

**RECOMMENDATIONS TO THE GOVERNMENT OF  
MONTENEGRO  
FOR  
2014 ECONOMIC POLICY**

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## I. INTRODUCTION

Despite the fact that the previous year was characterised by a negative growth rate of 2.5 percent, moderate growth rate is expected this year, which will, according to the Central Bank of Montenegro (hereinafter: the CBCG) estimate, range between 3 and 3.5 percent. This growth will be substantially higher even than the average growth in the region and in the European Union (hereinafter: the EU). However, high growth rate does not imply that the crisis period is behind of us, but it can be explained as a result of high number of one-sided positive shocks. To wit, a relative low base exists as a result of extreme weather conditions from the first quarter of the last year. Furthermore, due to extremely favourable hydrological situation, a substantially high growth in the energy sector was evident (growth rate of 69.6 percent for the first seven months). Moreover, extremely high growth rates were evident in the construction (29.9 percent) and forestry (49.9 percent<sup>1</sup>) sectors. It is clear that it will not be possible to achieve these rates also in the following year. In addition, high level of real sector illiquidity and negative growth in large number of other sectors indicates that Montenegro is facing numerous difficulties. Even tourism, which was the main driver of economic growth, recorded a lower number of overnights in the first seven months of 2013.

Montenegrin economy will face numerous risks in the following period: threatened fiscal stability, spillover of negative effects from abroad, a high level of NPLs, a high level of real sector illiquidity and the like.

The key risks are concentrated in the fiscal area and include a rapid growth of public debt, ongoing presence of the fiscal deficit and high amounts of guarantees. The importance of fiscal economy is even higher in a euroised economy, bearing in mind limited monetary policy instruments at disposal. Thus, key policy and key reforms are needed in the fiscal policy area. A set of significant fiscal consolidation measures was passed in the previous period, including: VAT increase; introduction of progressive wage taxes; adoption of a set of regulations aimed at combating shadow economy; intensified inspections, etc. These are well-devised measures that have already provided positive results. However, some new measures will be needed because, in addition to the negative crisis effects, some bad decisions in the past must be dealt with. Therefore, additional adjustment of

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<sup>1</sup> Shown by non-weighted rate, and the production shown by weighted rate increased by 57.3% over the same period.

public expenditures is necessary. In order to ensure a sustainable level of public debt, the share of budget deficit in GDP should be lower than the GDP growth rate.

For the purpose of ensuring a long-term fiscal sustainability, binding fiscal rules should be passed together with sanctions for their violation. These rules should ensure a long-term sustainable fiscal policy, increase credibility of the Government, and influence positively the credit rating of Montenegro.

One of the largest successes of the economic policy is the initiation of negotiations with the EU. Efforts should be intensified to open negotiations for Chapters 23 and 24 as soon as possible as they represent pre-requisite for opening all other chapters.

The banking sector is burdened with a high share of non-performing loans. The CBCG, in cooperation with the Ministry of Finance and the World Bank, developed the Podgorica Approach, a model for the resolution of non-performing loans (NPLs). Due to the importance of this project for both the financial sector and real economy, the pertinent regulation should be adopted by end-2013 or at the beginning of 2014.

The lack of development vision represents a particular problem and, therefore, we believe that one of the priorities should be the development of the economic development strategy.

A significant attention should be paid to the strengthening of competitiveness of the economy, a gradual change in the development model, the passing of systemic laws in accordance with best international practice, continuing deregulation and removing business barriers, and the like. Although the current account deficit declined, it is still high and it is not an indicator of the improved competitiveness of the Montenegrin economy. The change in growth model is also important: from the one driven by domestic demand to the one driven by export expansion. Although the change of growth model requires a longer period of time, it appears that little has changed in the last couple of years.

Special attention must be paid to the preservation of the financial stability, which should be a joint task of the CBCG, the Ministry of Finance, the Securities and Exchange Commission and the Insurance Supervision Agency.

Bearing in mind a large number of recommendations, we highlight 10 key recommendations that are elaborated in more detail below, the successful

implementation of which will largely affect successful implementation of the overall economic policy.

*Table 1 – Ten key recommendations for economic policy*

<b>Recommendation</b>	<b>Implementation deadline</b>	<b>Page(s)</b>
Stop further trending up of public debt	2014	59 and 61
Adopt fiscal rules	Q1 2014	60
Stop (limit) further issue of guarantees	2014	59
Determine strategic development directions for KAP	By end of 2013	22
Open negotiations in Chapters 23 and 24	By end of 2013	86
Prepare for new FDI wave	On-going	83
Substitute foreign labour force by domestic labour force	On-going	53
Prescribe the highest allowable interest rate	Q1 2014	68 and 69
Build new capacities in energy sector	Start during 2014	26-28
Improve institutional environment	On-going	10-13

Pursuant to its legal obligation, the CBCG hereby proposes Recommendations to the Government of Montenegro for 2014 Economic Policy. Analyses of the selected areas contain short background, the analysis of the most important possible risks in the upcoming period, strategic development directions, and proposed operational measures for their implementation. The recommendations are grouped into the following areas:

- Recommendations concerning institutional environment and deregulation;
- Recommendations concerning agriculture and forestry;
- Recommendations concerning industry;
- Recommendations concerning the service sector;
- Recommendations concerning education and the labour market;
- Recommendations concerning fiscal policy;
- Recommendations concerning the financial system;
- Recommendations concerning economic foreign relations and international integration;
- Recommendations concerning environment and sustainable development; and
- Recommendations concerning other areas.

## II. INSTITUTIONAL ENVIRONMENT AND DEREGULATION

### *Background*

A quality and sound business environment is fundamental for economic development and crucial for the transition process. A sound business environment and favourable investment climate is the key for attracting foreign and domestic investments and they are of utmost importance for the growth and development of the country.

Business environment in Montenegro significantly improved during 2012 and 2013 despite the fact that the last two years were among the most difficult years for the economic system of Montenegro since the global crisis outbreak.

The Council for Improving the Business Environment continued (the Council) with the reform projects in 2013 which were initiated in the previous year. These projects include the one-stop shop system for the registration of companies (including also on-line registration), simplification of the procedure for obtaining construction permits and carrying out bankruptcy proceedings, and the like. In February 2013, the Council passed the Programme of priority areas for the business environment improvement, regulatory and structural reforms for 2013, which envisaged that the following activities will be taken in the area of business environment improvement:

- Further implementation of one-stop shop in the process of issuing construction permits,
- Development of recommendations on fees and duties at local levels, paying special attention to utility fees for residential land,
- Introduction of full on-line registration of companies and enabling registration of companies in eight branch units,
- Improvement of the situation in the area of contract enforcement.

For the purpose of more efficient and faster implementation of measures under the Programme, the Council established 13 working groups in the area of the business environment improvement, education, health, pension system and public administration reform.

After the formal introduction of the Regulatory Impact Assessment (RIA) methodology into the Montenegrin regulatory system, the Department for Business

Environment Improvement gave opinions on 119 regulations and 69 laws in the period 1 January 2012 – early 2013.

The Electronic Registry (E-Registry) of Business Licenses<sup>2</sup> (a pilot project of RIA) has been functioning since the end of 2012. It was the result of joint activities of the Government of Montenegro, USAID and East-west Management Institute. This system consists of a material and electronic database of all licenses (some 530 licenses) issued by the competent authority and valid in Montenegro. The E-Registry is available to all citizens and it substantially simplifies the relevant procedures by saving both time and expenses.

With regard to a further implementation of the project “Guillotine of Regulations” in 2012, of total of 1872 recommendations, some 390 recommendations were implemented, while the implementation of 416 recommendations is planned for 2013 and 134 in 2014. Some 416 recommendations were implemented before the adoption of the Action Plan.

With a view to shortening deadlines and simplifying procedures for obtaining building permits and consequently to business improving, the Law amending the Law on Spatial Development and Construction of Structures was passed. The new law introduces the one-stop shop system, which implies that the relevant authority for issuing construction permits issues conditions necessary for compiling technical documentation and/or the consent to the issuing of the building permit, which leads to the shortening of deadlines, the reduction of costs, and more efficient public administration. After two years of the implementation of the Law on Spatial Development and Construction of Structures, which prescribes the deadline for issuing construction permit of 60 days and deadline for issuing conditions necessary for compiling technical documentation of 45 days, the practice showed that the one-stop shop system did not function equally in all municipalities. Specifically, it takes 216 days on average to obtain the permit in Mojkovac, and 211 days to get the same permit in Berane. Based on the Council’s analysis, the fastest way to obtain the permit is in Bijelo Polje (17 days), Pljevlja (24 days), and Kolašin (56 days). The drafting of amendments to the aforesaid law is pending and they aim to shorten the deadline for issuing the construction permits from 60 to 30 days, while the deadline for issuing conditions for technical documentation will be shortened from 45 to 30 days.

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<sup>2</sup> [www.licenca.me](http://www.licenca.me)

The system of multilateral compensations<sup>3</sup> started in 2013, which contributes to the improvement of business environment by enabling overcoming negative economic crisis effects and, in particular, reduction in liquidity. This system ensures the connection of business entities through the closure of borrowings and receivables without the use of liquid funds.

In the area of registration of immovable property, the Law on State Surveying and Cadastre of Immovable Property was amended to prescribe the shortening of deadlines for deciding on requests for the registration of immovable property of up to 15 days. However, the introduction of notary service in the registration of immovable properties increased the costs of the procedure.

The new Labour Law enabled more flexibility to employers in outsourcing and easier dismissal of workers due to unaccomplished expected tasks and objectives.

By prescribing Tariffs for the work of bailiffs, it was expected that the adopted Law on Enforcement and Securing of Claims and the Law on Public Bailiffs (2011) would become effective by the end of 2013.

Two business zones were established in Montenegro, one in Berane and one in Kolašin. Aiming to foster SMEs' development on the planned and infrastructure-equipped land with benefits to be obtained from their local administration, the Government and the Investment and Development Fund, the Government of Montenegro passed the Business Fostering Programme with local administration of these two municipalities. Investment in the following sectors was planned within business areas: agriculture, forestry, fishing, manufacturing industry, transport and warehousing, professional, scientific and technical activities, and information and communication. The establishment of business areas is aimed at ensuring more favourable operating conditions which will increase exports and employment.

The results of numerous activities carried out for the improvement of business environment are also recognised in the World Bank 2013 Doing Business Report, in which Montenegro improved its ranking by six places and is currently ranked at 51<sup>st</sup> place.

Shadow economy represents significant problem as it jeopardises sound business environment. Therefore, the Government of Montenegro established a working group at end of 2012 to deal with this problem. The main objective of its work is to

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<sup>3</sup> [www.kompenzuj.me](http://www.kompenzuj.me)

contribute to an increase in transparency, objectivity and coordination in the work of public bodies, the ultimate effect being a reduced share of grey economy. The Working Group drafted the Action Plan for Combating Grey Economy for 2013. As a part of this plan, the Law of VAT was passed in 2013, and the Law on Excise Duties was amended to enable a more efficient control and reduce the existing room for frauds in practice. During 2013, the *Law on Prevention of Illegal Business Operations* was passed to aim at reducing the level of shadow economy, the collection of public revenues, and introducing order in taxes.

The Customs Administration carried out a campaign “Corruption is Not an Option” during 2013 and focused on increasing awareness of natural and legal persons on the importance of their active involvement and contribution when it comes to fighting corruption.

Regardless of numerous activities taken to improve the business environment, there are certain deficiencies and problems that need to be removed in the upcoming period.

### ***Main risks***

- Inefficiency and slow administration in implementing legislation
- Slow court procedures in resolving commercial disputes
- Difficulties in collection
- Insufficient inspection surveillance and presence of shadow economy
- Highly monopolised market
- Possibility of unfair competition
- Insufficient development of infrastructure
- Unresolved property and legal relationships
- Inexistence of clear planning documentation
- Lack of detail zoning plans
- High utility taxes in the construction sector (particularly at local level)
- Presence of corruption
- Local barriers (multiple and high utility taxes and fees)
- Insufficient labour force mobility
- Lack of qualified staff
- Further deepening of real sector illiquidity
- Disobeying of legislation
- Slow court procedures in respect of restitution

- High costs of notary services
- Unequal conditions and procedures in respect of issuing construction permits in different municipalities

### ***Development strategy***

- a. Increase public administration efficiency, particularly at local levels;
- b. Increase efficiency in implementing enacted legislation and improve the exercising of the rule of law;
- c. Open market to all segments with limited competition providing equal rights to all participants;
- d. Aiming to attracting investors, each local administration unit should create facilities programme;
- e. Improve anti-monopolistic policy functioning;
- f. Continue the application of Regulatory Impact Assessment (RIA) methodology in passing new legislation;
- g. Continue combating shadow economy by strengthening inspections and imposing stricter penalty measures;
- h. Improve efficiency in implementing the enforced procedure;
- i. Strengthen the mechanism of restitution and expropriation;
- j. Employ public enforcement officers at the shortest who will be responsible for the implementation of commercial contracts;
- k. Find space to reduce fees for notary services;
- l. Introduce automatic bankruptcy;
- m. Take activities to reduce illiquidity of the economy;
- n. Strengthen entrepreneurship development as generator of growth and development;
- o. Sanction all investors breaching contractual obligations;
- p. Strengthen financial support in creating new and developing existing SMEs through the Investment and Development Fund.

### ***Operational measures***

Continued implementation of regulatory reform should enable the removal of business barriers and creation of better conditions for exercising the rule of law. This will further reduce possibilities for corruption and ultimately create better and more stable business environment. More efficient court proceedings and efficient implementation of the law is the prerequisite for attracting foreign investors.

Many laws aiming to improve business environment were passed in the past few years but there is some inconsistency in their application. With a view to removing business barriers and maintaining a stable business environment, the relevant authorities have to provide efficient application of the enacted laws.

Investors make increasingly more objections to the lack of professionalism of public administration officers and inefficiency of the administration work. Therefore, the public administration's training system should be improved with a view to enabling the acquiring of skills, competences and providing continuous training. Moreover, administrative procedures should be improved, implying shorter deadlines for acting, collecting documents *ex officio*, and determining actual fees in accordance with administration costs.

The efficient enforcement of the Law on the Prevention of Illegal Business Operation is needed, which will reduce the level of grey economy and prevent the possibility of unfair competition. On the other hand, its efficient implementation will increase the repayment of obligations and reduction of intercompany debts, and reduction of tax debt using all benefits provided by this law<sup>4</sup>. This will also create assumptions for achieving higher budget revenues. The Action Plan for combating shadow economy should be implemented on an ongoing basis in the following period.

Efforts should be made to establish a better quality corporate management, focusing on principles of protecting minority shareholders and "social responsibility" (stakeholder corporate management principle).

There are many instances of new owners not adhering to all provisions of privatisation contracts, sometimes generating additional costs to companies and the government budget. The authorities should keep systematised records of contracts' implementation and timely respond by taking appropriate actions.

The application of the RIA methodology should be continued. Its implementation is essential, since it is a complex tool aiming to enable *ex ante* evaluation of new legislation (laws and secondary legislation). Recommendations given under the "Guillotine of Regulations" project should also be implemented in accordance with the Action Plan.

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<sup>4</sup> Law on the Prevention of Illegal Business Operations provides all forms of payments, compensation, debt and receivables assumption, transfer and assignment of rights, and the like.

Aiming to develop some local administration units and attract foreign investors, each local administration should create its facility programme for foreign investors, thus also improving business environment. The package of measures might include tax facilities to new investments, establishing business areas, creating municipal zoning plans, efficient local administration, and the like. For the purpose of faster and more efficient procedures, local authorities should establish working bodies to be available to investors. Moreover, the authorities should introduce tax facilities for employing certain categories of unemployed persons in underdeveloped local administration units. With a view to attracting investments and facilitating start up businesses, in the municipalities in the North in particular, the number of necessary permits and approvals for the start up and the number and amount of local taxes should be reviewed and unnecessary taxes should be abolished.

The one-stop shop system should be improved for obtaining construction permits in all local government units to reduce the number of days waiting for the construction permit and ensure that the actual deadline for obtaining construction permit in practice corresponds to the legally prescribed deadlines.

Since foreign investors pointed to “ambiguous legislation and conflicting laws, procedures and secondary legislation”, it would be necessary to make detailed analyses of some laws for the purpose of removing uncertainties and limiting possibilities for misinterpretation and misapplication by companies

Unresolved property relations often represent big problem for the investors. Therefore, restitution and expropriation mechanisms should be improved for the purpose of creating more favourable legal basis for encouraging investments.

Montenegro is a small country so it is not unusual that many companies behave as monopolists or oligopolies. However, such a situation could be highly unfavourable from the aspect of consumer welfare so it is necessary to prevent any misuse of dominant position. Thus, it would be necessary to completely open the market in all segments where competition is limited by fostering investments into these areas and creating more favourable investment conditions. Thus, one may have an impression that prices of some services are more expensive in Montenegro than in other countries in the region.

Taking into account a significant share of the foreign labour force, the procedure for obtaining working permits should be shortened and accelerated. In addition, it would be useful to examine the possibility of interim working permits being valid from the period of filing the application until the permit issuing. The government

should also examine a more restrictive policy of issuing working permits in sectors with available labour force in the Montenegrin market.

The collection of bad corporate debts in Montenegro is within the jurisdiction of courts. Thus it is necessary to pass all required regulation and documents to ensure appropriate environment for the work and functioning of public enforcement officers.

An additional analysis on notary service tariffs should be made to find a way to reduce the high prices of notary services.

With a view to mitigating the illiquidity problem, the automatic bankruptcy principle should be introduced. Thus, the real sector would be cleared and the financial sector's stability would be improved by transferring mortgage claims to banks' equity. In order to give companies sufficient time to eventually exit the blocking on one side, and to prepare all necessary preconditions on the other side, we believe that the abovementioned law should be passed with the grace period of one year. In the upcoming period, the key precondition should be performing intensive training of bankruptcy administrators which would mitigate potential unemployment increase resulting from failure of some companies. Bankruptcy should be financed from assets of economic entities in bankruptcy. The state should also contribute to mitigating the illiquidity problem through regular settlement of its obligations.

### **III. RECOMMENDATIONS CONCERNING AGRICULTURE AND FORESTRY**

#### ***Background***

The agriculture sector (agriculture, forestry and fishing) has a significant but still not a satisfactory position in overall Montenegrin economy. The share of gross value added in total GDP has been on a downtrend over the past period, i.e. from the beginning of 2000 when the calculation of GDP according to SNA93 and ESA95 methodologies has started. In addition to certain annual fluctuations, gross value added of agriculture dropped from 11.3% of GDP in 2000 to 7.9% of GDP in 2011 (based on current prices).

Due to its complexity, the agriculture sector, i.e. Chapter 11 Agriculture and Rural Development is one of the most demanding chapters in the negotiation process with the EU, which places this sector before a series of challenges and commitments to be met in the following period in order to harmonise fully with the EU *acquis*.

Key activities in the agriculture sector in medium and long term should be directed towards upgrading the volume of agricultural production and creating incentives for the revitalization of villages. A substantial contribution to these activities was provided through the support of international projects through IPA (Instrument for Pre-Accession Assistance), FAO (Food and Agriculture Organization), and MIDAS (Montenegro Institutional Development and Agriculture Strengthening). The Implementation of the Twinning project “Strengthening Rural Development Programme under IPARD in Montenegro” started on 13 June 2013. The project is funded by the EU and is carried out by the consortium of the Netherlands, Lithuania, Estonia and the like.

The use of pre-accession funds for rural development is of particular importance for Montenegro. They will provide a significant support to both agriculture producers and strengthening of administrative capacities. The document titled “Montenegro Agricultural and Rural Development Programme under IPARD 2013” is basically a development programme for rural areas and as such it is harmonised with the strategic documents from the agriculture area. IPARD programme is intended to propose measures based on strategic documents which implementation will enable utilisation of funds from IPA Component V.

Grants for 2013 IPA Component V (in the amount of 7.285.467 euros from the EU), together with the national co-financing, should enable the Montenegrin agriculture and rural areas to improve the efficiency of food market and implement EU standards in these areas in the pre-accession period. Moreover, agriculture is a segment that largely contributes to *agriculture, forestry and fishing* sector. In that respect, the production of organic food in particular with the available forest potential will be resources that should be used and marketed in the following period.

In the past few years, the following key documents regulating the forestry sector were passed: the National Forestry Policy, the Law on Forests, and the National Action Plan for Combating Illegal Activities in Forestry. Results of the first National Forest Inventory show that forests account for almost 60% of Montenegro's territory<sup>5</sup>. The National Forestry Policy for Montenegro and Spatial Plan for Montenegro until 2020 served as the basis for the Inventory. An expert team engaged within FODEMO project drafted the Strategy with the Plan for development of forests and forestry – the National Forestry Strategy. This document represents also the basis for the preparation of the Report on strategic environmental impact assessment. Montenegro forests are a recognisable symbol of ecologic state through its quality, functions and products and simultaneously they represent good basis for the rural development and increase of the employment in rural areas. Forests are important for maintaining flora and fauna through net absorption of large quantities of carbon dioxide, and for mitigating effects of climate changes, and preventing the land erosion. There are still doubts whether forestry in Montenegro is managed in a sustainable manner.<sup>6</sup>

### ***Main risks***

- Migration of rural population and deagrarization resulting in depopulation of villages
- Insufficient labour force and training
- Undeveloped infrastructure in rural areas
- Breeding of inadequate assortment
- Inadequate forest management and fire danger
- Loss of competitiveness due to lower subsidies than the those obtained by competitors and extensive production

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<sup>5</sup> Ministry of Agriculture and Rural Development: National Forest Inventory of Montenegro - summary, Podgorica, 2011.

