Law on voluntary financial restructuring of debts to financial institutions to extend the scope for loans restructuring. The CBM tightened supervision on commercial banks' own strategies to deal with NPLs; however, a comprehensive strategy has not yet been developed.</li> </ul>
<p><b>PG 4:</b> Ensure effective, efficient and independent regulatory and safety authorities to implement the full opening of rail and energy markets.</p>	<p>Montenegro has <b>partially implemented</b> PG 4:</p> <ul style="list-style-type: none"> <li>• The Law on Cross-Border Exchange of Electricity and Natural Gas was adopted in June 2016 to further align with the EU's third Energy Package; adoption of implementing regulations is ongoing.</li> <li>• The power distribution activities of the Montenegrin Electric Power Company were legally separated from the supply function in June 2016. The functional unbundling of the distribution system operator and certification of the national electricity transmission system operator is ongoing but not yet completed.</li> <li>• The independence of the Energy Regulatory Agency has been strengthened.</li> <li>• On rail transport, no progress was achieved on ensuring effective and independent regulatory and safety authorities; amending the law on rail transport is planned in 2017.</li> </ul>

<p><b>PG 5:</b> Continue to facilitate the provision and range of financial and non-financial support services for SMEs with a view to foster participation in global value chains. Support the development of the private consultancy market.</p>	<p>There has been <b>limited implementation</b> of PG 5:</p> <ul style="list-style-type: none"> <li>• An increased level of financial support for SMEs has been maintained, with an expanded scope of available credit lines and improved repayment conditions.</li> <li>• Financial resources dedicated to non-financial support services remain limited.</li> <li>• Further reform measure on SME support were developed for inclusion in this year's ERP.</li> </ul>
<p><b>PG 6:</b> Prolong working lives and reduce disincentives to work through strengthening the link between activation measures and social assistance, in order to improve the labour market participation of the longterm unemployed, women and youth. Implement strategies to align education and skills policies with labour market needs.</p>	<p>Montenegro has <b>partially implemented</b> PG 6:</p> <ul style="list-style-type: none"> <li>• The benefit for mothers with three or more children was reduced, but needs to be dealt with in a comprehensive manner to ensure that women have an adequate economic position. Plans have been announced to strengthen unemployment benefits and improve the efficiency of employment services. Activities have begun to improve cooperation between employment offices and centres for social work, to improve activation. No actions have been taken for the pension system.</li> <li>• ALMPs continue to be implemented, but with low financing and coverage, weak targeting and no impact assessment. A new law proposes a better basis for improved design.</li> <li>• New qualification standards are being implemented in VET and teachers' trainings are planned. In higher education, a new study and funding model are planned. Weak cooperation with the private sector and career guidance and the oversupply of higher education graduates are not addressed. There have been no real advancements in enrolment policies and work-based learning.</li> </ul>

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## ANNEX 2: COMPLIANCE WITH PROGRAMME REQUIREMENTS

Montenegro's Economic Reform Programme 2017-2019 was submitted to the European Commission on time on 31 January 2017. No components of the ERP are missing.

### *Inter-ministerial coordination*

The preparation of the ERP was centrally coordinated by the Office of the Deputy Prime Minister, the Ministry of Finance, and the Ministry of Economy. An inter-ministerial ERP working group involving line Ministries worked on its preparation.

### *Stakeholder consultation*

The draft ERP was published on the Government's website for public consultation, but only on 13 January 2017, with a roundtable discussion with stakeholders taking place on 20 January 2017, which did not provide enough time to incorporate comments in the final programme. The draft was also presented to the parliament for information and discussion. The government provided a summary of the comments received and if and how they have been taken on board. Several business stakeholders raised concern over the timing of their involvement and asked to be involved at an earlier stage and to be given more time to provide comments.

### *Macroeconomic framework*

The programme presents a clear and concise picture of past economic developments. Given the volume of investments in progress, the baseline macroeconomic scenario supporting economic policy seems plausible. However, the cautious estimates for private and government consumption and for the growth of imports could be arguable. Analytical capabilities are gradually improving. This is, particularly the case of the analysis –for the first time– of the total external debt, including the private one. However, it covers only the period until 2015. Data coverage is also improving, although labour market projections remain largely incomplete. The baseline framework appears coherent, consistent and sufficiently comprehensive. The programme also offers an alternative low-growth scenario based on the occurrence of a sharp contraction of FDI. In this scenario, aggregated demand would contract due to the reduction of investment and consumption; moreover, the startling sharp decline of imports (related to construction and investment) would also soften the negative contribution of net exports and rapidly reduce the current account deficit, which seems at odds with data records.

### *Fiscal framework*

The fiscal framework appears barely sufficient to support the policy agenda beyond 2017. The ERP measures comply –at least theoretically– with the fiscal policy guidance of the Ministerial Dialogue of May 2016. However, their impact is basically limited to 2017 and it will need to be assessed in practice. Furthermore, the medium-term fiscal strategy and the fiscal correction plan remain incomplete, and they would need to incorporate additional measures beyond 2017. The measures presented in the programme are broadly balanced, with both revenue and expenditure measures accounting for some 1.6 % of GDP each. While the most important measures were frontloaded already in December 2016, many of them are short-term. On the revenue side, the fiscal impact of measures like the collection of tax arrears or the legalisation of undeclared work is far from certain. Measures on the expenditure side range from an upfront cut on social benefits or public sector salaries, to some milder ones, like the six-month postponement on freezing the years-of-experience bonus in the public sector (replaced in the meantime

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by an 1 % decrease in the base salaries of salaries with coefficient above 4.10 until end-2018), or the rather narrow increase in computer equipment VAT. The ERP did not cover last year's recommendation to conduct a review of tax expenditure and exemptions. The programme also offers an alternative low-growth fiscal scenario. However, this alternative scenario is much less developed than the macroeconomic one. Work in government finance statistics is ongoing under the action plan for implementation of the ESA2010 methodology. The public finance management reform strategy (adopted in 2015) progress slowly. Overall, a comprehensive medium-term fiscal strategy, including durable fiscal consolidation measures (planned for the second quarter of 2017), still needs to be developed.

### *Structural reforms*

The structural reform sections (4, 5 and 6) mostly follow the guidance note. However, at times, the diagnostics divert from the guidance note by presenting a diagnostic per sub-sector or measure, rather than for each of the nine sectors foreseen in the template. The number of reform measures is limited to 20 and the page limit (40) for section 4 is only overshoot by a couple of pages. The reporting of the implementation of the policy guidance can be improved and should provide more precise information about the actions taken and their impact. Similarly, the monitoring and reporting on the implementation of the priority reforms could be further improved, especially as regards the level of information provided in Annex 12. The Commission welcomes in this regard the government's intention to set up a high-level competitiveness council tasked to monitor the ERP implementation.