

Annex 5.

Economic Reform Recommendations for the Year 2003

1. Background

According to its legal responsibilities the Central Bank of Montenegro is obliged to give the Government recommendations regarding economic policy.

The recommendations are based on the concept of sustainable and comprehensive economic development and integration with the European Union, through further improvement of the legal and institutional framework, the development of enterprise, starting with the following strategic goals:

1. Economic growth depending primarily on the development of the private sector
2. Compliance with the legal framework and the implementation of the Law with European Union Regulations
3. Maximum use of the resources of Montenegro in the areas having comparative advantages (relocation of the production factors according to those areas)
4. Protection of the environment
5. Decrease of external macroeconomic imbalance and achieving monetary and fiscal stability
6. Decrease in unemployment
7. Legalization of the grey economy

Accomplishment of the economic policy goals will be achieved in 2003 through the following macroeconomic indicators:

1. Increase of GDP by 1,5
2. Stop decrease of real income
3. 8% inflation
4. Increase of employment (about 5,000 new jobs)

The recommendations apply to the following segments:

1. Recommendations regarding fiscal policy
2. Recommendations regarding, building, regulating and upgrading of the efficiency level of the financial system
3. Recommendations regarding real sphere
4. Recommendations regarding export-import trade policy

2. Recommendations for certain segments of economic policy

2.1. Recommendations regarding fiscal policy

The current Budget concept for 2003 is hard to be sustained since it is based on unrealistic and inconsistently planned earnings. In designing the Budget, expenses were used as defined amounts and on that basis earnings were planned, which are based on a high tax burden and an increase in customs fees and taxes.

In order to establish fiscal stability the following steps should be undertaken:

1. Gather public earnings and expenses functions within the Ministry of Finance, and specially within payment control through the Department for Public Revenues and Customs Administration. It is necessary to synchronize reform of the fiscal system with the payment system reform in order to maintain and increase payment of the public earnings, specially public earnings paid upon rejection. It is necessary to improve the customs system in the sense of full registration of border turnover and customs fee payment.
2. Not to postpone further introduction of taxes on additional value and carry out intensive public campaign as a support of introduction process.
3. See the real economic base and its resistance to tax pressure. In that sense it is necessary to redefine the level and broaden the basis of the tax burden in order to distribute tax burden equally and make a stimulating tax environment (redefine tax on additional value and income tax)
4. Eliminate postponement of tax and contribution payment on certa-

- in subjects' income and cancel compensation in accordance to Provisions of the Law.
5. Control payment of earnings on the basis of state owned companies yield.
 6. Consolidate Budget expenses with real Budget earnings through:
 - i. Maintenance of the salaries in the public sector at the same level in the real sense and do not relate other personal and social remunerations for the minimum earnings as a base, but for real possibilities of financing the Budget and Funds
 - ii. Decrease in the number of employees in state administration
 - iii. Decrease material expenses
 - iv. Cancellation of subsidies, borrowings and loans which are going to be spent or used to cover debts, and which are neither directly nor indirectly returned to the Budget. This specially applies to borrowings of the companies that are foreseen to amount to EUR 5,2 million.
 7. Develop policy of managing donations and public debt. When negotiating donations do not ask for donations for the Projects, which are directly going to consumption, but for those economically validity. Maintain the level of foreign debt as low as possible and adjust it with the existing plan for payment of foreign debt in order to avoid making of an excessive Budget deficit in future years.
 8. Consolidate Government funds on unique account of the state vault in conformity with the Law on Budget.
 9. Increase transparency of the Ministry of Finance operations with the banking sector and redirect activities towards market financing vs. borrowings from the banking sector.
 10. Develop a policy of managing liquidity through follow-up of in-flow and out-flow and through registering the obligations according to the inception date of an obligation, and not according to the payment date.

11. Redefine the policy of public industries in the sense of financing the Project, which besides social justification has also economic one and increases employment.

12. Funds acquired from banks privatization should be used for frozen savings services

Financing of the Budget Deficit

The Law on Budget regulates sources for financing the Budget deficit. The Law on Budget prescribes that the Government should request recommendations from the Central Bank within the process of preparations of the Law on State's Budget, on Debt Limitations and Guarantees, it should also state the deadline for the Central Bank to respond. Such recommendations are not required from the Central Bank for the preparation of the Budget in 2003. Besides other Republic Institutions, the Central Bank was involved in the preparation of the macroeconomic model that was used as a basis for the Budget projection.

The Law on Budget for 2003 foresees financing through borrowings from abroad and through the banking sector. In accordance with the Budget for 2003, 20,5 million € will be acquired from abroad (15 million € from the World Bank and 5,5 million € from EU). We planed to borrow 3,5 million € from the banking sector.

Bearing in mind the existing situation and foreign debt conditions, we would like to point out the use of these international loans. The loans should not be used for current expenses. There is the possibility of financing public industries from this portion. We do not suggest borrowings from the local banking sector since the level of outstanding debt has already been high (23 million €). We should first decrease Budget expenses, and then compensate the lack of funds with the issuance of Government Securities.

2.2. Recommendations regarding, building, regulating and upgrading of the efficiency level of the financial system

Besides implementing the Central Bank's policy for 2003, for the purpose of further development of the financial system we would like to recommend to the Government that in cooperation with the Central Bank and other authorized institutions it should do the following:

1. Upgrade the regulatory framework through:

- 1.1. Passing the Law on Insurance and Integration of Bank Supervision and Insurance Companies
- 1.2. Passing the Law on Servicing Frozen Savings and Prior to Sanctions Foreign Debt
- 1.3. Passing the Law on Protection of Deposits
- 1.4. Passing the Law on Public Debt
- 1.5. Defining the jurisdiction and regulations for the Short-term Securities Market
- 1.6. Passing the Law on the Payment system with abroad
2. Prepare and begin with the process of privatization of the state owned banks (Podgoricka Bank).
3. As a part of regulations defined in the Constitutional Charter, divide joint assets and liabilities of Montenegro and Serbia.