<sup>6</sup> For more details, see the *Forests and Forestry* paper, published within the study “Montenegro in the XXI century in the area of competitiveness“, published by Montenegrin Academy of Science and Arts (MASA).

### *Strategic development*

- a. Complying with the sustainable development principle and increasing the agricultural production volume with particular focus on organic production and promotion of the Montenegrin food production specificities.
- b. Ongoing implementation of the EU Common Agricultural Policy (CAP).
- c. Improvement of agricultural production in the north of Montenegro.
- d. Support investments in village development, including infrastructure.
- e. Encourage the development of higher quality products with higher profit, strengthen organic production and the production in protected area (greenhouses) which reduces risks of adverse external impact and creates the possibility of expanding production of different types.
- f. Improve competitiveness and stimulate production development in family agricultural holdings.
- g. Value forest wealth to a higher degree, adhering to the sustainable development concept.

### *Operational measures*

The government must continue to support agricultural production, particularly the one of the most developed countries in the world. Otherwise, if lower amount of subsidies is granted than it is the case with competitive countries, agriculture producers will find themselves in less favourable position compared to the main competitors. Incentives provided to the development of agriculture are important for poverty reduction and stopping of migrations. It is obvious that Montenegro must not leave agriculture only to market, but an entire programme of support is needed that would be based on three pillars:

- Improvement of competitiveness of producers,
- Sustainable management of resources, and
- Improvement of the quality of life in rural areas

The Government should consider also providing tax reliefs to agricultural producers. Total amount of taxes that is collected from agricultural producers is small and the study of the World Bank clearly proved that in countries with high taxation of agriculture there is a low level of agricultural growth and decelerated growth of entire economies.

Promotion of indigenous products of high quality both at the domestic and international market is particularly important. The trademark “Good from Montenegro” on some products contributes to recognising the Montenegrin brand (specific product). The right for obtaining this prestigious trademark as the guarantee of quality was provided to 14 companies for 74 products. The fostering of organic production and recognisable brands is a consistent implementation of the very concept of ecological state. The ongoing support to organic production will contribute to the strengthening of competitiveness of Montenegrin producers of organic food. As stated in the National Action Plan for Organic Production 2012 – 2017, the ongoing training of producers and advisors for the organic production will be performed.

The proposal of the Law on Organic Production, which is in the Parliament procedure, is harmonised with the Council Regulation (EC) 834/2007, and it should be adopted as soon as possible.

By presenting the harmonisation of domestic legislation in this area with the EU *acquis communautaire* at the bilateral screening (in December 2012), the need for a gradual harmonisation of laws and documents with the EU Common Agricultural Policy (CAP) was clearly highlighted. The EC document as of November 2010 (The CAP towards 2020: *Meeting the food, natural resources and territorial challenges of the future*) mentions three main objectives of CAP: viable food production (improvement of competitiveness), sustainable management of natural resources and climate action (foster green growth), balanced territorial development (support economic development in rural areas, employment etc).

By adopting the Strategy for Food Production and Rural Area Development in 2006, Montenegro set up the foundations for agricultural reforms, defined clear development objectives, and agriculture policy which is harmonised with the EU Common Agriculture Policy. A new strategy should be developed in the upcoming period to keep pace with the objectives of the revised CAP.

The development of agriculture would enable the provision of income, increase in employment in northern municipalities and influence simultaneously the revitalisation of villages and reduction in migration of population. One of the projects that boosts the development in agriculture is the project “Development assistance to farmers in remote areas of Montenegro”, which aims at the development of livestock breeding in the north of the country. It has been carried out by the UN Food and Agriculture Organisation (FAO) in cooperation with the Government of Montenegro and it has proven to be very successful. Since this

project is in its final phase, similar projects should also be realised with an objective of development of production in the north of Montenegro through various types of support (training, machinery, development of associations, and the like).

Poor infrastructure characterises many rural areas in Montenegro, and it is particularly evident in inaccessible remote areas. This has adverse effect on their economic and social status, contributing to depopulation of villages. The mitigation and stopping of such adverse trends is possible only with a strong support of the Government through the allocation of budget funds, in particular through the agro-budget. Measures for the improvement of the quality of life and expanding economic activities in rural areas intended for the reconstruction and development of villages and development of rural infrastructure may partially influence the declaration of the agriculture and improvement of the conditions for agriculture production. Achieving sustainable development of rural areas is one of important challenges of overall development of Montenegro. This corresponds to the Montenegro National Development Plan 2013-2016, which identifies policy areas where agriculture and rural development are included in the area of development of sustainable growth. Therefore, ongoing investments in agricultural infrastructure are needed as well as in roads and their maintenance to foster further development of villages. Appropriate use of the IPA component V funds in the upcoming period will be extremely important.

The structure of production should be directed towards plants that could potentially yield higher profit such as early cultivation of fruits and vegetables and increase of the production in greenhouses. The government must continue to support agricultural production, particularly the production similar to the one of the most developed countries in the world. Otherwise, our agricultural producers would be in unfavourable position and uncompetitive. Budget support should focus on those programmes in which Montenegro could attain comparative advantage, these being: viticulture, olive growing, production of fruit and early vegetables, livestock farming and production of ecological food. Montenegro has good natural conditions for developing these agricultural branches.

Agricultural production in family agricultural holdings (farms) should be more developed. Being in line with the Law on Agriculture and Rural Development passed in July 2009, agricultural holdings' development and their improvement is stimulated through the National Programme for Food Production and Rural Areas Development in the period 2009-2013. Thus, it is particularly important to use IPA component V in an adequate manner. The adoption of the Programme for

Agriculture and Rural Development of Montenegro under IPARD 2007-2013 represents the basis for the use of funds under this component. This programme defines three measures within two priority axes and a measure of technical support. One of the measures refers to the investments in agricultural holdings, i.e. measure 101 – Investments in agricultural holdings to restructure and to upgrade to EU standards.

Damages to agricultural products and crops, livestock and other resources regularly accompany agricultural production. Although producers may insure against some of these risks under the regular insurance system, they rarely use this possibility due to expensive insurance premiums and large scope damages exceed the producers` possibility of repair. Thus, the state participation in insurance costs would be highly desirable.

Forests are the basis for creating value added in the area of wood production, renewable energy sources, food production, and tourism. According to rough estimates indicated in the draft *Strategy with the Plan for Forest Development and Forestry*, the share of forestry and wood production in GDP is somewhat less than 2%, which is insufficient considering the available potential (Forests of Montenegro cover 60% of the territory of the country and their structure is natural). Increase of economic contribution is possible through an increase in the volume of forest cutting (together with necessary investments) and through an increase in value added in the wood production chain. For the purpose of export of products of a higher degree of processing, wood sector potential should be used for stimulating connections between wood producers with wood processors. Human resources in forestry should be continuously improved, using all available assistance of international institutions and projects.

Due to its undeniable potential within the entire industry (agriculture, forestry and fishing), forestry represents one of the possibilities for social and economic improvement of undeveloped areas in Montenegro.

A portion of EU IPA funds for rural development and other purposes in period 2014 -2020 is directed towards forestry development. Thus it is necessary to attract through adequate measures and plans, funds for the development of this insufficiently developed segment.

## **IV. RECCOMENDATIONS CONCERNING INDUSTRY**

### **1. Metal industry**

#### ***Background***

In recent years, metal industry, has been facing extreme problems both at the international market and in Montenegro. An opportunity to solve inherited problems by privatization was missed and the global economic crisis has only worsened the situation. The physical volume of industrial production, as one of the branches that suffered the hardest consequences arising from the crisis, has recorded a continuous decline since 2008, with the exception of 2010 when the growth was recorded. The share of basic metals in the overall industry significantly reduced in the last five years, from 41.3 percent in 2008 down to only 21.2 percent in 2012.

The decrease is a result of insufficient and unprofitable production in KAP, which was caused by a number of factors (the global crisis, the price of aluminium on the world's market, poor choice of strategic partners, redundancy, high production costs, obsolete equipment, and the like).

In 2010, the Government of Montenegro and KAP signed the Agreement on settlement, which guaranteed indebtedness of KAP in the amount of 130 million euros and 5 million euros for the social program. This was an attempt to solve the problems of high indebtedness of KAP with commercial banks and to perform optimization of operations. However, such decision proved to be wrong in terms of fiscal risk.

During 2012, problems in KAP worsened due to internal inefficiencies and substantial reduction in the price of aluminium in the global markets. Irrational operations of the company affected defaults to creditors of the Russian owner - CEAC, due to which the Government's guarantees given to Deutsche Bank in the amount of 23.4 million euros were activated. In March 2012, the Montenegrin Parliament supported the Government decision to take over 22 million euros worth of the KAP's debt to Deutsche Bank, terminate the contract with the Russian owner - CEAC, take over the company, and introduce a new management.

Problems continued in 2013, and the first significant event of the year was the request of the Government (Ministry of Finance) to Commercial Court for the introduction of bankruptcy in mid-June, due to a debt in the amount of over 24 million euros. Bankruptcy proceeding was initiated on 8 July. Meanwhile, in early July, OTP and VTB banks informed the Government that they will activate the loan guarantees totalling 102 million euros. The Government settled the guarantees through new indebtedness.

In recent years, the **Steel Mill (Tosçelik)** has been facing serious problems in financing production and an unfavourable situation in the steel market resulted in a significant reduction in the volume of production. With regard to completing the Restructuring program, the Government provided a loan guarantee to the Steel Mill in amount of 26.3 million euros for severance payments to employees, modernization and mitigation of technical-technological underdevelopment of production. Nevertheless, there was a need to modernize the production in order to increase market competitiveness of the company and create a loss free business environment. In order to address the problem of redundancies, a social program was implemented. However, due to record losses incurred in the period 2009-2010, poor performance of the company, and inability of the owner to pay off debts, bankruptcy was introduced in mid-April 2011 and in May same year the Government had to pay off that loan. Bankruptcy also represented termination of the contract with the current majority owner.

As of May 2012, company Tosyali from Turkey became the new owner of the Steel Mill, and bought the assets of the Steel Mill in the amount of 15.1 million euros. Production started in July 2012, with the establishment of a new company - Tosçelik, in the form of a limited liability company. The plan of the new owner was to invest around 35 million euros in the next three years, to increase the number of employees from 308 to 550, and finally increase the volume of production from 120.000 tons to 400.000 tons. Tosçelik ended 2012 with a loss of nearly 3.5 million euros.

### ***Main Risks***

- High fiscal, social and environmental expenses caused by KAP bankruptcy.
- Jeopardizing the country's reputation and investment environment due to unresolved issues with strategic investors.

- Further deterioration of the fiscal position, due to potential new expenses of the Government in solving problems in the metal industry (subsidies, social programs, and the like).
- Fall in aggregate demand due to lower earnings and layoffs of a number of employees in the KAP.
- Further decline in the prices of metals, especially the price of aluminium in the world's markets.
- Failure to comply with environmental standards in business operations and high environmental recovery fees.

### ***Strategic development***

- a. Define a clear strategic decision on the fate of KAP and Bauxite Mine.
- b. Modernization of the metal industry, which will comply with modern high ecological standards, according to the needs of domestic demand and export, with the use of energy efficient production.

### ***Operational measures***

In case KAP survives the bankruptcy, a new strategic investor should be found. In that situation, the Government should provide guarantees that those future investors will really invest and make of it a successful company to benefit Montenegro. The precondition for the survival of KAP is the modernization of production equipment and technology in order to obtain an effective product that meets the standards and has a competitive price in the international market, as well as resolving the issue of electricity supply.

It should be noted that without significant Government subsidies (electricity), it is unlikely that a new investor can organize profitable business. Therefore, a serious consideration of the option of closing KAP is necessary.

At the same time, solutions to restore business operations in bauxite mines should be found. The following options should be seriously considered: 1) closing down of the company, 2) repeating the Steel Mill experience - the introduction of bankruptcy and attempt to find new strategic partners through bankruptcy.

## **2. Energy**

### ***Background***

The energy sector is one of the key strategic industries of the Montenegrin economy, and nowadays is becoming one of the priorities in economic development policies. Reforming the energy sector and integration into the regional and European energy market represents a precondition for future sustainable development of the economy and it is expected that this segment of the economy will be one of the key drivers of development in the upcoming period.

The energy sector has a significant impact on the economic development of Montenegro. In previous years, the production of electricity from domestic sources did not meet the overall needs (whereby situation significantly improved in 2013 due to a reduced capacity of KAP), and indicated the dependence on import. This situation substantially contributes to deterioration of the balance of payments position of the country. In the long run, the reliance on electricity import makes the system less stable than potentially possible. Increasing the capacity of the electricity production is a necessity, not only in terms of economy, but also for the preservation of minimum energy independence.

On the other hand, there are irrationalities in electricity consumption that are most prominent in certain corporate entities and the household sector. Thus, energy efficiency improvement begs an important question of reducing import dependence. The entire energy chain, from production through transmission and distribution to final consumption is characterized by a relatively low level of energy efficiency. Development needs for energy of the corporate and household sectors is increasing and energy production is insufficient, so the production increase and improvement of the energy balance have become strategic development goals, bearing in mind that the energy sector is a powerful driver of economic growth and development has multiple effects on other activities, new jobs, higher wages and a better living standard.

A huge unexploited potential, especially of renewable energy sources, could be a chance for the development of the northern region of Montenegro considering that most of the hydro potential, wind potential, and coal mines are located in the north of Montenegro, which is economically less developed than the rest of the country. Valorisation of projects could, inter alia, affect the slowing down of negative demographic trends in this part of Montenegro.

In 2012, the Government started to upgrade and update the existing strategic document of the energy development adopted in 2007. The new document - Energy Development Strategy by 2030, which draft has been submitted for a public debate, aims to increase investments in the energy sector in order to renew the existing and valorise new sources of energy, create a sustainable, secure and competitive energy supply from all available sources, provide energy efficiency and increase exploitation of renewable energy sources. The reasons for the adoption of a new Strategy are related to deviations, delays and incompleteness of certain issues that were not covered by the previous Strategy.

Along with the aforesaid Strategy, a strategic environmental impact assessment aimed at identifying critical points that would have a negative impact on the environment, health and social - economic condition of the population was prepared.

In order to harmonize the national legislation in the field of energy with the EU legislation, the following laws were adopted: Energy Law, Energy Efficiency Law, and Law on Exploration and Production of Hydrocarbons. These laws are largely compliant with the EU *acquis communautaire*.

Analyses conducted in this area show that Montenegro has the greatest potential for energy development in renewable energy sources such as: big and small hydro power plants and wind power plants. Great attention was paid to the construction of small hydro power plants that can be put into operation very quickly and do not have a detrimental impact on the environment. Construction of 35 small hydro power plants (according to the Energy Development Strategy by 2030) in 13 streams with annual electricity production of approximately 300 GWh is foreseen in the upcoming period. Eight agreements on concessions were signed with six concessionaires for the construction of small hydro power plants (on confluents of the rivers of Lim, Tara and Zaslavnica near Nikšić). There is a plan to build four hydro power plants on Morača with the capacity of 238 MW with an expected output of 721 GWh.

The construction of cogeneration on landfill gas in Podgorica with power of 1.1MW is also planned. The value of the investment is 2.6 million euros. Taking into account various types of waste and the possibility of "recycling" and the effect on the ecology and tourism, this type of energy generation is of strategic importance.

Since 2009, the electricity market has been open to all consumers, except for households, for which it shall be open by 2015 (in accordance with the provisions of the Treaty establishing the Energy Community). Montenegro signed the Protocol of the United Nations on Framework Convention on Climate Change and the Kyoto Protocol from 2007. However, the modalities and terms are yet to be agreed. In cooperation with the UNDP, the Government prepared the first National Report on Climate Change, which identifies the main pollutants.

Montenegro does not have access to international resources of natural gas, has small coal reserves and has to import oil. Oil retail trade is liberalized, but the liberalization of the entire energy sector is at an early stage, the competition is still very limited, and the energy sector institutions require further improvements. Regulation on mandatory strategic oil and oil products reserves is prepared, but its adoption is still pending.

### ***Main risks***

- Increase in the price of capital in the international market could substantially increase the price of energy project financing and slow down the implementation of planned projects;
- Insufficiently examined environmental impacts of building new plants;
- Insufficient capacities for operational activity (construction of basic and environmental facilities), inadequate "know-how" in the field of energy, especially when it comes to research activities;
- Quality of investment project analysis. Any investment analysis needs to be elaborated in detail and explained in terms of costs and benefits in order to avoid "inadequate" investments;
- Business barriers that prevent free market economy in general and in particular in the energy sector;
- Despite the Energy Efficiency Law, Montenegro has not yet developed financing mechanisms and sources of financing (grants, budget resources, international organizations, and the like), that would allow long-term assessment of the possibilities for energy development in accordance with the principles set out in this Law.

## *Strategic development*

- Construction of new facilities, in cooperation with leading strategic partners, either through private or public-private investments. Construction of new facilities is important from the aspect of providing energy independence and reducing the current account deficit;
- Reduction of legal gaps and completion of legislation in this area in order to create a clear, economically viable, environmentally safe development direction in this area;
- In the long term, employ all energy potentials of Montenegro that meet the principles of sustainable development and do not have negative impact on the environment;
- Energy efficiency increase in final consumption, primarily in industry, services, transport and households sectors.
- Promotion of new technologies and standardization in the construction of residential buildings and the use of heating and/or cooling systems: substituting direct transformation of electricity into heating energy and using new technologies acceptable from the environmental protection aspect;
- Increase efficiency of energy companies by reducing operational costs, technical and commercial energy losses;
- Modernize and revitalize the existing and build new infrastructure for energy generation, transmission and distribution following the principles of international technical standards, loss reduction and sustainable development;
- Increase utilization of alternative energy sources (solar energy, wind energy, biomass and the like);
- Implement a project of strategic stocks of oil products in accordance with the EU energy policy.
- Regulatory, legislative and operational integrations in the process of joining the EU in the field of energy and environment, including integration into the Energy Community of South East Europe (ECSEE) and the energy market of the European Union;
- Transparent pricing of electricity and the continuation of social welfare programs in the process of reform changes in the energy sector in order to protect the living standard of the most vulnerable population.

## *Operational measures*

The key recommendation in the field of energy refers to the building of new capacities. Montenegro has a substantial potential, a capacity to build a new thermal power plant facility, and its exploitation of alternative energy sources is negligible. Construction of new facilities would provide full energy independence, reduce the current account deficit, increase employment and GDP.

Adopt and fully implement the Energy Development Strategy by 2030.

Encourage investors to use renewable energy sources, construct new facilities for the production of electricity from small and big hydro power plants.

Consider the option of gasification of Montenegro. Potentials for gas delivery include connecting to the Adriatic-Ionic gas pipeline and to gas pipeline that will pass through Serbia and Bulgaria.

The following measures should be implemented in the field of energy efficiency:

- Continue the revitalisation programme of HPP “Piva” in cooperation with the KfW and the revitalisation programme of HPP “Perućica”, as well as revitalisation of TPP “Pljevlja” in the part referring to the construction of a new waste transport system, landfill cultivation and building in the “DESOX” system.
- Continue the project of developing a transmission network at the regional level.
- Work on reaching an agreement with the neighbouring countries on the use of common hydro potential. Continue negotiations with Bosnia and Herzegovina and Croatia on the division and use of common hydro potential. In the case of HPP Boka and/or HPP Kruševo, do the necessary research for routing investments.
- Develop a database and a high-quality statistical support for the consumption and distribution within the Energy Efficiency Action Plan.
- Protect the state and consumers from potential negligent behaviour of concessionaires. Oblige concessionaires to repair and maintain facilities on a regular basis through the introduction of mandatory provisions in the concession agreement.

With a view to better utilisation of renewable energy sources, it would be necessary to:

- Continue activities on the valuation of the hydro potential of Montenegro;
- Create a new Action Plan for the Energy System Implementation by 2030;
- In order to assess the overall impact on the environment and ecosystem and viability of projects, a large number of various experts should be included from the micro-sites selection phase to the initial operating phase of the HPP.
- Continue modernization and development of the distribution network, which would allow more stable transmission and easier access to the new projects into the distribution system;
- Improve the distribution network at locations where the construction of small hydro power plants and wind power plants is planned. Provide funds for the construction of auxiliary facilities (electric substation, overhead transmission line), which will be the obligation of the concessionaire or the operator. Also, it is necessary to define the most cost-effective and most functional point of connection to the distribution or transmission network;
- Speed up the preparation and adoption of spatial planning documentation for all proposed power plants and simplify the procedures for obtaining construction permits (both at state and local levels) aimed at faster project implementation;
- Adopt all secondary legislation stemming from the Energy Efficiency Law to enable its full implementation. Within the secondary legislation, create transparent and clear criteria and method of selection of potential investors in the energy sector.
- Adopt a ten-year working program for the development of renewable energy sources;
- Prepare project for the hydro power plants maintenance after the expiration of concessions;
- Accelerate the harmonization of legislation in order to facilitate obtaining the necessary permits for the construction of wind power plants and strive for broader utilization of solar energy and biomass.

It is necessary to continue exploration of oil and gas at the Montenegrin coast, coal in the Berane area and research of the remaining hydro potential.

Work on creating the conditions for the implementation of the strategic 90-day oil derivatives stocks in accordance with the EU energy policy.

## V. RECOMMENDATIONS CONCERNING SERVICE SECTOR

### 1. Tourism

#### *Background*

Long-term trends in international tourism demand point to a growth trend in tourism over the past 60 years. In spite of periodical shocks, statistical data on global international arrivals have been showing continuous increase since 1950, thus making tourism the fastest growing economic activity. According to the UNWTO report, international arrivals will grow by around 3.3 percent per year by 2030 (Tourism Highlights 2013).

Importance of tourism i.e. *accommodation and food services* as a comprehensive activity is increasing also in the overall Montenegrin economy. This is supported by the data that the share of GVA (Gross Value Added) in the tourism sector i.e. accommodation and food services in the total GDP of Montenegro in 2011 was twice the GVA in this sector in 2000 when it was 2.5 percent.

Montenegro's economy trending largely depends on the movements in the sector of *accommodation and food services* (in the previous classification, title of this sector was *hotels and restaurants*), thus, it is necessary to work continuously on providing high-quality and internationally comparable data and/or information, which would be the basis for high-quality decisions on the future development. Monstat released a series of calculated TSA (tourism satellite accounts) data, such as: GVA of tourism activities, tourism direct GVA, internal tourism expenses, internal tourism consumption, and a variety of other data. Tourism statistics improved due to the availability of statistical data on foreign cruise ships in Montenegro, with a series of nautical tourism data (the number of foreign vessels for leisure, sport and recreation), the introduction of research module on survey on tourist spending of households in Montenegro, and the like. Despite a number of statistical indicators on *accommodation and food services*, it is necessary to introduce a statistical survey on foreign tourist consumption to allow for better assessments of total income from tourism and also a high-quality basis for future assessments of certain indicators.

According to available data, tourism represents the most prospective and most dynamic activity in the future economic development. It is a complex system implemented throughout most sectors which create an overall picture of the

Montenegrin economy. According to the latest estimates of the WTTC (World Travel and Tourism Council) for the upcoming decade (2013-2023), Montenegro is highly ranked (third place) measured by the increase of direct share of travel and tourism in GDP (8.1 percent annually). The world's average is 4.4 percent. According to the statistical indicators of tourist arrivals and overnights, good results were recorded in 2011, 2012 and the first half of 2013. Therefore, we should continue with the promotion and valorisation of unique resources that will encourage the development not only of coastal but also other regions<sup>7</sup> of Montenegro, which implies the development of areas where tourism has been marginalized or has partly contributed to revenues and total GDP.

The following investments will contribute to the strengthening of this sector in the overall economy of Montenegro: Porto Montenegro and the opening of the new Regent hotel in 2014, the resort in Kumbor – opening is expected in mid-2016, Blue Horizon project, Lustica Bay Resort project and the like.

Program activities related to the development of tourism are defined in the Master Plan, according to which Montenegro should become a developed tourist destination with a unique product that is offered throughout the whole year and with a balanced economic development of the north and south. Rural tourism represents a great potential, which, along with the agricultural sector, could contribute to the strategic objective of the Montenegrin Government - balanced regional development.

Despite the progress that has been made in the past, there remain problems in the sector: the lack of offer, transport infrastructure, inadequate number of parking space, heavy traffic jams, the problem with waste management and disposal, overcrowded beaches, short season, water supply problems in some municipalities and other.

### ***Main risks***

- Short season;
- Lack of high-quality hotel facilities and other high-quality commercial accommodation facilities;

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<sup>7</sup> Conditionally a region, since the whole Montenegro is presented as a single statistical region at all three levels pursuant to NUTS regulation (more detailed information are available at the Monstat's website – NUTS classification)

- Insufficient differentiation of products and services and underdeveloped offer for the target groups of tourists;
- Inadequate utility and local infrastructure;
- Inadequate competitiveness in price and quality;
- Insufficient number of highly qualified domestic staff, particularly management in the tourism sector.

### ***Strategic development***

- a. Find a balance between mass and elite tourism valorisation;
- b. Improve the structure and quality of accommodation;
- c. Stimulate investments in the construction of high-class hotel facilities and upgrade the existing accommodation capacities;
- d. Diversify tourist offer and extend the season;
- e. Work on building of the MICE capacities (Meetings, Incentive, Conventions and Congresses, Events and Expositions) in tourism and its promotion;
- f. Continuously work on the revitalization of rural areas (develop rural, eco and other forms of tourism);
- g. Continuously raise the quality of Montenegrin tourism through education of new staff and professional development of the existing staff.
- h. Work on the improvement of road and auxiliary infrastructure (water supply, electricity, waste water, solid waste, parking space).

### ***Operational measures***

Over the previous period, mass tourism recorded an important share in one of the leading economic branches - the tourism sector. It is characterized by a large number of visitors (guests) with low income per guest. Most accommodation capacities, for example, hotels with fewer stars, were adapted to these guests. Mass tourism stimulated the development in most of the municipalities that have had modest development opportunities for the promotion of any other product or service. However, Montenegro, as a small tourist destination, must work on the improvement of its image, diversify and improve its product as much as possible. Although we cannot ignore low-income generating guests, we must focus on elite tourism i.e. attracting high income generating guests. This can be achieved by raising the quality of the offer, building luxury hotels and accommodation that will enable the development of high-end tourism. This is supported by the fact that the strategy document, which provides guidelines for the development of tourism in Montenegro - Tourism Development Strategy of Montenegro by 2020 - defines the

objective - Montenegro should become a high quality tourist destination with a diversified offer.

The structure and service quality of accommodation facilities in Montenegro still do not allow a sufficient valuation of the economic potential. Observed in percentages, hotels and similar accommodation which should represent the backbone of the tourism industry account for a substantially lower share in relation to the private accommodation (hotels and apartments - hotels - 18.1percent , and private accommodation 38.4percent of the total number of beds).<sup>8</sup> As hotels and similar accommodation facilities generate more revenue per guest, there is a need to build a high-quality profitable hotel sector because the demand on the international market focuses on high-quality hotel accommodation.

During the intensive investment cycle in Montenegro, a certain number of privatized complexes have successfully fulfilled their contractual liabilities, which substantially raised the level of tourist services and the overall tourist offer. In addition, some 50 percent<sup>9</sup> of hotel capacities are below the level required by the international tourist market. As Montenegro aims to develop high-end tourism, it is necessary to improve the existing capacities, complement them with the appropriate content that would meet high expectations of guests, at the same time investing in the construction of new hotels which would fully meet the standards of high-end tourism.

One should consider preparing a separate strategy to focus only on high-end tourism, clearly defining places (natural resources) of possible development of high-end tourism. Clearly defined strategy would preserve the exclusivity of the coast, natural resources, i.e. parts of the coastal and mountain regions that still have a chance to develop and build the capacity for high-end tourism. At the same time, the fact that former hotel accommodations at the best locations are not exploited represents an additional problem. Some of the reasons are: the lack of managerial capacities to find the best and most attractive investors for such property, long-term processes of preparing projects for the market, and the like. This has only negative consequences in terms of lack of revenues from tourism, due to long-term non-exploitation of capacities. It is important to emphasize that planned investment projects in the upcoming period will affect the increase in the tourist offer which will be richer for tourist complexes and hotel capacities (five and six stars), golf

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<sup>8</sup> Source: Monstat, Accommodation capacities, by the type of the accommodation facilities, August 2011. Number of beds which is not included in shown results and which refers to: hostels, motels, tourist settlements, camps and the like (See the source)

<sup>9</sup> Specified in the Action plan for the tourist season preparation – Agenda of reforms in tourism , March 2013

courses, marinas and other supporting facilities in several coastal municipalities and in the Capital. Planned investments and those that are already in progress in Tivat, Budva, Herceg Novi and Podgorica are in accordance with the Tourism Development Strategy by 2020, which strategic goal is to increase hotel capacities, i.e. high-quality accommodation.<sup>10</sup>

It takes additional engagement at all levels to improve the quality of the overall tourism offer and the extension of the season. One of the main challenges in the tourism industry is the insufficient offer. Montenegrin tourist product is not sufficiently diversified, with still high expressed seasonal character. During the previous period, substantial effort was made to promote Montenegrin tourism at fairs, through brochures, panoramic maps, and the like. Promotion of the tourist product should be intensified towards target groups (hikers, cyclists, divers and tourists who are interested in "wellness", sailing, sport), because this type of Montenegrin tourist offer became distinctive only few years ago. Offer diversification, with the improvement of existing products is a continuous process that is based on the adjustment of the tourist product to the needs and expectations of tourists i.e. different target groups. The potential can be seen in religious, health tourism, sports and recreation, adventure, rural, eco-tourism, and the like. Tourism diversified in such a way would enable the extension of the tourist season throughout the year, improve regional development, and increase total tourist spending.

Congress tourism represented an expanding market in the previous period. MICE (Meetings, Incentive, Conventions and Congresses, Events and Expositions) activities usually comprise higher category hotels, which have the organizational and technical infrastructure for the implementation of certain types of events and gatherings. Since the Montenegrin tourist season is mostly limited to summer - winter contents, developing MICE tourism can represent a significant step towards the prolonging of the season, bearing in mind that travelling takes place mainly during months outside the main tourist season.

The largest part of the development potential based on the use of available resources is located in areas that are underdeveloped or least developed. Therefore, it is necessary to work continuously on the revitalization of rural areas, infrastructure, local roads and the like. Lack of quality infrastructure affected the investment activity, which, regardless of the natural resources wealth, was insufficient in terms of investing in the northern part of Montenegro. Previously

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<sup>10</sup> Tourism Development Strategy by 2020, measure 1.3, page 35.

implemented activities, in cooperation with GIZ (German International Cooperation), were related to, among other things: defining strategic directions for the development of tourism in Montenegro (at national and local level), linking agriculture and tourism, hiking, cycling and the like. These and similar activities represent the basis for further development plans when it comes to tourism development, especially in less developed regions of Montenegro. As stated in the National Strategy for Sustainable Development, the priority tasks in the field of sustainable tourism are the diversification of tourist offer, such as agritourism, ecotourism, mountain, health and other forms of tourism, especially in the north of Montenegro. Rural tourism creates conditions for faster economic and cultural transformation of the village. The development of rural tourism will bring multiple benefits to local people, because in addition to the revitalization of villages and infrastructure, it will ensure employment and increase revenues. It will also affect a reduction of migration and an increase of agricultural production.

The strategy for the human resources development in the tourism sector emphasizes the need for professional education and qualifications that will meet all the specific requirements of *accommodation and food services*. The increase of accommodation capacities and increasing tourism offer requires new qualified staff. At the same time, it is necessary to intensify cooperation between the tourism industry and the education system aimed at education of required staff. There is a need for the continuous professional training qualification of personnel that will meet all specific requirements and offer in the tourism sector. When it comes to human resources in tourism, certain activities are directed towards providing seasonal labour force, while others relate to defining curricula that will match needs of the tourism industry and the labour force offer in terms of both quality and quantity. Implementation of this measure could affect a substantial decrease in the total unemployment rate, and specific jobs in the tourism industry would be "left" to experts.

There are a number of large infrastructure problems that hinder the development of tourism, which can be divided into problems of traffic, transport infrastructure and utility infrastructure. Problems with traffic and transport infrastructure primarily refer to insufficient and poor quality transport infrastructure, traffic jams during the season, and the like. There is also partially resolved or unresolved issue of waste waters and solid waste treatment. In addition, there are problems in the electricity supply, especially during the tourist season. Although the conditions in these segments have improved over the years, continuous investments in transport and utility infrastructures are necessary because they represent important segments which can substantially affect the overall tourist offer of Montenegro.

## **2. Transport**

### ***Background***

Transport plays an important role in the economic development of Montenegro. Its linkage and dependence from the other activities make it a strategically important branch for the economic development. In this regard, as a service industry, transport contributes to the growth of visible trade, international services, development of tourism and industry. It also affects the degree of integration of the country, both in regional and wider international environment.

Construction, modernization and reconstruction of the transport system are important for the development and connecting Montenegro with the rest of the world. Modern transport includes infrastructure and technology that are extremely expensive, with high fixed costs, long repayment period of investments, and therefore it is often the case that there is no private interest for the adequate development of this industry.

Since we are in the process of pre-accession negotiations with the EU, it is necessary to have in mind one of the general objectives of the European transport policy, which is reflected in the competitiveness, safe and sound transport, with an emphasis on environment protection.

Although Montenegro partly improved its transport infrastructure, especially airports and some key roads, infrastructure still lags significantly behind the needs of a dynamic economy. Identifying these bottlenecks is of great importance both for the further economic development of the state and the regional integration of Montenegro. In the area of international services, the share of revenues from transport comes second (after the revenues from tourism). According to the latest available data (first six months of 2013), the share of revenues from transport (both cargo and passengers) makes up 24.9 percent of total revenues from services. The largest part of revenues refers to maritime and air transport (63.5 percent of total revenues).

In 2013, railway transport recorded improvements. It was renewed with three electric trains of the Spanish manufacturer *CAF*. The restructuring of the railway transport, which is defined by the Strategy of Restructuring the Railways of Montenegro in 2007, is nearing the end of its second phase which implies further segmentation of new limited liability companies. It is expected that they will be privatized after the sale of the Government's share package.

Regarding the road transport, negotiations with the Chinese company for the construction of the highway Bar - Boljari are ongoing. Its importance is reflected in connecting the Montenegrin coast with the north of Montenegro, border with Serbia and through Serbia with the Central European countries. Also, the project of reconstruction of local roads funded with the support of the EBRD is under way. The EBRD and the Transport Directorate of Montenegro are considering granting a loan to provide funding for the reconstruction and upgrade of the local road Lubnice-Jezerine, including the construction of the tunnel.

Maritime transport is also recording progress. Namely, the Montenegrin fleet is renewed with two boats from China: "Kotor" and "21. Maj". This represents a very important contribution to the national economic growth. It was announced that another two ships will join the Montenegrin fleet in 2014.

The construction of a part of the Porto Montenegro project on the Adriatic coast enabled attracting a large number of foreign yachtsmen who were offered a complete service throughout the year following the highest world standards. At the same time, the setting of the cornerstone at the Luštica peninsula officially marked the beginning of construction of the Luštica Bay development, which will also have a marina within the residential and commercial facilities, thus increasing the possibility of providing nautical services, and expansion of activities of the Adriatic Shipyard Bijela, that is, the repair services for yachts and mega yachts. Requirements for safe maritime navigation are complemented by the new Law on Maritime Navigation Safety.

Progress has been made in the field of environmental protection. Given that the marine industry is one of the biggest polluters, the Government of Montenegro adopted the Law on Ratification of the Annex VI of MARPOL 73/78 Convention, which regulates air pollution from ships.

With the adoption of the Master Plan for a state-owned company Airports of Montenegro by 2030, the Government has defined a strategy for the development of the airports` infrastructure in order to improve the capacity and quality of services in air transport. The plan includes the implementation of a set of development airport capacities, which will provide safe, sound and environmentally responsible air transport, based on relevant environmental standards. A new flight Podgorica - Brussels provided by the low-cost airline Ryanair improved accessibility of Montenegro and the demand for air transport services.

It is important to point that, in terms of safety, the condition of Montenegro roads remains a concern due to numerous road accidents, deaths and injuries. According to the preliminary Monstat data, the number of accidents declined by 38 percent, annually, in the first half of 2013. An Action Plan for the implementation of the 2013 Strategy for Road Transport Safety Improvement was adopted. Bearing in mind that road transport safety is one of the fundamental elements of the transport system quality, the Action Plan envisages the continuation of reconstruction and repair of roads, which would create conditions for safe transport, reduction of traffic accidents and risks for passengers.

Although the evaluation of achieved results in almost all areas of transport was positive, they need further investments due to the fact that the gross value added of this activity (transport and storage) in the total GDP reduced by half in 2011 (4.7 percent) compared to 2000 when it was 9.5 percent. It is necessary to improve transport safety, ensure a more efficient use of the existing capacities, further implementation of investment projects, the provision of new services, and an increase of quality of the existing ones.

### ***Main risks***

- Financial sustainability, given the high cost of modernization of transport infrastructure;
- Inadequate level of transport safety. The number of road accidents is still high. In addition to the human factor, the lack of a safe road network is one of the main culprits for this situation;
- Low levels of technical equipping of the infrastructure and staffing in this industry. The problem is how to retain and motivate high-performing qualified staff;
- Low interest of high-quality investors in major and demanding investments, with long repayment periods and low profit margins. The problem of finding a strategic investor in crisis times;
- Risk of a substantial public debt growth in the case of the highway construction;
- Slower development of tourism due to the inadequate transport infrastructure.

### ***Strategic development***

- Continue the improvement of the transport infrastructure by using all available financing and co-financing sources. First of all, exploit the resources available through EU arrangements such as IPA funds and/or encourage public-private partnership with the goal of finding solutions to finance investments;
- Continuous work on raising the level of transport safety at a higher level;
- Continuous work on improving quality of the existing transport services and introducing new, more modern services with the aim of generating more revenues, and customer satisfaction;
- Increasing investments in technical-technological railway infrastructure equipment, especially the quality of the network in order to increase average speed and diminish traffic delays;
- Repair critical points in order to reduce the number of traffic accidents;
- Make efforts to ensure regular maintenance of public roads;
- Continue implementation of major infrastructure projects and accelerate the completion of restructuring and privatization of the transport sector;
- Seriously consider all options when it comes to the construction of the highway; On one hand, the construction of the highway is a prerequisite for the rapid development of tourism, it may also affect GDP growth and the development of many other areas, but on the other hand, a high share of the public debt in GDP leaves little room for additional borrowing;
- Promote environmentally friendly cycle transport;
- Work on strengthening the institutional and legislative framework;
- Work on the harmonization of the legal framework with the requirements of the EU directives.

### ***Operational measures***

With a view to improving this activity, it is necessary to eliminate transport deficiencies, namely: complete the reconstruction of initiated sections of motorways and regional roads, modernize traffic signals in order to raise the level of traffic discipline, eliminate hot spots in the affected areas, as well as address the problem of bottlenecks. In order to align with the EU *acquis communautaire*, it is necessary to adopt a new road safety law.

Make a list of priorities in the choice of investments in this area, and complete the necessary project documentation to be able to take advantage of the EU funds or to make private investors interested in private-public partnership.

It is necessary to improve the maintenance of the busiest roads in the country. Extensive precipitations in Montenegro during winter lead to the creation of landslides, mudslides and escarpments in the affected areas. Due to this, timely recovery from identified risks and adequate transportation equipment in the event of natural disasters should be special precautionary measures.

There is a need for the improvement of the railway transport infrastructure. The final phase of the railway restructuring should be completed, i.e. some sections of the railway system to be finally privatized. It takes investment in railway links in order to increase an average speed and reduce transport delays in extreme winter conditions.

Take advantage of the signed ECAA agreement (European Common Aviation Area) by continuing activities related to the opening of new air lines, which represent the economic benefit of tourism and promote Montenegro as an attractive tourist destination.

Continue implementation of the Master Plan for the development of the state-owned company *Airports of Montenegro*. Continue the investments in the modernization of Montenegrin airports. It is necessary to provide all the necessary conditions for the smooth functioning of air transport during bad weather (heavy snows, ample precipitations, fog). Create conditions to attract as many low-cost companies as possible, especially during the tourist season.

In the maritime transport, Montenegro should continue progressing towards becoming a full member of the Paris Memorandum (Paris MoU - The Paris Memorandum of Understanding on Port State Control), which involves the harmonization of the inspection of navigational safety with the Paris MoU.

No progress can be reported in the combined transport. Despite the fact that Montenegro fulfils the infrastructure conditions for this type of transport, its share in total transport is very small. The development and promotion of combined transport would be a significant competitive advantage for the state. Thus, it should be defined more precisely in the legislation.

The new Law on Ratification of the Annex VI of MARPOL 73/78 Convention should be implemented in order to minimize the negative impact of port transportation on the environment. In addition, given the negative impact of

transport on the environment, ecological cycling should be promoted as a healthy lifestyle to contribute to reducing traffic jams and household budget costs.

Continue the process of harmonization of the national institutional and legal framework with the requirements and standards of the European Union.

## **VI. RECOMMENDATIONS CONCERNING EDUCATION AND LABOR MARKET**

### **1. Education**

#### ***Background***

Reform of the education system in Montenegro began in 2000, and the adoption of so-called “Book of Changes of the Education System of Montenegro” sets out the vision of education, directions and goals of strategic development. Initial activities involved regulatory changes. Their implementation started after the adoption of the statutory regulations and new regulations were also adopted. The goal was the decentralization of the education system. A series of laws and regulations were adopted, new reform implementing institutions and bodies were established. Their content is defined in the key documents/strategies: from preschool through elementary and vocational to higher education.

The implementation of the action plans is under way. They provide the following important strategies in the area of education:

- Strategy on the Development and Financing of Higher Education in Montenegro (2011-2020),
- Strategy for Development of Vocational Education of Montenegro (2010-2014),
- Strategy of Early and Preschool Education (2010-2015),
- National Lifelong Career Guidance Strategy (2011-2015).