2.3. Recommendations regarding the real sphere

The basic activities of the Government in the real sphere should be directed to secure a stimulating business environment and system legislation, as well as to prevent the grey economy.

2.3.1. The building of a stimulating environment

The building of a stimulating environment and forming a suitable institutional framework, which is under the Government's responsibility, make a base for starting the investment cycle and the accomplishment of economic growth. A more stimulating environment is one that already has had a certain level of economic freedom, where private property has been well protected and where the Law has been fully enforced. All this represents the basis for the empowerment and development of the private sector.

To create a stimulating environment it is necessary to:

1. Cancel customs and of-customs obstacles and increase effectiveness of statistics in this area
2. Make a schedule for the cancellation of price control in other areas.

3. Redefine the level of the tax burdens
4. Increase efficiency of Court protection
5. Pass a set of Laws in order to protect minority shareholders (and protection of minorities and individuals in all areas) and to protect private property rights in general.
6. Change the Law on Restitution and pass sub-regulation
7. Pass the Law on Intellectual Property Protection
8. Implement Laws relating to corruption
9. Create conditions so one can easily enter and exit business
10. Pass Laws and sub-regulations to regulate debtor-commissioner relationships, and ways to resolve internal debt
11. In order to break monopoly pass the Law on Monopoly
12. Give all companies exemption from tax and contribution payments for new employees for two years (tax loans), and after that all obligations will be executed according to the regular procedure
13. Invest transparently through the banking sector as much as the Government money meant for enterprising. Part of the incentives for enterprising through micro crediting should be transparent and public (loan announcement, results, payback, all should be in the daily news and on the web.)
14. Establish a Contact Center for contacts with international financial institutions (IFC, EBRD, ...) in the Agency for Small and Medium Enterprises, in order to provide new sources of financing for small and medium enterprises
15. In order to decrease tax rates, stimulate all activities increasing funds bid on the market – Short-term Securities, Pension Funds, Insurance Companies, etc.
16. Comprehend consistency of the Laws dominating regulations of the business environment of the private sector: Law on Business Companies, Law on Accounting, Law on Securities, Law on

Bankruptcy, Law on Banks, and consistency of whole legislative system.

17. Analyze Laws already passed from the aspect of harmonization with the EU and Serbia.
18. Improve mechanisms to resolve disputes relating to the private sector, especially in the sense of promptness in resolving disputes (improvement of Court Administration activities, prevention of corruption, Court system reforms)
19. Pass Laws regarding Labor Market stressing the increase in liberalization and decrease in tax and contribution rates, i.e. working costs
20. Quickly implement the Pension System reform, towards capitalization of the Pension System
21. Find an alternative for Old Age and Disability Fund's income since replacement of this component from the tariff structure of the payment system will be done
22. Quicken education reform and enable the opening of private schools to train professional staff for business and enterprise. A professional development strategy will increase the quality and decrease expenses in education
23. Design a development strategy of the competitive advantages of Montenegro, to underline development of certain areas that would increase the capital in-flow in Montenegro

2.3.2. Recommendations for prevention of the grey economy

The building of a simulative environment by itself influences the prevention of the grey economy. More radical moves should be undertaken in the following areas:

1. Pass the Law on Conflict of Interest
2. Implement the Law on Money Laundering
3. Upgrade customs services

4. Improve the Department for Public Revenues services
5. Establish the National Auditing Organization
6. Besides earnings, all cash payments of Government bodies and funds should be directed to the banking system (pensions, social welfare, transfers to citizens, loans and so on)

2.3.3. Development and improvement of statistics

One of the basic obstacles in following economic reforms, economic growth and development, and in preparation of future strategies is the underdeveloped statistical system that does not provide a good information base. Statistical system of Montenegro should be made in a way to meet the needs of all institutional sectors in Montenegro, and international standards in this area.

The first step regarding this area should be the implementation of the methodological standards SNA system (System of National Accounts - 1993)

The Project of statistical system reform should be carried out in a way to cover the following items:

- 1) Organization of statistical system and delegation of responsibilities among authorized institutions:
 - a. The Statistical Institute - system of national accounts, statistics of real sector, employment, etc.
 - b. The Central Bank - monetary statistics, payment balance
 - c. The Customs Administration - statistics of import-export
 - d. The Agency for Foreign Investments - Statistics of direct foreign investments
 - e. The Ministry of Finance - statistics of public finance
- 2) Legal framework
- 3) Program of statistical research
- 4) Methodology of statistical research
- 5) Professional resources

- 6) Technical potential and equipment
- 7) Financial plan
- 8) System of data presentation
- 9) International cooperation

Statistical payment functions (final accounts processing) previously done by the payment system should be replaced to the Statistical Institute in order to calculate macroeconomic endpoints, which are informational base for economic policy implementation.

2.4. Recommendations regarding foreign trade policy

1. Eliminate quantitative limitations in foreign trade policy
2. Pass the law on Foreign Trade
3. Regulate capital flow with abroad
4. Strategy of capital and financial in-flow should be based on direct and portfolio investments, and not on the increase of the public foreign debt of Montenegro

When passing the Law on Foreign Trade and Regulation of Capital flow with Abroad within the Law on Payment System with Abroad, we should pay attention in order to respect basic directives of the Law on Foreign Investments, and that the basic solutions are in conformity with the basic concept of the economic system in Montenegro that foresees the free flow of people, goods, services and capital.