Bearing in mind that the reform of the education system, given its content and coverage, is one of the most important and demanding forms of social changes, that it represents a process that takes time, and that there are no indicators that, at this stage, can explicitly express the results achieved, an initial analysis can provide descriptive statements. It should be noted that activities were undertaken in all segments and that an important part was financed from international funds (funds from donors, the IPA program and the pre-accession EU support). The capacities of the academic and administrative staff in some higher education institutions have been improved through the cooperation and implementation of projects with higher education institutions in the European Union. Procurement of modern equipment and new teaching aids have substantially improved the working

conditions. Other education institutions in Montenegro have also recorded improvements.

In addition to advantages, the current situation has the following disadvantages:

- The number of students at the University of Montenegro increased from 2,931 since 2003 (when Montenegro joined the Bologna process) to 18,253 (academic year 2012/2013), representing a burden on limited resources of the University and its capacities. Although the number of educated population increases, the economy is still facing a significant imbalance between the needs of companies and knowledge offered by graduate students;
- Over 80 percent of high school graduates continue their education at higher education schools instead of entering the labour market, which is resulting in the inability to meet the needs of the labour market;
- The higher education reform, vocational education modernization, and the training system have not yet provided results that would affect the structural imbalance at the labour market;
- The quality of education in Montenegro is very different, both at the higher education level and various study programs in the same institutions of higher education;
- Increase in the number of higher education institutions and the number of students, as it was mentioned above, without the existence of link between the growth and the analysis and alignment with the market needs;
- Academic units are being established apparently without enough critical appraisal of the possibilities of their sustainability over the long term, both in personnel and material-financial terms;
- Private investments represent an integral part of higher education. Cooperation between higher education institutions, which aims to improve that the overall quality of education is not satisfactory, especially between public and private higher education institutions.
- There is a fewer number of people with higher education than in developed countries.
- The concept of lifelong learning is still not sufficiently promoted and developed.
- The higher education system is not internationally competitive and attractive.
- International cooperation and academic mobility is not satisfactory.
- Scientific research is underrepresented in the higher education process.

A Decision on financing study programs of public interest and the number of students in private higher education institutions in the academic year 2012/2013 from the budget of Montenegro, which the Government of Montenegro adopted at the beginning of the year (OGM, 8/2013 as of 7 February 2013), represents an important novelty in the field of education. This is the first time that private higher education institutions use budget funds of Montenegro. Namely, the study programs of public interest are identified and it was decided that 115 students should be financed from the budget of Montenegro.

The new Law on Higher Education is in the preparation phase.

The project “Support to special classes for inclusive education” was implemented in Podgorica as a continuation of the project “Social network for inclusive education” for the inclusion of children with disabilities from special classes into regular primary schools.

Statistical Office of Montenegro (MONSTAT) published<sup>11</sup> results of the research it conducted in cooperation with the Ministry of Science in 2012 on the investments in research and development in 2011. This type of survey was conducted for the first time in Montenegro, in accordance with the EU legislation on science statistics (Commission Regulation (EC) No 753/2004) and on the basis of the methodological manual "Frascati".<sup>12</sup>

The data were obtained from the processing of annual reports collected through questionnaires from companies that are performing research and development in Montenegro in 2011. The survey included 44 science research institutions which, at the time of processing of the questionnaires, were in the Register of the Ministry of Science and 21 private entities that invested in research and development in 2011. The data analysis showed that the cost of investment in research and development amounted to 13.1 million euros or 0.41 percent of GDP. For example, Europe spends less than 2 percent for these purposes, USA 2.6 percent and Japan 3.4 percent of GDP. MONSTAT planned to process data on investments in research and development in 2012 by the end of 2013.

The Ministry of Science is co-financing 104 national scientific-research projects (2012-2015) in cooperation with other six ministries. Since September 2012, the number of researchers in the register of the Ministry of Science increased from 1,191 to 1,208. The number of licensed science-research institutions in the register

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<sup>11</sup> Statistical Yearbook 2011.

<sup>12</sup> Annex to the EC Progress report in Montenegro 2013, for the period 01 September 2012 – 25 April 2013

of the Ministry of Science increased from 46 to 50, while three more institutions are in the process of licensing.

### ***Risks***

- Lack of financial resources due to the economic crisis for the full implementation of planned activities;
- Lack of trained and motivated staff in the education system for the realization of the planned tasks;
- Inadequate education programs as a result of a lack of understanding by partners (educational institutions, local administrations, entrepreneurs, NGOs).
- Extensive approach in transferring knowledge to the participants in the education system (the traditional method of presenting the subject, without building skills and inelastic with respect to changes and demands of the labour market).
- Insufficient number of occupational standards and uniformity of educational programs, without taking into account specific features.
- Lack of representation in the educational process of the scientific-research work, which is the key factor of the development.
- Lack of mobility and interest of teachers and students to use training opportunities and professional development abroad.
- Lack of material and technical equipment of educational institutions, as the requirement for a functioning education process.
- Different cultural and educational level of the population, as an expression of the historical conditions and their impact on education reform implementation.
- Delay of the education system reform to meet the labour market needs.

### ***Strategic development***

A modern education system that will stimulate socio-economic development should be developed through:

- a. Involving all institutional and individual stakeholders from the educational system in activities defined under the educational strategies to achieve the goals of the reform.

- b. Developing cooperation between educational and labour market institutions.
- c. Developing standards of education in accordance with the principles of the National Qualifications Framework and on the basis of information on the labour market needs in order to bring comparability of qualifications and educational policies in line with the projections of the labour market development and needs of the society.
- d. Encouraging and recognizing scientific-research work in higher education institutions.
- e. Developing and promoting the concept of lifelong learning.
- f. Keeping enrolment policy that allows a reduction of the structural imbalance at the labour market.
- g. Involvement of local governments, employers' representatives, business associations and other NGOs in activities of the education reform.
- h. Encouraging public-private partnerships in education through cooperation of university units with business entities in order to meet the needs of the labour market.
- i. Involving organizations dealing with social inclusion in the education reform activities.
- j. Monitoring the implementation of regulations in practice and proposing amendments to the legislation.
- k. Analysing international experiences and implementing mandatory rules and recommendations, with the use of professional, technical and material assistance from the European Union.
- l. Providing planned funds or up to a level of least lacking ones in comparison to the planned for the implementation of the education reform.
- m. Supervising and controlling the implementation of reforms at all levels of education, with the key role being that of the Ministry of Education and Sports.
- n. Coordinating and monitoring all activities of the Ministry of Education, based on the fact that the Ministry represents the link with the Ministry of Finance (source of funds) and the Ministry of Labour and Social Welfare (labour market issues), as well as with the Government of Montenegro.

### ***Operational measures***

The aim of the reform is to develop an effective quality system of education and research that will enhance the social and economic development of the society, respecting the principles of citizens' equality.

The education reform implementation in Montenegro, it is necessary to respect planned tasks and deadlines set out in the abovementioned strategies i.e. implement action plans as realistic as possible.

Bearing in mind that the knowledge and development of science represent the fundamental pillars of any society and its progress, and that the education reform is a very complex project both regarding its scope and significance, it is necessary to point out some operational aspects of the reform. In this regard, in order to achieve the objectives it is necessary to:

- Work continuously on securing and improving the quality of the higher education as a priority.
- Connect vertically and horizontally different levels of education or enable mobility and advancement of knowledge through a compatible connection between the levels of education.
- Develop standards of education, which will enable the accurate comparison of educational qualifications and verification of education acquired in a formal and informal way.
- Strive for linking higher education and the labour market and increasing entrepreneurial-innovative characteristics of education.
- Continuously adjust enrolment policy to the labour market needs, using also the Government's document "Enrolment policy at the University of Montenegro", in order to avoid hyper production of hard-to-employ population and reduce structural imbalances at the labour market.
- Create realistic assumptions for increasing the participation of the population with the higher education, so that the share of this population aged 30 to 34 would be at least 40 percent in 2020.
- Develop a lifelong learning model based on good international practice.
- Develop a research-oriented higher education. Increase funds for this purpose.
- Contribute to the promotion and encouragement of mobility and interests of teachers and students to use training opportunities and professional development abroad.
- Develop cooperation with all institutions dealing with social inclusion and create the material and technical conditions for increasing participation in the education system and social inclusion of persons belonging to this category.

There is a need for a continuous control and coordination of activities of all participants responsible for the implementation of reforms which should be implemented by the Ministry of Education and Sport. It is necessary to make the requirements for establishing a faculty and for the control of their work more severe.

Given the large number of institutions engaged in informal education, it would also be useful to carry out the accreditation of these institutions.

In addition, it is necessary to provide funds (state and municipalities budgets, private sources, EU IPA funds and foreign donations) to avoid jeopardizing the objectives of the reform.

## **2. Labour market**

### ***Background***

The economic crisis has affected the status and trends in the labour market. This is evidenced by the basic parameters: the number of employed and unemployed persons, changes in the level and structure of the phenomenon, the scope of taken measures, and activities that the Government implemented with a view to mitigating negative effects.

The following text covers the most important labour market indicators.

According to MONSTAT data (Labour Force Survey - LFS), the activity rate of the population aged 15 to 64 is 58.6 percent (Q1 2013 data), while the employment rate is 45.9 percent.

Observed by sectors, the share of the agricultural sector in total employment amounted to 4.4 percent, non-agricultural sectors accounted for 18.5 percent, while the share of the services sector was 77.1 percent.

The number of unemployed persons amounted to 53,600 (Q1 2013 data) of which 21,300 or 39.8 percent were women. The unemployment rate was 21.6 percent.

Characteristics of employment are also the following: regional inequality (the lowest employment rate is in the northern region and the highest one in the central region), the age structure of employees is unfavourable (the lowest employment

rate is recorded by employees aged 15 to 24 and the highest by employees aged 25 to 49), the employment rate for women is lower than the average rate, the highest rate of employment is recorded by persons with higher education, and the rate is decreasing as the level of professional qualification is decreasing.

According to the Employment Agency of Montenegro, there were 30,337 unemployed persons (women accounted for 14,372 or 47.4 percent) on the records as at 30 June 2013.

The lowest unemployment rates, from 6.5 percent to 9.2 percent were recorded in the municipalities of Budva, Plužine, Bar and Kotor, while the highest rates, from 24.1 percent to 28.7 percent were in the municipalities of Andrijevica, Bijelo Polje and Kolašin (24.1 percent). The unemployment rate in Podgorica is about 10 percent. The abovementioned points to a problem of regional unemployment, i.e. the highest unemployment rate (with the exception of Plužine) precisely in the least developed - northern region of Montenegro, which has the least financial capacities to solve the problems of unemployment, and vice versa (in the south).

Absorption capacity of employment, shown in the number of advertised job vacancies best exemplified the impact of general economic trends in the labour market. In this regard, in the period 2007 - 2008 i.e. the period of the "economic boom", the number of advertised vacancies recorded an increase (from 48,284 advertised vacancies to 64,854 or 16,570 - 34.3 percent more). During the period of the economic crisis, that number decreased to 47,551 in 2009 and 39,168 in 2010, which represents an increase of 25,686 or 39.6 percent of advertised vacancies. In 2011, there was an increase in the number of advertised vacancies (5,790 or 14.8 percent), with a slight increase in 2012(365 or 0.8 percent).

According to the Employment Agency of Montenegro (Report on the work of the Employment Agency of Montenegro for six months of 2013), at the end of H12013, there was a decline in the number of advertised vacancies (from 26,121 to 21,469), which represents a decrease of 4,652 or 17.8 percent of advertised vacancies compared to the same period of 2012.

The number of foreign citizens who are usually hired on a seasonal basis has a significant impact on employment. This number increases from year to year (with the exception of 2010), leaving less room for employment of the local labour force. In 2012, 20,712 working permits for foreign citizens were issued, while a significant number of them was employed without the permits.

Seasonal employment is a form of employment that increasingly affects alleviating the unemployment problem, because up to 20 percent of the total unemployed persons are hired for such activities during season. From year to year, this type of employment confirms the increasing trend in employing persons by the Employment Agency of Montenegro, not only in the tourism and hotel management, but also in the following sectors: construction, agriculture, trade, health care, and others. Almost every year, the number of domestic labour force hired for seasonal jobs is increasing in comparison with to the previous year, namely between 5,500 and 10,000 employees (data for 2012).

A high long-term unemployment (an indicator of the number of unemployed persons registered by the Employment Agency of Montenegro who are looking for work over one year) represents unfavourable characteristics of the labour market in Montenegro. For a number of years it has been expressed as a percentage - 55 percent to 60 percent (from about 15,700 to about 22,600 persons). At the end of H12013, this number was 14,353 or 47.3 percent of the total number of unemployed persons.

A high share of young unemployed persons is an indicator of the share of unemployed persons under the age of 25 in the total number of unemployed persons. In recent years, it is ranging from 15.5 percent to 20.1 percent (from about 4,400 to about 7,800 persons). At the end of H1 2013, this number was 5,663 or 18.7 percent of the total number of unemployed persons.

A significant increase in the number of university graduates and a substantial deficit of the labour force with secondary education is a characteristic of the labour market in Montenegro. At end-2006, there were 2,369 university graduates or 6 percent of the total number of unemployed persons on the records of the Employment Agency of Montenegro. At end-2012, the number of registered university graduates amounted to 6,752 or 21.6 percent. This was due to the fact that more than 80 percent of high school students continued their education at higher education institutions. This creates a deficit in the offer of labour force with secondary education and a very high surplus of stuff with higher education.

The Employment Agency of Montenegro recorded a large number of persons in the category of hard-to-employ persons. This refers to more than 35 percent of the total number of unemployed persons, i.e. older unemployed persons, persons with different types and degrees of disability (physical ability for inclusion in the labour market), members of the category of internally displaced persons (RAE population) and others. Employing of these people is very difficult and requires

specific measures and activities and substantial resources. Despite the fact that there is a binding regulation for employers to hire disabled persons, that there are benefits for the employment of these persons, that there are programs for the employment of these persons and funds provided for their implementation, there are still no significant results in the employment of this category of unemployed persons.

In addition to the structural unemployment, regional unemployment represents a significant problem. The problem is particularly expressed in the northern region of Montenegro. A decline in economic activity over the past two decades, depopulation of rural areas, and migration of people from the north of Montenegro to the central and southern parts of the country affected the deepening of the problem and made its resolution more difficult.

In accordance with the Law on Employment and Exercising Rights with respect to Unemployment Insurance (OGM 14/10), the Employment Agency of Montenegro regularly and consistently implements active employment policy measures. Activities are focused both on employers and the unemployed and other users of its services.

The main activities include:

- Education and training of adults, i.e. programs for the so-called *well-known employer* and education and training for the labour market (within which there are education programs for vocational training and skills acquisition programs).
- The allocation of subsidies to employers for employment of young persons in seasonal jobs, according to the program "Subsidized employment of young persons in seasonal jobs." The implementation of the program is ongoing (from 01 June to 09 September 2013). The subsidy for the employment of a person is 100 euros per month for young persons without work experience and 80 euros per month for those with work experience. In the previous period, most subsidies were distributed in: tourism and hotel management - 65.97 percent, trade - 28.47 percent and other sectors - 5.56 percent. The same trend will be continued in the future.
- Due to high demand of employers (274 employers who expressed the need for employing 646 persons) and graduate students (863), the "Working practice for graduate students" project, with the six-month duration was extended in 2013 in order to create conditions for conducting 12 months

internship for the graduate students to become eligible to take the professional exam.

- A program of professional training of persons who acquired higher education, which is a continuation of formal education with a view to gaining work experience, knowledge, skills and competencies necessary for performing tasks independently. This program has attracted much attention, both of employers (they were registered for the employment of 5,317 university graduates) and university graduates (4,211).
- Vocational orientation, within which the most important programs are the following: professional informing, counselling, selection and workshop activities.
- Lending program for self-employment and entrepreneurship development in Montenegro, with programs: virtual companies and providing specialized training and education in business skills to the Employment Agency's loan beneficiaries. In 2012, 80 loans were disbursed in the amount of 500,000 euros, intended for the creation of 100 new jobs.
- The Employer Survey, a regular annual activity of the Employment Agency whose implementation can provide detailed information about the needs of Montenegrin employers as well as their difficulties in securing the necessary staff, which best reflects the condition of the labour market in Montenegro.
- The implementation of international projects (IPA projects, components I, II and IV, some of which have been completed while others are ongoing).

The most important project carried out in the labour market in Montenegro through the action plans adopted by the Government of Montenegro is the "National Strategy for Employment and Human Resources Development 2012-2015." It is a continuation of the "National Strategy for Employment and Human Resources Development 2007 - 2011." Approaches from the European strategy for smart, sustainable and inclusive growth – "Europe 2020" have been used in its development.

### ***Main risks***

- Lack of financial resources due to the economic crisis for the full implementation of planned activities;
- Reduced potential for the creation of new jobs as a result of slower economic growth;
- High economic illiquidity and expensive banking loans;

- Limited opportunities to maintain the level of employment in some companies with hard working conditions;
- Structural unemployment - a mismatch of supply and demand of the labour force in the labour market, particularly for highly skilled personnel;
- Unresolved status of a large number of business entities in Montenegro whose accounts are frozen and risk from the increase of illegal employment;
- Increase of the structural imbalance between supply and demand due to conflicting enrolment policies with the labour market needs;
- Limited resources for active labour market measures;
- Low level of activity, especially among the female labour force;
- High share of long-term unemployed persons;
- High rate of young persons' unemployment;
- Problem with the shortage of staff with a high school diploma;
- Large volume of unregistered employment;
- Regional unemployment;
- Unfavourable ratio in seasonal employment of domestic and imported labour force.

### ***Strategic development***

- a. Involving all relevant institutions and individuals, initiators of activities defined in the strategic documents in order to achieve the objectives of the reform;
- b. Developing cooperation between the labour market and educational institutions and harmonization of the education system with the market requirements, which will decrease the number of unemployed and increase the employment rate i.e. reduce structural unemployment;
- c. Developing cooperation with employers and their involvement in the implementation of employment programs to the highest possible extent;
- d. Providing continuous financial support, including foreign donations, grants and fundraising through partnerships and joint projects to achieve goals of the adopted strategy of employment and lifelong career guidance;
- e. Improving the business environment and reducing business barriers;
- f. Introducing tax incentives for new jobs and investing in underdeveloped areas;
- g. Implementing active employment policy measures, with a large coverage of beneficiaries and funds for the implementation of these measures;
- h. Developing educational and entrepreneurship programs for a large number of users;

- i. Encouraging employment of the local labour force in relation to foreign workers;
- j. Developing special programs for employment in the region with above-average unemployment rates;
- k. Implementing special programs for hard-to-employ population;
- l. Monitoring the implementation of regulations in practice and proposing regulatory changes, based on the study of foreign experience and the application of mandatory rules and recommendations, using professional assistance from the European Union.
- m. Strengthening the inspection oversight in order to suppress illegal work and employment;
- n. Performing the oversight and supervision functions of implementation of the reform and other activities, at all levels, with the key role of the Ministry of Labour and Social Welfare.

### ***Operational measures***

Starting with the overall objective of the "National Strategy for Employment and Human Resource Development 2012-2015" and priorities that are conditioned by this objective, it is necessary to ensure continued financial, professional, human and material-technical support in order to achieve specified values.

The strategy assumes the realization of ambitious activities defined by the Action plan. Bearing in mind the content and scope of planned activities, the following courses of action could, be recommended in the broadest context:

- Continue work on the harmonization of legislation relating to labour market with European legislation;
- Improve business environment and administrative efficiency;
- Intensify cooperation with employers and involve them in the activities on implementation of the training programs;
- Encourage the initial micro, small and medium entrepreneurship that creates new jobs;
- Initiate pilot programs in social economy, to be implemented in the north of the country;
- Develop a lifelong learning model based on good international practice;
- Develop standards of education, on the basis of which the educational qualifications will be accurately compared and verify the formal and informal education;

- Continue with the opening of CIPS<sup>13</sup>, in order to improve the support to education of the adults
- Work on the training of teachers, in order to enable the implementation of new educational contents;
- Encourage the inclusion of the most vulnerable groups in the education system;
- Work on the integration of vulnerable groups;
- Create conditions for the implementation of the Law on professional rehabilitation and employment of disabled, health endangered persons, RAE population, and the like;
- Stimulate employment of young persons and assist in the acquisition of the first practical experience through the work engagement training;
- Implement training programs that improve the competitiveness of the unemployed at the labour market, especially programs that provide direct employment.
- Encourage seasonal employment;
- Encourage linking of agriculture and tourism through grant schemes (especially in the northern part of the country);
- Encourage the development of local partnerships in addressing the problem of unemployment;

Bearing in mind a high number of foreign employees and a high number of unemployed local population, training programs, retraining and additional training should be organized. This would stimulate the substitution of foreign labour force. These activities would provide a considerable room for a relatively rapid decrease in the unemployment rate.

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<sup>13</sup> Centre for Information and Professional Counselling (in the Employment Agency of Montenegro).

## VII. RECOMMENDATIONS CONCERNING THE FISCAL POLICY

### *Background*

Montenegro has faced the majority of challenges over the past two years since the onset of the global financial crisis. Euroisation in Montenegro limited available monetary instruments, so the fiscal policy represents the only effective stabilisation policy. As such, it must ensure macroeconomic stability. Euroisation influences the improvement of budget discipline and at the same time is an important condition for the system viability since potential sources for deficit coverage are limited. Liquid budget and provided funds mean stability and support for the economy and the financial sector.

After 2012 and the severe weather conditions that resulted in a decline in budget revenues, as well as the calling of government guarantees for KAP loans and extreme fiscal deficit, the same problems with government guarantees occurred in 2013 again for KAP loans with OTP bank and VTB bank in the total amount of 102.5 million euros.

Funds needed for the budget financing in 2012 were provided with the support of the World Bank and commercial banks. However, funds for budget financing in 2013 were provided from additional borrowings and a series of unpopular but important fiscal measures that the Government decided to implement during 2013 to increase budget revenues.

The implementation of the new Law on Fees for Access to Certain Information of General Interest and for the Use of Tobacco Products and Electro-Acoustic and Acoustic Devices, which was adopted in H2 2012, continued. This law envisaged the obligation of paying fees on the use of SIM cards, electricity meter, and cable TV connection, use of tobacco products in hospitality facilities, and the use of electro-acoustic and acoustic devices in hospitality facilities. The Ministry of Finance stated that 10.7 million euros were collected in the state budget over then one-year period from the fees on SIM cards, electricity meters, cable TV connections and the use of tobacco products. It is envisaged that this measure will remain effective until the end of 2013.

The international crisis has made a strong negative impact on the real economy which was evident through a decline of economic activity and deterioration of recovery potentials and growth drivers. In addition to the negative impact of the

new wave of the euro area crisis, economic recovery was weakened by internal factors: a lower volume of trade, the calling of guaranties, tax arrears, etc. This was an additional cause of the decline in economic activity, deflection from the planned public revenues collection, as well as a significant budget imbalance in 2013.

The Government of Montenegro adopted measures of additional consolidation in 2013 through the freezing of pensions (whereby expenditures for pensions will increase only with an increase in the number of pension beneficiaries), additional reduction in the portion of discretionary expenditures, and the introduction of a higher rate of personal income tax above the average. These measures were aimed at increasing budget revenues and therefore decreasing the budget deficit.

The Government of Montenegro passed a decision to increase the VAT rate from the 17% to 19% and maintain the lower rate and the zero VAT rate at the same levels. The increase of VAT is an interim measure which implementation started on 1 July 2013. The intention was to terminate further deterioration of fiscal stability, i.e. imbalance between public revenues and public expenditure. Together with other fiscal consolidation measures, this measure should contribute to a reduction in the borrowing requirements and, consequently, reduction in public debt in the future, which will improve the stability of the fiscal, financial and macroeconomic system.

Regardless of the VAT increase, Montenegro belongs to countries with the lowest VAT rate. We think that the competitiveness of the economy is not jeopardised, and that on the other hand tax revenues will increase.

Besides these measures, Law amending the Law on Excise Taxes entered into force in Q2 2013. This law envisages an increase in excises on cigarettes and other tobacco products, alcohol and alcoholic beverages in order to harmonise the Montenegrin legislation with the relevant EU regulations.

During 2013, the Law on the Prevention of Illegal Business Operations was passed and it aims at decreasing the level of shadow economy, increasing the collection of public revenues, and introducing tax discipline. The implementation of the law has already given positive results in the form of improved tax collection.

The Government of Montenegro announced that it adopted the Information on realisation and effects of measures from the Action Plan for Combating Shadow Economy for period April – July 2013 which was prepared by the Ministry of Finance. The information indicates, *inter alia*, that the Committee for combating

shadow economy continuously monitored the dynamics and effects of the implementation of all activities concerning combating grey economy in the period April – July 2013. It paid special attention to combating grey economy in the labour market and products and services turnover – recording cash turnover and eliminating space for tax evasion. It was noted that all measures defined in the Action Plan are taken according to the scheduled deadlines and that the collection of public revenues has been improved in the first six months 2013, being 40 million euros higher y-o-y. The inspection oversight was also intensified, which contributed to an increase in the volume of tax discipline, which directly influenced a decline in illegal operations and an increase in public revenues.

The new 2013 budget envisaged the introduction of a set of fiscal measures aimed at providing an increase in revenues as well as reducing unproductive spending. However, budget revision will be needed during 2013 to ensure funds for the payment of guarantees called in 2013.

The global uncertainty risk, evident especially in the European Union, combined with the weaknesses of the domestic system brings in a high degree of negative expectations and concern that the introduction of additional measures and conducted cost adjustments might not be enough to regain the balanced budget. Negative trends and the growing pressure on the fiscal position will require more radical fiscal adjustments to the previously fixed budget positions.

The above mentioned difficulties resulted in the growth of public debt which reached 51.1% of GDP in the first six months 2013. Forecasts indicate that debt will additionally increase in 2013 due to the need for additional funds for settling certain obligations and covering the 2013 deficit. Expensive funding sources additionally burden the future servicing of obligations, potentially creating fiscal instability factors. It is also expected that new borrowings will be needed in the upcoming years when Eurobonds mature (2015 and 2016), as it is likely that their total amount will not be paid from regular revenues. This will result in the increase in the government debt in the following years.

The public debt was followed by an increase in guarantees. Guarantees are always a potential public debt. Even though the public debt remains below the Maastricht criteria, its uptrend is a matter of concern as is the danger of its becoming the factor limiting the economic growth.

Fiscal stability is a precondition of overall economic stability and a long-term economic growth. It is important to make sure that the public spending is in line

with objective abilities. Although the current public spending declined, it is expected that even more rigid fiscal measures will be needed in 2014.

The following year will be a year of great challenges. Sustainability of public finances, competitiveness of the economy, and ultimately the living standard will depend on the implementation of the current measures.

### ***Main Risks***

- Ongoing fiscal deficit;
- Continuation of the public debt uptrend (the risk that the amount might exceed the Maastricht Criteria) and issued guarantees which pose a threat to fiscal sustainability;
- The appearance of new exogenous shocks and their spillover due to the development of instability in the euro area;
- Failure to reach the projected growth rates;
- Risk of social pressures;
- Impact of negative demographic trends on the increase of pension expenditures;
- Limited access to capital markets and expensive sources of financing;
- The need for financing or co-financing large infrastructure projects may additionally burden the fiscal position and threaten fiscal sustainability;
- A decline in imports as a basis for accounting of the most important tax revenue categories;
- High illiquidity of the corporate sector, a high level of tax arrears, and a failure to service fiscal obligations;
- Calling of issued government guarantees;
- EU accession process requires the allocation of significant funds for these purposes;

### ***Development strategy***

- a. Continue the consolidation of public spending and pursuing restrictive fiscal policy in line with the existing macroeconomic environment;
- b. Continue gradual reduction of the public expenditure share in GDP;
- c. With a view to securing a long-term fiscal sustainability, it is necessary to intensify activities in the field of standardization and implementation of fiscal rules and fiscal responsibility;

- d. Improve fiscal control and reinforce implementation of internal and external audit of all spending units of the Budget;
- e. Invest more effort in combating shadow economy with a view to increasing the budget revenues;
- f. Increase the control of operations of public companies aimed at reducing negative results and reducing the transfer of budget funds to them;
- g. Take measures to improve taxpayers' tax awareness, increase fiscal discipline, and reduce tax evasion;
- h. Develop appropriate mechanism for a gradual reduction of tax arrears;
- i. Improve the Strategy for public debt management for three-year period;
- j. Develop mechanisms for the reduction of debt at municipal level;
- k. Gradually reduce the share of current budget and prioritise an increase in the share of capital budget;
- l. Focus government interventions in the economy on capital projects;
- m. Stop (limit) the issuance of government guarantees;
- n. Increase the level of public spending transparency at all levels, especially at the municipal level;
- o. Pursue adequate policy of domestic and foreign borrowing so as to avoid exposing the country to a public debt crisis;

### ***Operational measures***

Due to the aggravated conditions in domestic and international markets, Montenegro's fiscal policy in 2014 should take more prudent approach, restrictively created budget, allocating sufficient reserves for contingencies such as government guarantees' calling and new global negative shocks' spillover.

Due to the high level of budget deficit in 2012 and 2013, fiscal adjustments and deficit reduction should be carried out as soon as possible. The objective is to have a lower share of the budget deficit in GDP than the GDP growth rate. The conditions for a more effective tax collection should be provided so that measures of the increase of VAT and personal income tax rate above the average wages gave planned results. In accordance with the tax increase and depending on the economic situation, the policy of gradual decreasing of the share of expenditure in GDP should be maintained in the upcoming period. In that respect, a linear reduction of public expenditure at a rate from 3% to 5% should be carried out in all budget units, except in public expenditure that are legal obligations. Fiscal consolidation requirements and increase in competitiveness of the economy are one of the priorities in the European integration process.

In the case of extended enforcement of the Law on Fees for Access to Certain Information of General Interest and for the Use of Tobacco Products and Electro-Acoustic and Acoustic Devices, the possibility of abolishing duties on SIM cards, electricity meters, cable TV connection and the use of tobacco products should be considered for socially deprived categories of citizens, such as beneficiaries of financial support for families, disabled persons, and beneficiaries of health assistance and care.

Public debt and issued guarantees trended up rather rapidly over the last two years which is a trend that should be stopped in order to achieve macroeconomic stability and fiscal sustainability. Repayment of the principal and high interest rates may threaten economic growth in the following period.

Public procurement is suitable for cost cuts to reduce unnecessary spending and setting priorities which full implementation will materialise these advantages. A law amending the Public Procurement Law to be in line with the relevant EU regulations should be adopted as soon as possible.

The solutions created by the EU six-pack regulations should be implemented and they refer to the treatment of excessive fiscal policy imbalances in order to ensure budget balance in long run and consequently apply requirements of the EU *acquis* concerning this area.

Software for recording spending unit obligations on accounting basis should be tested. This will enable the review of assumed obligations of all spending units in real time and substantial efficient management and planning of funds.

The Strategy for Public Debt Management for the three-year period should be improved. Guidelines should be defined more clearly and adequate risk assessment concerning public debt management, guarantees and cash management should be performed.

Public companies should be restructured to achieve higher performance efficiency, reduce negative results that are ultimately at the budget expense.

The Law on the Prevention of Illegal Business Operations should be implemented as soon as possible in order to reduce the level of shadow economy, collection of public revenues and introduction of tax discipline, which will ensure an increase of budget revenues and a decrease of tax arrears. In order to increase the budget

revenues, Montenegro should intensify the control and prescribe more severe penalties for failing to issue fiscal receipts.

The largest expenditure category in the budget still refers to the public administration employees. It is also necessary to continue the implementation of the Staffing Plan which defines restrictive employment. In addition, it is of high importance to conduct rationalisation which includes the reduction and rationalisation of the number of employees in the public sector.

Financial sustainability of the Pension and Disability Insurance Fund of Montenegro represents yet another important factor of fiscal consolidation. Pensions account for approximately one quarter of fiscal expenditures and a somewhat over 10% of GDP. Regardless of well-designed reforms conducted in this area over the previous period, the demographic structure, migration and consequently an increase in the number of pensioners remain the actual risks.

The Organic Law on Budget and Fiscal Accountability should be passed in the nearest future to determine fiscal rules and ensure harmonisation with the Council Directive 2011/85/EU, i.e. with the ESA95 standards<sup>14</sup>. The possibility to prepare the Law on Fiscal Accountability separately from the Organic Budget Law should be reviewed. Fiscal rules<sup>15</sup> should be transposed into the binding legislation as soon as possible. Sanctions should be envisaged for the violation of these rules, otherwise they will not have the expected effect, which is proved by the experience of a large number of countries. Fiscal rules would limit any possibility of an irresponsible pursuit of fiscal policy and have a favourable effect on the credibility of the Government and the country's credit rating.

The following amendments to the Budget Law should also be implemented: categorisation of consumer units; introduction of spending limits; introduction of the obligation to draft and adopt a fiscal strategy; define responsibilities and prescribe sanctions at all levels of pursuing fiscal policy; introduce conducting financial supervision of the legality and purpose of the budget funds use. Observed negative practice in the payout of certain budgetary items from the positions they are not envisaged for should be completely eliminated to ensure a consistent utilisation of funds for the purposes they were planned for. Redirection of funds from the capital to the current budget must not be allowed.

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<sup>14</sup> EU requirement within the negotiations on Chapters 17 (Economic and Monetary Policy) and 18 (Statistics)

<sup>15</sup> Binding rules on the maximum allowed level of public debt and budget deficit as a percentage of GDP

Activities on drafting and implementing the new Law on Public-Private Partnerships should be finalised in order to increase the efficiency of the limited strategic resource – capital, in both public and private ownership.

Appropriate management and maintenance of efficient control of budget revenues are of high importance. In order to achieve this goal it is necessary to:

- a. Continue conducting efficient collection of public revenues, simultaneously increasing the control of taxpayers and the application of the legal measures upon the taxpayers who do not meet their obligations in line with positive regulations;
- b. Define penalties for repeated violations of regulations;
- c. Mitigate the expansion of illiquidity in the corporate sector in a manner that both central and local government meet their obligations toward the corporate sector. This way the corporate sector will be relaxed while at the same time the payment spiral among the companies will be set in motion.
- d. Improve the efficiency of taxpayers' tax receivables collection in order to increase tax revenues;
- e. Define mechanism of tax arrears collection in the amount of about 350 million euros which will largely increase budget revenues and support the reduction of budget deficit.

The problem of state debt is the key issue that should be discussed in the following period. Sustainable economic growth requires efficient debt management; therefore, the issue of government guarantees should be ceased (limited), and it is necessary to maintain the policy of a large share of debt at fixed interest rate as well as the majority borrowings in euros from those institutions which offer a choice of the borrowing currency. It is also necessary to develop a qualitative strategy for the three-year debt management which will recognise all risks and contain policy of domestic and foreign borrowing that will protect the country from exposure to a public debt crisis.

The planning of major infrastructure projects funded from the budget at the time of severe economic situation and high recession pressures is very risky. An in-depth analysis of all projects will be necessary as well as paying special attention that their realisation does not threaten fiscal sustainability.

It is necessary to establish a transparent database for the projects connected to the budget, which would help achieve high quality analysis of fiscal risks, which would primarily help in the process of efficient decision making when deciding

upon priority investment projects. In line with the Budget Law, it is necessary to intensify the monitoring of ongoing investment projects in order to keep track of the spending of planned funds.

Establishing regulatory bodies and agencies resulted in significant costs for the budget and/or corporate sector. It is necessary to consider that after the application of the specialisation principle, their centralisation and/or reduction of their number should start. If the existence of a substantial number of working groups, committees and boards is needed, the possibility of terminating remunerations for members of those bodies should be considered in order to cut expenses. The analysis of relevance and importance of working groups should be made as well as their activities, and a clear classification should be made with regard to the importance for the country's interests and to that end, a decision on remuneration for members of these bodies should be passed.

Over the past several years, the Central Bank has reiterated the need for implementation of the OECD instructions concerning the transfer of prices referring to the tax evasion. International companies often evade legal tax burdens by using the system of transfer prices in cross-border transactions. Via this mechanism they shift the profit into a country with lower tax rates in order to pay lower corporate profit tax. The OECD gave a series of recommendations which need to be implemented and which refer to the intensification of rules on reporting foreign investments; abolishment of tax agreements made with tax havens, securing a more efficient exchange of information and the like.

## VIII. RECOMMENDATIONS CONCERNING THE FINANCIAL SYSTEM

### 1. Banking and non-banking sector

Positive GDP estimates for the current year made by both competent domestic and international financial institutions speak in favour of a relative optimism when it comes to the developments in the banking sector. On the other hand, borrowing conditions of domestic banks at foreign markets are limited by high interest rates as a result of risk perception regarding our region. Limited offer and higher borrowing costs at foreign markets forced the banks to find alternative in domestic sources of financing primarily through deposits as they are currently the cheapest source of financing. The growth in non-performing assets that results in the extension of the bank consolidation process and lack of qualitative business plans still represent an obstacle for the lending activity growth.

The banking system stability reflects, *inter alia*, through banks' liquidity and solvency indicators, which are above the prescribed level. The growth in total loans and other receivables in the first six months 2013 of 4.9% relative to the previous year-end were not only the result of the new loans growth of 343 million euros but also the result of the changes in regulation and IAS implementation. Thus the banks transferred a portion of written off loans and other receivables (classified in category E) from the off-balance sheet records into on-balance sheet records.

The key vulnerability of the banking sector and the potential source of risk to financial stability represent an ongoing growth of non-performing loans even besides banks' efforts to reduce them in the post-crisis period. Non-performing loans trended up even besides relative success achieved by transferring NPLs to the parent banks' balance sheets, selling and/or restructuring these loans. Non-performing loans and other receivables<sup>16</sup> accounted for 17.8% of total loans and other receivables.

Key challenge in 2014 will be the reduction of NPLs as it was the case in the previous years. As individual approach in resolving such systemic problem gave partial results, the initiative to create a systemic solution on the path banks – the

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<sup>16</sup> The share of non-performing loans and other receivables, pursuant to the amended regulation which entered into force on 1 January 2013 is calculated as the percentage of non-performing gross loans and other receivables, without interest and prepayments and accruals, in total loans and other receivables. Data are still not comparable with the previous year since the review of data for non-performing loans has not been completed yet.

regulator – the government was accepted. In addition to resolving this issue, its implementation will foster economic activity and maintain financial stability. The “Podgorica Approach” was created to support voluntary restructuring of non-performing loans which was fully supported by the Central Bank, the Ministry of Finance and the World Bank. This is a very complex project which realisation requires passing of *lex specialis* for its enforcement in practice. By increasing the performance of solvent legal entities’ – companies and entrepreneurs – faced with interim liquidity, this project will also strengthen banks’ performance as foundations of stability and support of our system recovery. The project will provide long-term positive impulses for initiating economic activities and consolidating real economy.

Past due loans and other receivables<sup>17</sup> have represented a problem of Montenegro’s banking system for the fifth consecutive year. Past due loans and other receivables amounted to 581 million euros at the end of June 2013. Past due loans and other receivables accounted for 23.6% of total loans and receivables. Past due loans and other receivables of corporate and retail sectors accounted for 38.3% and 19.9% in total loans and other receivables, respectively.

The fact that deposits are trending up is encouraging and that resulted in the improvement of credit and deposit relationship. Deposits<sup>18</sup> recorded growth of 1.5% in the first six months of 2013 relative to end-2012, while they recorded annual growth of 9.0%.

High liquidity characterised the banking sector in the first half of the reporting year. Restrictive lending policy of banks reflected on the increase of cash and overall liquidity.

Lending interest rates were extremely high both in 2012 and 2013 due to high country risk premium and more expensive sources of funds, uptrend in non-performing assets, riskiness of clients and overall business environment. Considering limited access to sources of funds, banks focused on domestic sources secured by supply of higher deposit interest rates which resulted in high interest margins.

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<sup>17</sup> The share of past due loans and other receivables, pursuant to the amended regulation which entered into force on 1 January 2013 is calculated as the percentage of past due gross loans and other receivables, without interest and prepayments and accruals, in total loans and other receivables. Data are still not comparable with the previous year since the review of data for past due loans has not been completed yet.

<sup>18</sup> Total deposits (including funds at escrow account) without accrued interest and prepayments and accruals.

Thus the Central Bank passed a Decision on Interim Measures for Limiting Bank Interest rates in November 2012. After six months of its application, the weighted average effective interest rate (WAEIR) declined. Moreover, a substantial reduction in the margin between the WAEIR and the weighted average nominal interest rate (WANIR) occurred, which has been below 1 percentage point from the moment of passing of the decision.

### ***Micro-credit financial institutions (MFIs)***

Total assets and liabilities of microcredit financial institutions (MFIs) at end-June 2013 amounted to 37.1 million euros, recording a 0.9 million euros or a 2.5% increase in relation to end-2012.

Total liabilities<sup>19</sup> accounted for 38.2% of total liabilities and capital. The largest source of MFI financing was borrowings. Total borrowings amounted to 12.6 million euros at end-Q2 2013 which was an 82 thousand euros or 0.6% decline relative to end-2012.

MFI capital was 22.9 million euros at the end of the second quarter 2013, i.e. it accounted for 61.8% of total liabilities and capital. Capital from donations made up 61.6% of total capital, while 23.9% referred to retained earnings, and 8.8% was capital issued. MFIs reported profit of 1.3 million euros at end-Q2 2013.

### ***Insurance market***

Pursuant to the class of insurance, eleven insurance companies operated at Montenegro insurance market. Five companies were engaged in non-life insurance while six of them were engaged in life insurance activities.

Total assets and liabilities of insurance companies amounted to 150 million euros at end-June of the current year and it reported growth of 5.5% relative to end-2012. Solvency of insurance companies was satisfactory. The capital to solvency margin ratio amounted to 186.61%<sup>20</sup> as at end-Q2 2013.

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<sup>19</sup> Liabilities on loans taken and borrowings, conditional grants, subordinated debts and other liabilities.

<sup>20</sup> Pursuant to the amendments to the Insurance Law that entered into force in August 2012, solvency is measured by the capital to solvency margin ratio.

Gross insurance premium amounted to 7.2 million euros at end-June 2013. Non-life insurance accounted for the main share (86.3%) in total reported gross premium, while the remaining 13.7% referred to life insurance. As for the structure of gross premium of non-life insurances, motor vehicle liability insurance accounted for the main share (52.6%), followed by other property insurance (11.8%), accident insurance (10.9%) and motor vehicle insurance (8.8%). On the other hand, life insurance accounted for the main share (86.8%) in the structure of life insurances.

Insurance market reported gross income of 1.8 million euros at end-June of the current year. Currently, there are not threats to the financial stability at insurance market.

### ***Lease market in Montenegro***

The lease market was characterised by the y-o-y increase in the number of delivered contracts. Consequently, an uptrend recorded in the number of new contracts characterised also the category of new placements.

In the reporting period, six providers of leasing services operated in Montenegro, of which four leasing companies held the status of legal persons and two were banks. The largest number of active contracts was signed with legal persons (51.7%), followed by contracts signed with natural persons (47.8%), while contracts signed with entrepreneurs made up 0.5% of total contracts. Financial leases accounted for 85.6% of the number of contracts signed, while the remaining portion referred to operating leases.

Observed by the value of contracts concluded in Q2 2013, 79.7% of total value of concluded contracts referred to purchase of passenger's vehicles, 16.1% referred to purchase of commercial vehicles, 2.9% referred to purchase of building machinery and equipment, while only 0.5% referred to purchase of real estates.

### ***Main risks in the financial sector***

- High exposure and economic connectivity of Montenegro with the region and EU member states, and the fact that the banks are majority foreign owned made the economy of Montenegro and the financial sector vulnerable and sensitive to negative trends in the region;
- Difficulties faced by some of the parent banks in their domicile markets;

- Still present high illiquidity of the real sector and a decline in financing from external sources result in a prudent approach to bank lending;
- Still present high percentage in non-performing loans and other receivables and past due loans and other receivables as the largest sources of credit risk;
- High percentage of past due loans and other receivables in the corporate sector. Loans and other receivables of corporate sector to total loans and other receivables amounted to 38.3%.
- Unfavourable maturity match of funds and sources of funds, primarily deposits and loans, deprives the real sector of long-term loans for financing development projects under favourable conditions;
- Insufficient degree of integration of certain segments of the financial market;
- Underdeveloped offer of securities in the secondary market;

### *Development strategy<sup>21</sup>*

- a. Create a stimulating business and investment environment and remove business barriers in order to start economic activities;
- b. Continue with activities in cooperation with the Central Bank and the World Bank on the Podgorica Approach to resolve non-performing loans in banks;
- c. In cooperation with the CBCG, undertake activities on the creation of the regulatory framework which refers to the establishment, operation and supervision of factoring companies, and activities on the improvement of the current legal framework regarding the supervision of lease companies operations;
- d. Define the level of cap rate in amendments to the Law on Contracts and Torts (OGM 47/08, 04/11);
- e. Promote insurance market growth mechanisms as one way of securing additional inflow of capital into the system;
- f. In cooperation with the developers of the official statistics, work on the promotion of regulatory framework for the development of official statistics with the EU directives;
- g. Strengthen supervisory capacities of all financial market regulators in order to harmonise the regulatory framework, in addition to a joint care of financial stability, in order to meet the obligations towards EU accession.

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<sup>21</sup> Development strategy and the Operational measures do not contain measures which are not the responsibility of the government, but are under the CBCG's competence.

## *Operational measures*

Favourable investment climate and encouraging business environment would lead to the improvement of economic activities and banks' lending activities in order to support long-term development projects. The encouraging business environment would mean an additional challenge to the Government in order to continue with reforms that will maintain competitiveness of Montenegro's economy, in particular in the labour market and employment, then taxes, corporate governance and the exercising of the rule of law.

The largest vulnerability of the banking sector in the first six months of 2013 was credit risk which was recorded in high level of non-performing loans. Thus, the activities concerning Podgorica Approach must be continued to resolve non-performing loans of banks through the adoption of *lex specialis* on voluntary financial debt restructuring.

Factoring companies operations must be regulated and the oversight of lease companies operations must be standardised. To that end, the Government should cooperate with the CBCG in adopting a new law on factoring companies operation or amending the Law on Contract and Torts and amending the Law on Financial Lease. Due to the experience of the Central Bank in the supervision and regulation of the banking system, the operations of these companies should be under the jurisdiction of the Central Bank.

Extremely high interest rates were present in some MFIs and rarely in banks. The Central Bank managed to prevent a further growth of interest rates through the Decision on Limiting Interest Rates which was passed in November 2012 for the period of six months. Legal regime for interest rates was aimed at limiting the ceiling of interest rates on deposits and loans without jeopardising banks' lending activity. However, bearing in mind the fact that high interest rates exceeding the growth in non-performing loans influence the financial stability, the possibility of prescribing contractual interest rates should be discussed. The practice of limiting interest rates is well known in the EU member states and in the USA and in some regional countries (Croatia and Macedonia). Fourteen EU member states prescribed the ceiling for interest rates on loans. Different institutions are included in this programme either individually or jointly with other institutions, such as: the Central Bank, Government, legislation bodies or courts. Montenegro should implement the "best international practice" in this area, since the Law on Contracts and Torts prohibits usury interest rate, but it does not regulate the maximum contracted interest rate, which should be done by amending the legislation.

Regardless of the fact that the insurance sector does not have much influence on financial stability due to its relative size, it is necessary to intensify the activities aimed at promotion of growth and development of the insurance market as a whole. Higher gross premiums and insurance companies' balances imply more money in the system to be directed towards other financial intermediaries, eventually enabling the revival of economic activities in the country. To that end, it is necessary to intensify education and promotion activities with the aim of better positioning of insurance activities in the financial services market (leaflets, TV shows, etc.). Taking into account the lack of staffing in the area of actuary services, it is necessary to promote the education of necessary actuaries and implement standards for their licensing

For the purpose of promoting efficiency and effectiveness of regulatory and supervisory capacities of all financial market regulators, an ongoing work is needed on the harmonisation of the existing and/or developing new legislation based on the EU directives and international standards. Surely a good statistical database is one of the main preconditions for passing timely measures of the economic policymakers and thus the harmonisation of the current regulation with the EU regulations will entail the need of harmonisation of statistical databases of the producers of the official statistics. Screening meetings with the EC representatives within Chapter 18 Statistics have been already held during 2013 and the Official Statistics Programme 2014-2018 will define further activities of the producers of official statistics. In this context, coordination and communication of all financial market regulators to define legal solutions that will ensure information flow and data harmonised with the EU regulations in the statistics area.

## **2. Capital Market**

### ***Current status***

In the first six months of 2012, the Montenegro Stock Exchange recorded a turnover of only 10.09 million euros, which is a 9.5% y-o-y decline. Simultaneously, the average monthly turnover amounted to 1.8 million euros, while the highest turnover was realised in April in the amount of 3.9 million euros. The entire turnover was recorded through secondary trade, with the highest turnover recorded in companies' shares (86.5%), various types of bonds (7.3%) and mutual investment funds' shares (6.2%). Total market capitalisation of shares

was 2.8 billion euros as at 30 June 2013. The Monex20 was approximately at the same level at end-June 2013 as it was at end-2012, while the Monex PIF, recorded a decline of 864.4 index points or 25.1% relative to end-2012.

Market indicators and a decline of the stock exchange indices show that the capital market is in deep crisis which is induced by the global financial crisis. The fact that entire turnover at the stock exchange was realised through secondary trading in 2013 and throughout 2012 confirm the absence of investors' interest that would induce the primary issue of shares and its trade. A high level of uncertainty of recovery of international economy reflects negatively on the investors' appetite for investing in Montenegro, indicating that its recovery will be a long process.

With regard to the achieved level of regulatory and institutional development of the capital market and market infrastructure, bilateral analytical review of regulatory and institutional framework for Chapter 9 Financial Services was held in Brussels in June, where it was stated that the regulatory framework is partially harmonised with the *acquis communautaire* in this area<sup>22</sup>. The adoption of a new Law on capital market is planned by the end of 2013 which will incorporate lacking solutions from relevant directives. The adoption of this law will contribute to a high level of harmonisation of the financial system in this area.

### ***Main risks***

- Inadequate market liquidity as a result of high operational losses and unresolved debtor-creditor relationships;
- Shallow market in terms of types of trading instruments;
- Inadequate protection of minority shareholders' rights;
- Insufficient level of transparency and quality of financial statements of companies listed in the exchange market;
- Negative aftermath of the capital market price bubble bursting which has a negative impact on the risk sensitivity and investors' confidence;
- Poor management of funds' property;
- Further deceleration of privatisation of remaining big companies.

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<sup>22</sup> Regulatory framework of capital market covers rules reflecting on investment services and securities market, founding, operating and supervision of investment funds and regulated markets, compensation schemes for investors, publishing of prospectus, prohibition of market misuse, etc.

## *Development strategy*

- a. Continue with the harmonisation of regulations with EU practice in the aim of fostering the creation of a more complex market structure and market material, as well as the increase in market liquidity;
- b. Start with activities on the review of required normative, financial and operating conditions for a gradual implementation of the second pillar of compulsory pension insurance into the pension system;
- a. Intensify the connection of the market with the regional and European markets, in terms of volume and quality of trading instruments;
- c. Improving the protection of minority shareholders' rights and the compliance with the basic principles of corporate management;
- b. Implementation and compliance with the IFRS;
- d. Intensify education activities of the population.

The harmonisation of regulations with the EU *acquis* should be continued particularly in the part referring to the operations of investment funds.

Develop feasibility study for the implementation of the second pillar of compulsory pension insurance based on individual capitalised savings (occupational pension scheme) and draft special law based on IOPRP directive on occupational pensions.

Continuously strengthen institutional and administrative capacities of the Securities and Exchange Commission for performing intensified supervisory activities in order to ensure consistent application of regulations by the capital market participants.

Continuously improve the system of oversight of trading by establishing a proactive system which uses statistical tests and which may identify irregularities in trading at an early stage.

It is necessary to take appropriate activities for the development of the secondary market of short-term T-bills, corporate bonds and new initial public offerings (IPO). This would increase the possibilities for debtor finance of the business entities in cases when borrowing from the banking sector is made difficult and too expensive.

Organise and intensify activities on the education of participants in the market on the possibilities of regional connecting in the stock market, in order to promote trade, deepen the market, increase information flow, reduce investment risk, etc.

Monitor on continuous basis amendments in the area of international financial reporting standards (IFRS) and propose amendments to local regulations within the accounting reform. Insist on full implementation of the IFRS in order to eliminate speculative activities resulting from asymmetric information flows.

Improve continuously the quality of stock market reports regarding the information provided, primarily the parts referring to risk indicators of shares in order to adequately inform the market participants on the risk/yield ratio of certain trading instruments.

Encourage the implementation of the Corporate Management Code in order to further improve the quality of corporate governance in companies whose shares are listed at the stock market. Support the implementation of these principles as a precondition for preserving the market credibility and upgrading the level of overall corporate culture.

## IX. RECOMMENDATIONS CONCERNING INTERNATIONAL ECONOMIC RELATIONS AND INTEGRATION

### **1. Balance of payments and competitiveness of Montenegro's economy**

#### *Current status*

Montenegro's balance of payments data show a gradual current account deficit decline in the past several years relative to the pre-crisis period. The current account deficit declining trend has been ongoing since the beginning of the crisis, largely as a result of the economy's crisis adjustment and a decrease in aggregate demand. However, despite declining external imbalances, it is obvious that the external trade deficit is significantly high and permanently present.

Against the backdrop of slow economic recovery, decreasing foreign accumulation, and a slow recovery in lending activity, the issue of a long-term current account's viability remains the most important. Still significant FDI inflow provides sufficient foreign accumulation for its financing, but it is one of the deficit generators on the other hand. The existence of the long-term deficit points to the fundamental external imbalance for which the financing by itself is not a permanent solution, yet the modalities for a gradual decrease and adjustment need to be sought. After the crisis adjustment and the deficit contraction caused by decreased possibility to finance, a set of measures should be taken in order to make strong reforms in our economy and to make external position better in the long-period.

The global crisis stressed the vulnerability of Montenegro's economy and raised the issue of current growth model's viability. The growth relied on the demand growth and not on productivity, and the export is concentrated on several low value added metal industry products with low technological sophistication. The demand driven growth was connected to a rapid import increase at the expense of deteriorated external situation. Low export base, low diversification of exports and high dependence on exports indicate low competition position of Montenegro and they point to the necessity of improving the current situation. As a result, strengthened and diversified export and increased productivity and competitiveness appear as imperatives for Montenegro's economic development in the upcoming period. Along with adequate engagement of the Government and increasing initiative of the private sector, including stronger financial and non-financial

support, Montenegro's economy needs structural reforms in order to accelerate its development and growth.

Creating measures and instruments for pursuing a competitive policy in the “new” economy remains a challenge for Montenegro. New EU development projects – smart, sustainable and inclusive economic growth – require structural reforms and sustainable economic growth based on growth of domestic and foreign investments, technological modernisation of industry and agriculture, creating export-oriented economic structure, increased employment, stable prices, sustainable external trade, and the current account deficit.

### *Main risks*

Potential risks that may adversely affect Montenegro's balance of payment position and competitiveness include:

- Slow economic recovery of the EU member states and in the region;
- Problem of corporate illiquidity;
- Low productivity;
- Low exports and its diversification;
- Insufficient measures for fostering exports and high costs for financing export operations;
- High dependence of exports on metal industry products;
- Growing inflation pressures;
- Public finance instability;
- Slow lending activity recovery;
- High dependence of domestic consumption and production on imports;
- The growth of energy-generating and food prices in the global market with a direct impact on the increase of imports and imported inflation;
- Low degree in processing products and the export of raw materials;
- Threat from increasing imports without a significant development component (higher import of consumer goods and lower import of capital goods);
- High foreign trade deficit financed by borrowing;
- Slow adoption of international quality standards;
- Threat of price competitive imported products;
- Insufficient orientation towards production for exports;
- Decline in FDI inflow and limited access to international financing sources;

### *Development strategy*

- a. Increased competitiveness and productivity;
- b. Strengthening the export sector with a higher diversification of exports;
- c. Increased promotion of export and export potential;
- d. Increased volume of export and “creating” new exporters;
- e. Pursuing the import substitution policy;
- f. Increased financial support for new export businesses and strengthening non-financial support;
- g. Adoption of international quality standards;
- h. Investments in strategic branches of Montenegro’s economy - tourism, agriculture and energy;
- i. Reducing dependence on metal industry;
- j. Using the advantages offered by free zones and associating companies into clusters;
- k. Lower export of food by creating favourable conditions for the development of agricultural and food industry and substituting the import of agricultural and food products, with the focus on organic output;
- l. Stimulating the development of entrepreneurship;
- m. Attracting foreign capital in production activities and production export.
- n. More investments into research and development, knowledge, innovations;
- o. Improving business environment and investment climate, protection of copyright and intellectual property rights;
- p. Implementation of international quality standards.

### *Operational measures*

In order to improve competitiveness of Montenegro’s economy and boost exports, there is an obvious need for expanding and diversifying exports. Domestic market is very small to base the development model on it, thus it would be important to break through to the global market. The Government should put export increase as its priority economic objective with the appropriate coordination structure and aggressive domestic and foreign campaign. In general, domestic economy’s capacity needs quality and standards for exports to be improved, spreading production to the industries traditionally not present in exports.

With a view to strengthening Montenegro’s export and raising competitiveness of the economy, it would be necessary to continue with strong export advertising and fostering. A new export fostering strategy should be passed since the existing one was passed during the economic boom and the new one should be adjusted to new

Montenegro's economic requirements and a new growth model. The export's success requires continuing the current promotion of Montenegro at the international markets, participation at fairs, economic meetings and the like. The accent should be put on a better use of the Montenegrin missions abroad for commercial and export purposes.

The existing structure of Montenegro's exports needs changing in the upcoming years. The largest portion of the export products are mostly metal industry and labour intensive products. The structure should be changed to increase the export of products with a higher processing degree, based on new technologies and innovations. Higher finalisation of products results in significantly higher prices of export products, higher earning, more competitiveness, and many positive effects on economy. This has to be a long-term task because the structure cannot be changed in a short period of time.

In order to raise the general level of product competitiveness, private investments into modernisation and innovation should be fostered and stimulated. Conditions for further application of the *Strategy for development of small and medium enterprises 2011-2015* should be provided. New businesses should continuously be supported financially and non-financially, and special programmes, like franchising, technological parks and business incubators should also be supported and developed.

To gain higher level of competitiveness and productivity, the focus should be put on small and medium enterprises and on new export oriented production companies. Montenegro passed the *Strategy for fostering competitiveness at the micro level 2011-2015*, which defines measures and activities for the development of corporate competitiveness. It would be necessary to ensure that the abovementioned strategy is pursued as planned so that the SME sector in Montenegro could strengthen and become more competitive. The Directorate for the Development of SMEs should implement the project of creating a unified database of SMEs to identify all sectors and companies with the largest innovative, development and export potentials, serving as the basis for the activity plan in the upcoming period. The noticeable insufficient private sector's share in European research programmes requires continued education of the private sector and the SMEs on possibilities offered under EU projects.

A growing export as a strategic commitment of Montenegro may lead to increasing the volume of already exported products and also to "generating" new exporters and new export products. In order to receive the desired results faster, these two

options should be combined. This would result in higher export values in the combination with greater diversification. A detailed database of exporters and export products is required in order to serve as a good information basis for decision-making and objective-setting. Proper data would provide precise information on what is exported, who the exporters are and how to improve the export potential. To gain useful information on foreign markets and possible export obstacles, the possibility of establishing a working group consisting of existing large exporters should be discussed.

The analysis of exported goods should be made to provide information on which goods need to be imported and which could be compensated by substitution. There is a significant room for producing a large portion of consumer goods in Montenegro, particularly in food industry. Such policy would decrease the country's dependence on imports, foster domestic output, and increase domestic products marketability.

Financing is a necessary precondition for growth and development of every economy. The results of the *Investment Climate Survey 2012* for Montenegro pointed to insufficient financing as the highest limitation. The accent in the upcoming period should be put on financial support to new export oriented businesses. Consider possibilities for allocating additional funds under the Investment and Development Fund (IDF) allocated for financing new operations and funds to support the entry into new markets. The IDF's lending and factoring support to SMEs, agricultural producers and entrepreneurs should be continued. Possibilities of using EU institutions' funds should be utilised and the need for establishing the institution for export lending and insuring should be considered. The application of existing financial instruments for SMEs should be continued as well as the discussion of new ones (these including new guarantees, export support instruments, private equity funds<sup>23</sup>).

The quality and availability of non-financial support, as well as activities of the Trade Information Service should be improved in the upcoming period. Improvement of the existing and the creation of new business incubators should be

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<sup>23</sup> Internationally recognised as private equity funds, these funds raise funds from qualified investors (pension funds, insurance companies, large companies) and invest them into differently developed companies, risk of future operations' development, very low or non-existing liquidity and companies with very limited access to financing. Funds enter the companies' ownership structure and these companies are particularly interested to actively participate at the company's operations and to contribute to growth and development of operation in all segments of their competence. In return, the expected return on investment is reasonably high from the risk aspect and ranges between 20 and 25 percent annually.

continued, as well as advertising activities and advices to existing and new business, and fostering development of women entrepreneurship.

The safe placement of domestic products at the EU markets requires the adoption of numerous quality standards. Food industry is a particularly demanding area. The promotion of standards` application should be continued by implementing a financial support programme to subsidise a portion of costs for introducing quality standards in new and existing companies. Due to the importance of the EU market to Montenegro and future integration processes, the informing of companies and citizens on certificates, technical standards, rules on goods origin and protection of goods at the EU market should be continued. Better implementation of the Food Safety Law and Food Safety Strategy should be enabled. The national standardisation strategy should be passed and the branding of Montenegrin products and the promotion of the geographical brand “*Made in Montenegro*” should be continued. Companies should be financially supported so that more of them receive the “*Good from Montenegro*” collective trademark. An option is to decrease the existing fees for request processing or the amount of annual fee for the right to use the trademark, so that more companies could receive the trademark.

Promotion and development of the Montenegrin economy’s strategic branches should be continued and these include tourism and agricultural and food industry and energy. Montenegro has comparative advantages and a large export potential in these areas. Tourism is foreseen to be the main driver of Montenegro’s development in the upcoming period. To implement it, the quality of the infrastructure should be improved, accommodation facilities improved, realisation of planned big investments (Ada Bojana, Velika Plaža, Luštica, Kumbor and the like) enabled, quality of accommodation facilities improved, accompanying infrastructure enhanced, and the like. Significant agricultural potentials should be exploited, with a stronger assistance and support from the state, using the IPA funds. Investments into renewable energy sources should be fostered.

Ensure better application of the CEFTA Agreement, particularly in removing business barriers.

Development of SME clusters may significantly contribute to increasing competitiveness and productivity of Montenegro’s economy. Introduction of 2012-2016 clusters should ensure further application of the Strategy for sustainable economic growth. The SMEs may benefit from joining the clusters through enabled access to new markets, transfer of knowledge, introducing new technologies, more efficient operations, and improving products quality. The

promotion of regional clusters should be more efficient. Clusters in agriculture, wood industry and tourist offer are becoming a more logical choice. Activities on establishing a scientific-technical park and an innovative-entrepreneurial centre should be more concrete. Activities on expanding Business zones development should be continued.

The Montenegro Institutional Development and Agriculture Strengthening (MIDAS) project should be continued. The consistent application of the Plan of promoting investment opportunities of Montenegro into agricultural sector should be continued. Consulting, knowledge transfer and fostering innovations in agriculture is to be fostered. Strengthening domestic agricultural output would significantly decrease the food import, which is now higher than export.

Additional efforts should be made in attracting FDIs into output production. In addition to opening new jobs and starting output, foreign investments bring new technologies, transfer of knowledge and quality management and higher product quality and competitiveness. In addition to the country's economic potentials in tourism, promote potentials in the agricultural food industry, organic production, energy, and the like.

Based on the global competitiveness index 2012/2013, the largest downsides of competitiveness for Montenegro are technological readiness, innovation and business sophistication. Research and development are not properly funded, particularly in the private sector. Additional efforts and support to the private sector is required to allocate more funds to research and development. The state may foster investments into research and development through financial support to companies for innovation and promoting the output. Possibilities for developing the national innovation system should be considered. The *Voucher schemes* project should be continued for innovative SMEs and the increase in budget for this purpose should be considered.

Ensure better legal protection and fasten the resolution of court disputes, and enable better protection and respecting of copyrights and intellectual property rights. Enable better application on the Patent Law and the Law on the Protection of Competition.

## **2. Foreign Direct Investments**

### ***Current status***

In recent years, Montenegro has significantly improved business environment and investment climate, as shown in the Doing Business Indicators' results, placing Montenegro among 25 percent of the leading countries in business environment quality. It is positive that net FDI inflow increased in 2012, thus stopping the decline recorded in the previous years. Preliminary H1 2013 data show a slight net inflow decline compared to the previous year. The structure is still unfavourable since the largest portion referred to the purchase of real estates, while Greenfield and export-oriented investments remained low. The share of investments into services is higher than the share of investments into output.

The Strategy for Attracting Foreign Direct Investments in the period 2013-2015 was passed in 2013, and it defines activities on promoting and attracting FDIs and the achieved integration of the strategy with the general development goals and the economic growth strategies. The direction of promoting investment potentials towards new markets may be seen as a positive step taking into account the recession in the EU countries and a decline of interest foreign investments.

As a strategic determination of Montenegro's development, continued privatisation process is of utmost importance for strengthening Montenegro's economy. Montenegro now enters a new phase of investment development oriented towards large Greenfield investments and development projects in infrastructure, energy, tourism, and production. To that end, creating necessary conditions for investments is a challenge. FDI inflow may only increase with a continuous effort of all state and local bodies on pursuing structural reforms and further improving of the investment environment.

### ***Main risks***

Potential risks with a possible negative impact on FDI inflows in the upcoming period include:

- Continued crisis in the Euro area countries and lower investment appetite;
- Unsuccessful privatisations – unfulfilling contracted investment and social programmes by strategic investors;
- Standstill in the privatisation of remaining strategic companies;

- Red tape – poor coordination between public and local administration (long and demanding local administration procedures);
- Unfavourable economic results resulting from a lack of new investments into output sectors;
- Insufficient level of transparency and foreign investors' lack of trust;
- Problem of unresolved ownership relations over land;
- Absence of a clearly defined spatial and urban plans;
- Insufficiently developed infrastructure.

### ***Development strategy***

- a. Improving investment and business environment – continuation of regulatory framework reforms and further harmonisation with the *acquis communautaire*;
- b. Attracting new FDIs to increase contribution to the total economic development, increased competitiveness and employment;
- c. Increase foreign investments into production sectors and attract competitive and export-oriented foreign investments.
- d. Continue the privatisation process;
- e. Increase Greenfield investments;
- f. Promotion and attraction of foreign investments into business zones;
- g. Fostering FDIs at the north with a view to equal regional development of Montenegro;
- h. Development of infrastructure, particularly in the areas of transport and energy;
- i. Continue the labour market and education reforms in line with development needs.
- j. Strengthen capacities of institutions responsible for the promotion and attracting of FDIs;
- k. Providing support to investors with a view to efficient realisation of contracted social and investment programmes.

### ***Operational measures***

Activities focusing on creating favourable and stimulating investment environment should continue in 2014. Improved business and investment environment is a prerequisite for sustainable economic growth and development. Strategic commitment of Montenegro to European integration and an active role in

international cooperation are factors that will affect the realisation of foreign investments in our country.

Clearly defined national programme of promoting foreign investments is important for better attraction of FDIs. The activities should be taken in line with the new Strategy for Attracting Foreign Direct Investments 2013-2015, a good basis for promoting investment potentials of Montenegro and attracting new investments. An action plan should be created for pursuing the strategy in order to complete activities. Moreover, the implementation of the strategy for developing SMEs and other strategies complementary to the strategy of attracting FDIs should be continued.

Attracting new investments aimed at boosting country's competitiveness, export and opening new jobs is important for the country's future development. The promotion of potential for Greenfield investments and the valuing of tourist potentials should be intensified. Increased investments into output sectors should be a priority objective in the upcoming period. Clear activity plan should be made for promotion of sectors of key importance for development of production capacities and international competitiveness. Since tourism, energy and agriculture are seen as three pillars of the future economic growth, the promotion and attracting FDIs into these sectors should continue.

It would be necessary to strengthen public companies, as possible, and prepare them organisationally for privatisation. Activities on companies' restructuring programmes should continue with a view to their transforming and preparing for the privatisation process. It would be particularly important to emphasize the importance of upcoming privatisations in strategic sectors (maritime affairs, air transport, and tourism) which quality and finding of strategic investors would directly affect competitiveness and viability in the upcoming period.

Continue activities on improving conditions for operations in business zones and further fostering of their development in line with the Plan of Fostering the Development of Business Zones in Montenegro. Promotion of business zones for investments should be intensified taking into account all benefits to investors, as well as the forming of clusters pursuant to the Strategy for sustainable economic growth of Montenegro by introducing clusters 2012-2016. The land in all free zones for Greenfield investments to export-oriented production programmes should be equipped in terms of infrastructure, to make this area more attractive to foreign investors.

Large regional differences in Montenegro are the problem that may be solved only with large investments. Investment potentials of the north need promotion with a view to gaining more equal regional development of the country.

Improving the existing and constructing new infrastructure is a necessary precondition for the implementation of large investment projects. Deficiencies of the Montenegrin infrastructure, particularly in the area of energy and transport, are obstacles for Greenfield investments, competitiveness and economic growth of the country. Continue with the development of infrastructure as a Montenegro's development project through private-public partnerships and concessions, since these would provide the support for new investments.

The current educational structure does not satisfy the demand for labour force at the domestic labour market. Educational programmes should be adjusted to the demand of domestic and foreign investors, pointing to the need for long-term investments into education.

Institutions responsible for the promotion and attracting FDIs should be further strengthened both financially and personally. It would be necessary to establish better coordination and cooperation of public institutions included in the promotion of investment potentials at the state and local level to create efficient support to foreign and domestic investors.

The institution that would be responsible for the realisation of contracted obligations should be clearly defined, tasked also with the provision of appropriate support (post-investment services) to foreign investors in accelerating the realisation of planned investments to Montenegro. Possibilities of establishing a "one-stop-shop" office for investments to provide foreign investors with information and necessary documentation for starting the realisation of these investments should be reviewed. This would provide all necessary information to foreign investors at one place, thus speeding up the realisation of investments. Clear procedures and deadlines for adopting spatial and urban plans should be clearly defined, taking into account the lack of urban plans being a reason for departing from, or postponing, the start of implementation of investment projects in Montenegro.

A precondition for better foreign investments attracting is resolving restitution and land ownership problem. Thus, the restitution mechanism for efficient problem resolution needs improvement, as it is a barrier for implementing investment projects.

Further pursuing of reforms should continue with a special focus on the areas that foreign investors have identified as poor i.e. construction (issuing licences, procedures for property recording and the like). Realisation of the “one-stop-shop” project or “everything under the same roof” in construction is a positive step, but investors’ experience indicates that the objectives of the project have not been achieved and that investors are not satisfied. Although the business environment survey results pointed to many deficiencies connected to the construction sector (building permits, utilities, long-term procedures for recording property, urban plans and the like), it would be necessary to make more efforts on reducing business barriers in these areas.

Montenegro has a strong potential for attracting FDIs especially in tourism and energy. The first big wave will appear after the crisis has ended, and meanwhile it would be necessary to create preconditions to value these potentials. This primarily means the promotion of investment potential with strategic partners, resolving the restitution issues, ending of urban and spatial plan, improving infrastructure and the like.

### **3. Recommendations concerning international integration**

#### ***Current status***

The strategic objective of Montenegro is a full EU membership. On this path, Montenegro had acquired a candidate country status on 17 December 2010 and the negotiations on membership were initiated in June 2012. Negotiations are divided into several phases, the first negotiation phase for the selected chapters, which includes the compliance analysis of Montenegro’s legislation with the *acquis communautaire* (the so-called *screening*), ended in June 2013.

The European Commission publishes Analytical reports for each negotiation chapter, with permanent consultations with relevant parties in the negotiation process. The EC will give its assessment of the readiness of Montenegro to accept and apply the *acquis communautaire* for 33 chapters, and the recommendations for opening of individual chapters.

The success of the European integration process depends on the ability to meet the requirements for membership in other international and regional organisations, as well as on the ability to meet the obligations arising from membership in these organisations. However, the complicating factor for continuation of negotiations is

a decision of the EC not to open additional chapters before opening Chapters 23 and 24.

### ***Main risks***

- Political disunity within the EU regarding the pace of further enlargement;
- Instable macroeconomic environment in the country that may postpone accession and open new requirements to Montenegro's negotiation team;
- Insufficient administrative and institutional capacities for negotiating;
- Strict EU criteria for the opening and closing of negotiation chapters;
- Insufficient capacities for efficient utilisation of IPA funds, as a manner to finance projects to comply with the EU requirements;
- Postponing of new chapters due to a delay in meeting obligations under chapters 23 and 24.

### ***Development strategy***

- Strengthen the capacities and increase the efficiency of institutions in meeting the political, economic and legal criteria for the EU membership;
- Make adequate selection in economic policies for 2014 and beyond, to reduce macroeconomic imbalances, particularly national fiscal pressures and simultaneously affect the degree of the economy needed for a further harmonisation process;
- Pass strategic documents and action plans defining the manner and deadlines for meeting obligations. The documents and plans need to be synchronised and united under the common objective and not segmented and directed towards individual contributions to chapters' closing.
- Use all available trainings and information sources to adequately use available EU funds, particularly IPA.
- Increase the efficiency in creating a decentralised system of EU funds' management;
- The Government and individual institutions included into the negotiation process should additionally strengthen their capacities to ensure consistency in *acquis* adoption and carefully monitor the implementation of laws.

## *Operational measures*

As regards the European integration, priority directions at this stage refer to a further harmonisation of the legal system with the *acquis communautaire* and the defining of the pace of harmonisation with the deadlines set by the EC in the analytical reports.

Consequently, the national strategic documents and action plans should be prepared and they should specify the manner and deadlines for meeting the criteria for the EU membership. After publishing the EC Analytical report, it would be needed to start drafting optimal negotiation positions based on the real sector analysis, and the platforms that would include drafts and agreements on transitional periods and eventual exclusions that Montenegro may ask, all aiming to better preparation for the application of the Acquis.

The selection of economic policies should be directed towards gaining stability. Fiscal policy should be guided towards meeting primary Maastricht criteria, and towards other EU legislation in this area. The continuation of the privatisation of state owned and restructuring of public companies is expected, to maximise the utilisation of public resources. The financial sector should be directed towards financial stability, and the income policies towards the accumulation of values. The systemic approach in pursuing policy should be micro and macro competitive in terms of choice.

Continuous efforts should be made in strengthening the administrative capacities of employees engaged in the European integration and coordination of the EU financial and technical assistance.

As an EU candidate country, Montenegro may largely use the pre-accession funds. National institutions delaying with IPA funds management should make the information on EU projects more available. Therefore, it would be necessary to train and engage the personnel that would prepare quality terms of reference to utilise as many funds. During the drafting of strategic and operational plans, stress should be put on the projects that would resolve infrastructural problems, prepare the market for the struggle with the competition in the common market, and develop human resources.

Despite achieved political consensus on the EU membership in Montenegro, the media, civil sector and universities need to work jointly on increasing the level of society's awareness on the EU membership. Continuous monitoring of the

implementation of the Communication Strategy should be relevant institutions' priority.

Taking into account the hard position of the European Commission on chapters 23 and 24, it would be needed to intensify activities on meeting the conditions for opening these chapters, since the whole process of Montenegro's accession to the EU would be delayed.

Due attention is to be paid to sectors and areas that need protection or the transition period for meeting EU demands. If these requirements are not timely explained, and the negotiation positions entered, subsequent corrections will not be possible.

## **X. RECOMMENDATIONS CONCERNING ENVIRONMENT AND SUSTAINABLE DEVELOPMENT**

### ***Current status***

Sustainable development concept in Montenegro is two decades old. It originates from the Parliament's Declaration of Ecological State Montenegro from 1991. Some elements of this Declaration were implemented in the Constitution, while enacting the National Strategy for Sustainable Development (NSSD) five years ago, created conditions for integrating the environment principles into Montenegro's development policies. The NSSD is based on global sustainable development principles and it foresees the following four goals:

- Economic growth acceleration based on the sustainable development fundamentals,
- Poverty reduction, protection of the most vulnerable groups and more equal economic development,
- Environmental protection and sustainable natural resources' management, and
- Ethical goal referring to the implementation of coherence and solidarity principles, respect of human rights and transition from the centralized decision-making to coordinated activities and decentralization.

The abovementioned indicates that social awareness in Montenegro is high, at least declaratively, but despite this, there is a substantial part of the territory that is polluted and exposed to negative human activities.

Montenegro has substantial natural resources, which is the primary potential of the country. A significant part of the territory is included in international conventions or protected by international agreements. Thus, the drainage basin of river Tara belongs to the M&B UNESCO biosphere sanctuary, while the National park "Durmitor" with the river Tara canyon and the Risan-Kotor Bay belong to the Natural World Heritage. The national park "Skadar Lake" is marked as Ramsar site – List of wetland sites of international importance, especially important as water birds' habitat. The national network of protected sites in Montenegro currently covers 9.04 percent of the territory. Five national parks ("Durmitor", "Lovcen", "Skadar Lake", "Biogradska gora", and "Prokletije") have the highest share in the protected natural territory (79.8 percent), while the rest refers to over 40 protected sites, including the monuments of nature, sites of special shapes, and sanctuaries.

Since Montenegro is an ecological state, it may be concluded that the percentage of nationally protected categories is insufficient. However, there is a large part of the country that may be subject to potential protection. An important precondition for the accession to the EU is recognition of environment as an important development resource and the efficient problem of resolving its protection.

Montenegro's natural values are constantly exposed to many sectoral pressures, and some of them are seriously endangered, particularly during the last decade of the "development boom". Adverse sectoral pressures primarily include unplanned and irrational utilisation of natural resources, converting natural habitats into semi-natural or artificial, intensive development of some sectors (primarily tourism and construction), accompanied by illegal and unplanned construction, poor waste management (disposal of municipal, medical and industrial waste) and waste waters (disposing of untreated waste waters into surface waters and the sea). Inadequate water management is a significant problem in Montenegro, which may lead to changes and losses in water resources, which results in adverse effect to the environment, and to the economic and social situation in the country. Biodiversity in Montenegro has been highly endangered over the recent years due to growing urban development and illegal construction in the narrow coastal area, illegal and overwhelming wood cutting, uncontrolled and illegal hunting and fishing, uncontrolled picking of edible and medical plants, mushrooms and fruits in forests, and illegal exploitation of boulder from river beds. Moreover, inadequate protection from fire is also a problem resulting in fire devastating habitats of some species.

All abovementioned pressures decrease available space for environmental assessment of the country's natural resources. As a result, protected areas are directly destroyed because of the lack of adequate protection systems. Thus, elemental urbanisation and illegal construction of weekend houses, houses and other constructions in the National Park "Durmitor" area resulted in the loss and change in the characteristics of the protected natural goods, and as a result, the boundaries of this national park should be revised<sup>24</sup>. This is just an example of a direct environmental aggravation.

Moreover, the key environmental problems in Montenegro mostly appeared due to the use of obsolete technology by many large corporate entities and an enormous increase in the number of cars. Thus, large polluters are concentrated in the vicinity of protected areas. Obsolete technologies used in Montenegro are characterized by

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<sup>24</sup> Proposal of the National Parks Law

a high degree of environmental pollution. These technologies are used in ferrous and non-ferrous metallurgy, plants for coil burn-out (boiler room, thermo-electric power plant), metal processing industry, and mining. Therefore, the areas in the vicinity of these plants are highly polluted and life-threatening. The analyses of the Environmental Protection Agency showed intolerable concentration of powder substances in many measuring areas. The fact that nothing has been done on decreasing pollution emissions represents a special problem, and one gets the impression that the *Declaration of Ecological State Montenegro* has been forgotten.

Human health is directly and indirectly connected to environmental conditions, confirmed by the fact that environment has been causing sickness in one quarter to one third of ill people.

Natural values represent the resource of special interest for Montenegro and it is necessary to provide their adequate protection. Protection and preservation of natural values is enabled by establishing an adequate legal framework and its further development, capacity strengthening in this area, and the ensuring of continuous monitoring of the nature preservation. An important aspect in this area is the promotion of the environmental protection, which goal is inclusion of the public, being an important factor in protecting natural values.

With a view to mitigating and preventing the abovementioned negative pressures on the environment, institutional and legislative framework in the fields of ecology and sustainable development is continuously improved, whereby the primary objective is the complying of the national legislation with the *acquis*. The basis for quality and efficient law provision in the environmental area was created by establishing the Environmental Protection Agency of Montenegro. Moreover, concrete activities are taken aimed at raising awareness on the environmental protection issues and problems. The establishment of three Aarhus centres (Podgorica, Berane and Nikšić) was a strong progress in this area, thus strongly contributing to the participation of the public in environmental protection. The adopting of the Montenegro's National Strategy for Air Quality Management with the Action Plan for the period 2013-2016 significantly contributed to air quality management in February 2013, as well as the establishing of the state air quality monitoring network. At the end of 2012, the Technology Needs Assessment for Climate Change Mitigation and Adaptation for Montenegro National Strategy and Action Plan were prepared, and this was a progress in raising awareness on climate changes in Montenegro and inclusion of the environmental policy in other sectoral

policies. The cooperation was established with many international organisations relevant for environmental protection.

With a view to resolving the issue of adequate disposing of all types of solid waste and its treatment, concrete activities were continued in the previous period. Of eight sanitary landfills, two were constructed – one in Podgorica and the end of the first phase of constructing landfill in Bar which started working in the middle of 2012. The improved waste management condition resulted from the purchase of vehicles and equipment for sixteen public utility companies in Montenegro (funds were provided from IPA 2009 programme). The construction of the first medical waste disposal facility ended. There is ongoing construction of facilities for waste water purification in Nikšić and Herceg Novi, and the construction of systems started in Bar, Kotor and Tivat. The *Industrial Waste Management and Clean-up Project* foresees the signing of a loan arrangement with the World Bank, which is expected to be effective from 2014. The project plans rehabilitation of three black environmental spots – Aluminium Plant Podgorica (solid waste disposal area and red-mud basins on the KAP sites), (poisonous waste landfill), Bijela shipyard (industrial waste disposal - grit), Thermo power plant Pljevlja (disposal of ash and cinder “Maljevac“) and Mine “Šuplja stijena” Pljevlja (flotation waste rock Gradac). The Project “Lake Skadar Ecosystem Management” has been implemented in cooperation with the World Bank aimed at enhancing mechanisms for the efficient cross-border cooperation, protecting and managing the sustainable economic development of the Skadar lake region. In addition, there are also numerous activities and projects implemented in the environmental protection area.

However, despite the progress in legislative and institutional framework, the key risks and factors that jeopardize natural resources of the country are still very high. The key problems in environmental protection are inadequate efficiency in the application of enacted legislation, a lack of implementing measures for sanctioning, and still insufficient population’s awareness on the importance of environmental protection.

The main reason not to sanction large polluters may be seen in economic reasons. Except TPP Pljevlja, many other polluters have been operating with serious difficulties for years. In such conditions, there is a concern that imposing full environmental expenses to these companies would mean the winding up and termination of activities, including the “opening” of social problems, since these companies employ many workers. This practically means supporting the concept that environmental protection generates enormous economic costs. Still, such policy is wrong for many reasons. First, it means violating existing legislation and

it may lead to the “mirror” effect, i.e. that other companies start breaching legislation. Second, the price of such policy is not paid only by residents that live near these companies but even wider, since poisonous particles are transferred through air, water and land aggravating flora and fauna, and thus the population’s health. Third, this increases costs to health fund by increasing curative costs.

### ***Main risks***

- Environment devastation;
- Production of food at high pollution spots;
- Increased pollution of territory affected by the overwhelming use of agrochemicals in agriculture by agricultural producers, whereby coming to the transmission of poisonous materials to agricultural products;
- Increased air pollution resulting from the use of outdated vehicles and vehicles without adequate protection systems, and dominant relying on fossil fuels.
- Insufficient energy efficiency and insufficient use of renewable energy sources.
- Pollution of locations full of water springs;
- Loss of water resources;
- Devastation of sea and coastal areas:
- Loss of biological diversity aquatorium due to high intensity of poaching;
- Degradation of aquatorium and some parts of coast as the result of pouring out untreated communal and waste water from hotel complexes, bad ecological behaviour, damages at oil tankers and other means of transport, non-constructed marine infrastructure for accepting ballast and other waste water and solid waste and transported goods that may endanger the environment;
- Danger of pouring out oil derivatives into the aquatorium and danger of explosions and fire (oil derivatives tanks in the Bay of Kotor and in the Port of Bar);
- Uncontrolled disposal and inadequate treatment of dangerous and non-dangerous waste;
- Endangered ecological balance, resulting from non-planned and illegal construction at the protected areas;
- Unfavourable ecologically-spatial effects of the foreseen construction of hydro energy facilities;
- Due to unbalanced regional development, high migrations may appear, resulting in rural settlements’ depopulation, decline in agricultural production,

high “pressure” on municipal infrastructure, further social disintegration and the like;

- Frequent forest fires;
- Increased pressure to pension and health funds, as well as the reduced human capital potential, due to the aging population tendency.

### ***Strategic development aims***

- a. Strengthen the environment protection from devastation, pollution, poaching, aquatorium degrading, negative influence of the climate changes, fire;
- b. Provide the implementation of the “polluter pays” principle;
- c. Pay more attention to the production of healthy and organic food in Montenegro;
- d. Provide rational utilisation of natural resources;
- e. Focus attention to renewable energy sources, like solar, wind, biomass and other energy;
- f. Improve the water management system;
- g. Protect coastal and maritime area from devastation;
- a. Provide and promote sustainable waste management;
- b. Prevent illegal construction, especially at protected locations;
- h. Encourage environmental awareness of citizens;
- i. Increase awareness on environmental protection into sector policies (spatial planning, energy, transport, agriculture, forestry) following the sustainable development principles;
- j. Promote anti-fire protection;
- k. Increase efficiency in the application of primary legislation regarding environmental protection and improve environmental safety system;
- l. Improve human capacities into sectors responsible for environment protection and sustainable development;
- m. Improve and clearly define management systems in protected areas;
- n. Establish sustainable environmental protection financing systems at the national and local levels;
- o. Pay more attention to balancing the country’s regional development.

### *Operational measures*

In order to define a clear vision of Montenegro's long-term development, it would be necessary to prepare a proposal of the National Strategy for Sustainable Development for the period 2014 – 2020 and the relevant action plan. In that area, general sustainability indicators should be revised, particularly stressing the principle of including green economy concept with a role to change the manner the society manages interdependence of economy and environment.

The authorities' priorities should be to increase the national protected area to 10 percent and to protect at least 10 percent of the coastal territory. It is necessary to revise the status of the existing protected natural sites, to set up a network of protected sites and to integrate them into space and planning documentation. Activities should focus on higher economic utilisation of protected areas' potentials.

With a view to protecting the environment from devastation, it is required to make plans for natural resources exploitation (forests, rivers, land and the like), and plans/programmes of protecting flora and fauna. It would be also important to pass a law on accountability for environmental damage, which would regulate the prevention and removal of damage, and the implementation of the "polluter pays" principle. As a precondition for a good environmental management and successful reporting to the relevant (national and international) institutions, it would be necessary to continue implementing the environmental protection system project. Drafting of the strategy for tourism development in protected areas would be of great importance.

To provide adequate soil protection from different types of pollution pursuant to the Environmental Protection Law, it would be necessary to pass the national plan for combating desertification and pollution with the action plan. It is necessary to enhance the monitoring of all (realistic and potential) land polluters and to impose severe sanctions pursuant to provisions of the Environmental Protection Law, including dismissal of the production process until ecological requests are fulfilled. The map of locations in which there is a high degree of land pollution should be created, while the polluters should detox the abovementioned locations. Food production should be prohibited in polluted locations, while producers should be compensated by the polluters. Efficient measure would be tax stimulation of the production process development that meets environmental standards, and tax discentives for the use of products causing damage to the environment and human health. Overuse of plant protection products in agricultural production has severe

adverse effects on land, air, and the very food products. Therefore, the import and use of plant protection products should be strongly controlled, and the application of organic and mineral fertilisers should be overseen. This area requires a long-term harmonisation of the national legislation with the EU directives. It is necessary to pass legislation on the application of the best agricultural practice, stimulation of using organic fertilisers and biological plant protection products. Organisation of practical trainings for producers should result in increased producers' understanding of environmental processes affecting crop production and intended the designated use of agricultural land.

Water will be a key resource in the coming decades, pointed by recent forecasts that global lack of water would amount to 30 percent by 2030. Therefore, greater attention should be paid to environmental protection of locations rich with water, with a view to creating comparative advantages for the future. The cadastre of spring waters and river sources (realistic and potential) should be created. It would be necessary to develop and conduct thorough long-term water planning with the special focus on developing policies for raising productivity and efficiency in water use in all segments, particularly in agriculture. It would be useful to create either a water protection strategy or water monitoring promotion strategy, with the recommendation for the long-term capacity development. Statutory sanitary protection areas should be established in local governments that have not done it yet. It would be necessary to work intensively on raising awareness on water saving and protection need. As per water monitoring, it should be pointed out that this is not a part of the Program of Environmental Monitoring in Montenegro, since systemic examination of surface and underground waters is conducted pursuant to the Ministry of Agriculture and Rural Development's program and in line with the Law on Waters. Therefore, the Law on Waters should be aligned with the Law on Environmental Protection to establish an integral environmental protection system. A proper solution for water protection in Montenegro would be the establishing of the Agency for Water that would be responsible for protecting the population's health and property from dangerous water effects, monitoring and protection of surface, underground and coastal waters, and the care of designated and rational use of water.

Montenegro has no protected coastal or narrow coastal areas and it would be necessary to speed up the protection of coastal or narrow coastal areas, taking into account high economic risk for its implementation over the past years. Since a significant part of the narrow coastal area is already devastated or seriously endangered, activities on protecting these areas are imposed as a priority. It would be necessary to establish a complete system for monitoring the coast and the sea

with a view to protecting the sea from all types of exploitation and devastation, and enabling a continuous viable use of natural resources in maritime goods. This requires establishing an adequate institutional and legal framework. It would be necessary to pass a Sea Law and pass a Strategy of internal sea management following the sustainable development principle, which shall clearly define the primary strategic maritime and coastal objectives. In addition to usurping coastal land, vessels are a significant source of aquatorium degradation due to spilling poisonous substances into the sea. To reduce and prevent adverse effects of vessels, it would be necessary to prepare a national intervention plan in unexpected sea pollution from vessels. To insure the compliance with the sea law, safety of people and protection of the sea aquatorium from environmental accidents, it would be necessary to establish the coast guard, as the supreme institution responsible for safety on the sea. It is necessary to improve environmental protection systems in ports and marinas, system for the protection from pouring out of oil derivatives in the aquatorium and systems for the protection from explosions and fire in oil houses derivatives in the Bay of Kotor and the Port of Bar.

One of the most significant problems Montenegro is facing is the issue of waste disposal and management; thus it would be important to intensify activities focusing on its solution. Pursuant to the Law on waste management, it would be necessary to intensify activities on drafting National waste management plan and prepare local waste management plans. It would be necessary to continue activities on rehabilitation and re-cultivation of non-sanitary waste disposals (disposal “Ćafe” in Bar, “Vrtijeljka in Cetinje), construction of sanitary landfill and four regional waste management centres in line with European standards. The national facility for safe waste disposal of poisonous waste (from polluted localities and existing economic industries) should be constructed, and it would be necessary to intensify activities on constructing planned facilities for processing medical and veterinary waste and on planned recycling centres.

Collection, recycling and renewing packaging waste are insufficiently developed activities in Montenegro. To develop these activities, it would be necessary first to establish a functional recycling system and then to intensify activities on organising a selective waste collection and establish a network of recycling facilities. Training of communal police officers for adequate reacting in cases of inappropriate waste treatment would be necessary. It would be required to foster production and use of dissolvable and environmentally suitable packaging. Therefore, it would be necessary to pass the law on packaging management and packaging waste. To resolve the waste issue in an adequate manner, it would be necessary to continuously raise awareness raising culture of the population with

regard to proper waste disposal and to stimulate waste reuse and recycling. The media should have a stronger role in promoting proper waste disposal and reuse.

Waste waters are one of the main polluters of surface, underwater, and coastal waters in Montenegro. To maintain and improve the quality of waters and achieve EU standards, it would be necessary to continue activities on realisation of the project of constructing the waste water purification facility. In parallel with its construction, due attention is to be paid to resolving the waste water products (mud) treatment issue since its inadequate treatment may additionally endanger the country's ecosystem. This points out to the need of timely defining the National Strategy for waste water products treatment.

To preserve and improve the air quality, and to prevent and reduce harmful effects to the environment, it would be needed to implement the national air quality management strategy in line with an action plan and compile the Report on implementing the National air quality management strategy at the annual level. It would be necessary to create concrete air quality management policies and plans in the zones where air quality is not in line with the prescribed standards and to define strategic approaches in resolving this issue. The air quality analysis showed that stationary sources, i.e. large industrial facilities, are the most serious polluters. This primarily includes the thermal power plant "Pljevlja" (which filter facility should be repaired and the ash landfill rehabilitated), then Aluminium Plant Podgorica (where it is needed to finally resolve the issue of rehabilitating the red mud basin), Steel Mill, etc. Moreover, household heating with fuels containing large contents of pollution particles pollutes air significantly, and therefore public awareness on its harmful effects should be raised. In order to increase the coverage territory for air monitoring quality, it would be necessary to increase the number of measurement places in the country.

In addition to stationary, air is highly polluted by means of transport exhausting contaminated particles into the air, particularly by vehicles without proper purification systems. Since the transport sector is constantly increasing so is air pollution. Therefore, more environmentally acceptable transport models should be developed, whereby a priority should be stimulating public transport use, particularly in urban areas. This primarily requires working on improving the public transport quality, and increasing its availability in many municipalities in the country. It would be necessary to apply stricter legislation on the import of new and registration of old cars, by stimulating the purchase of cars with low emission of hazardous particles and hybrid vehicles (e.g. by reducing the registration prices), introducing a specific car tax, which amount would depend on the quantity of

carbon-dioxide exposed into air (CO<sub>2</sub> tax). It would be required to establish the legal framework to ensure the production, turnover, control and use of biofuels and other renewable fuels for transport. Moreover, to reduce air pollution from vessels, it would be important to improve legal framework for ship fuel control after ratifying the Annex VI of MARPOL Convention. Standards for emission of transport vehicles and running the inventory of shows should be established.

Climate changes researches and projections indicate that climate changes will have the most significant results in the region where Montenegro belongs, and they will consequently affect the country's development perspectives. Climate changes in our area are mostly reflected through more often draughts, floods and temperature extremes. This requires a more responsible relation to the environment and a more rational use of natural resources. Primarily, the degree of integrating the problem of climate changes into sectoral strategies needs increasing. Pursuant to the Environmental Protection Law, it would be necessary to define the country's climate policy by defining the national plan for mitigating climate changes and establishing the National Council for Climate Changes.

Aimed at increasing protection of environment from fire, adequate legal framework should be created as well as plans for the protection of forests from fire. Special attention should be given to the prevention of deliberate fires as well as fires as a result of gross negligence. A possibility of creation of regional firefighting centre and joint purchase of firefighting airplanes and helicopters should be considered. Degraded forests should be renewed and recovered. Thus, forestation and forest recovery plans should be created.

The control of construction should be increased and illegal and unplanned construction in the protected areas should be prevented, while taking measures for removing their drawbacks.

The issue of protecting biological diversity from overwhelming poaching is an important issue. Its resolution requires enhanced control and implementation of statutory penalties and other measures, and working on developing stimulating measures for changing the prey's structure.

In order to protect the national parks in the most quality manner, it would be useful to establish the association of rangers, which would be responsible for direct oversight of the implementation of the environmental law, initiate a misdemeanor and/or penalty procedure in parks under their responsibility. The establishing of such institution would create the precondition for joining the International Ranger

Federation, thus enabling the training of inspectors at the National Parks of Montenegro, the sharing of experiences from different countries, and the transfer of best practices and oversight models that may be applied in Montenegro.

Activities should be continued on passing environmental protection plans at the local administration levels. Companies and organisations endeavouring to restrict their environmental impact should implement the ISO 14000 series standards referring to different environmental management aspects.

Special attention should be paid to the use of the EU funds and funds of other institutions focused on renewable energy sources and provide stimulation measures for their use. In that respect, a special recommendation is given with regard to the importance of fostering research, development and application of environmentally sustainable new technologies in the energy sector.

Aimed at establishing a sustainable financing system in the area of environmental protection, it is required to set up the Environmental Protection Fund – the Eco Fund, and the appropriate eco funds at the local level. Eco funds should be dedicated to operations related to financing and implementation of the programs and projects in the areas of maintenance, sustainable exploitation, protection and promotion of environment, energy efficiency and use of renewable energy sources as well as efficient implementation of the “polluter pays” principle.

Adequate implementation of these measures requires investments both by the public and private sectors. Against the backdrop of the global financial crisis, advanced countries recognised that the need of economic reforms and decreasing public debt in their Member States offers the opportunity for these countries to start establishing low-carbon, resource-efficient economies.

Environmental awareness of Montenegro is still extremely low. To improve it, the government and non-government sectors should continuously organise different campaigns and public disputes aimed at informing the public on the environmental issues. It should be necessary to continue introducing educational programmes at all education levels (kindergartens, primary and secondary schools, and universities), the corporate sector, NGOs, the media, and local communities as the target groups. Special focus should be paid to the corporate sector in the country by promoting campaigns in a socially responsible manner. In that respect, tax and other incentives should be used to stimulate companies’ investments into technologies not having adverse effects to the environment, and products promoting the sustainability principle should be fostered. It is of utmost

importance to provide active participation of the entire population in making decisions in resolving environment problems.

To maintain the balance between economic development, social justice and need to protect environment, the economy's financial infrastructure should reorient towards sustainability objectives. To achieve it, it is very important to recognise the role of financial institutions and investors in instigating sustainable development. Tending to allocate capital to companies operating following sustainability principles, financial institutions may strongly influence their clients, thus tending to align their activities with long-term sustainability objectives. The role of the stock exchange may also be important in the process of transferring to markets that integrate environmental issues by fostering transparency in environmental performance of rated companies and thus encouraging a responsible and long-term approach to investments. Therefore, the stock exchange should be fostered to promote accountable investing and corporative sustainability of Montenegrin companies.

In order to improve efficiency in the implementation of regulations, it is necessary to increase the institutional and staff potential for the implementation of obligations related to legislative and strategic framework and improve the coordination of institutions in charge of environmental protection and implementation of relevant laws. It is necessary to work on training and connecting municipal services for efficient dealing with challenges in all environmental protection areas. Also, integrated approach to the environment management system should be provided, bearing in mind that the Ministry of Sustainable Development and Tourism is not responsible for all segments of environmental protection. Aimed at mitigating negative impact on the environment, it is necessary to intensify the supervision of the environmental inspection. In order to increase the entire environmental protection system, it would be useful to appoint the Environmental Protection Ombudsman. Continuous activities on improvement of scientific, academic, business and administrative capacities are required as well as the establishment of a sustainable statistical system.

A sustainable socio-economic development cannot be accomplished without more moderate development at local and regional levels. There are three clearly defined regions in Montenegro with different development degree – continental, central and coastal region. More attention to measures focused on balancing of the regional development is needed to make a more equal treatment. Primarily, human capacity and infrastructure should be developed in less developed local administration units. It should be necessary to continue developing secondary

legislation in the function of providing consistency in local units' interest and general development framework, which provides allocating funds to all regions of the country and equal distribution of priority investments. To provide primary conditions for faster local sustainable development, pursuant to the National Strategy for Sustainable Development for the period 2014 – 2020 and the Law on Regional Development, it would be important to work continuously on developing strategic plans of the socio-economic development in local administration units in which these plans are not passed. Special attention should be focused on use of the EU funds for a balanced regional development. Thus, program and project capacities for applying for international funds should be enhanced. Statistical division of the country into regions is important to statistically follow up the development of individual regions. Aimed at efficient conducting of the regional policy, a statistical system should start to produce the key indicators according to the regional principle.

The population is becoming one of the key factors for the development. The results of projections indicate that the aging will characterise Montenegro's demographic development by 2050, which was confirmed by the 2011 Population Census data. Thus, compared to the 2003 Population Census data, population under 24 decreased, while population over 24 raises. The data show that it would be necessary to start pursuing population policy, while developing a national demographic strategy is a necessity.

## **XI. RECOMMENDATIONS CONCERNING OTHER AREAS**

### **1. Statistics**

#### *Current status*

The Statistical Office of Montenegro (Monstat) continuously works on improving statistical areas and surveys under its competence pursuant to the Law of official statistics and official statistical system<sup>25</sup>. A significant progress was recorded in many statistical areas during the previous period, including the use and updates of the business register. The methodologies were made for the statistical business register, the classification register, and the register of spatial units. Progress was recorded in the national accounts statistics through compiling the annual and quarterly gross domestic product pursuant to the new classification of activities NACE Rev2, and in agricultural statistics through the Pilot survey on crop production and autumn planting, the Pilot survey on milk and dairy products, and the like.

Simultaneously, the publishing of 14 new releases of transport statistics enabled a better access to data in this very complex area. Wages statistics improved by redesigning the questionnaire on monthly report on employees and wages of employees and the introduction of a new feature (employees by the type of staff records – paid working hours), and the labour force survey to which additional ad-hoc module on employees and health problems and a new set of educational issues were added in 2013.

After accessing the GDDS (General Data Dissemination System), Montenegro started with activities on accessing the SDDS (Standard Data Dissemination System), as a next step to improve availability, coverage and quality of statistical data. At the same time, SDDS should contribute to a better functioning of financial markets.

Supported by different financing programmes (CARDS, SIDA, OECD, Eurostat, IPA and the like), Monstat recorded significant progress in many statistical areas. In 2012, the Monstat staff attended over 90 international conferences, meetings, workshops, trainings, and study visits, and IPA projects financed most of them. The IPA 2009 multi-beneficiary project enabled the implementation of 10 pilot

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<sup>25</sup> OGM 18/12.

projects in the areas of external trade, national accounts, price statistics, energy statistics and the like. The IPA 2011 multi-beneficiary project (that started on 25 July 2012 to last 24 months) includes 14 pilot projects: national accounts methodology, quarterly national accounts, agro-monetary statistics, structural business statistics, purchasing power parities, harmonised index of consumer prices, water statistics, waste statistics, and the like.

All project have the same objective, i.e. they aim to strengthen the institutional capacity and contribute to improving quality in different statistical areas. Although progress has been made in national accounts, price, labour market statistics and the like, these and many other statistical areas require additional efforts in quality improvement.

Since Montenegro has become an EU candidate country, requirements of all users and participants for standardised, methodologically harmonised statistics meeting the *acquis communautaire* requirements significantly increased. After the bilateral screening meeting for negotiation Chapter 18 (statistics), EC representatives stated that the Montenegrin legislation is partially compliant with the *acquis communautaire*. This is an additional motive for Monstat to increase the efficiency in using funds offered through different projects by directing them to priority areas in order to meet all obligations for Chapter 18.

### ***Main risks***

- Lack of sufficient number of experienced and motivated statisticians in Monstat and other institutions producing statistics.
- Unsatisfactory working conditions for non-executive officers, a lack of working space, inadequate salary, which may lead to brain drain and a slowing of the process of developing statistics and the statistical system.
- Lack of adequate indicator, and/or data series (of agro-monetary statistics, revenues and costs from agriculture and the like) for the agricultural sector which would enable quality assessment of agricultural GVA trends and its contribution to the total GDP, although agriculture takes more important place in the GDP calculation.
- Non-existence of multi-annual time series of quarterly GDP data, and the series of quarterly GVA by individual sectors, which may result in passing non-quality recommendations for the economic policy in some sectors.
- Insufficient reliability of some data collected by interviewers.

### *Strategic development aims*

- a. Use all types of support and technical assistance programmes to Monstat aiming to create quality staff capable to respond to requirements in the process of accepting EU standards.
- b. Provide adequate spatial and financial conditions for better functioning.
- c. Work continuously on tourism statistics quality (physical and financial indicators) by introducing foreign tourists' consumption survey pursuant to the International Recommendations for Tourism Statistics (IRTS) 2008 standards.
- d. Establish a compilation of satellite accounts in tourism and define the frequency of compiling primary aggregates.
- e. Create a database for agricultural sector (except the number of individual farms, total used land, livestock and the like from the Agricultural census) on incomes and expenses of individual farms (if it is possible to calculate/assess data) to be used for calculating gross value added and intermediary consumption of agricultural sector in total GDP.
- f. In addition to starting the compilation of quarterly GDP by production method with value added at current and constant prices, calculate quarterly GDP following the consumption method at current and constant prices. Simultaneously work on calculating the annual GDP under the income approach.
- g. Work on the revision of GDP data for the previous period using the ESA 2010 methodology.

### *Operational measures*

Key activities should refer to providing quality staff able to “carry out” all necessary statistical research. Although it is true that there is an ongoing work on educating staff under different projects to use the possibility of secondment in Eurostat or other countries' statistical offices (such as the Hungarian Central Statistical Office), it would be necessary to maintain educated staff. The fact that Monstat employed 125 persons at the 2010 year-end and 102 at the 2012 year-end, while 203 persons should be employed pursuant to the Rulebook on internal organisation and systematisation (as of 2 April 2008), truly confirms the lack of employees necessary for all statistical areas to function. It would be necessary to provide adequate spatial, technical and material conditions. Inadequately paid employees are not motivated to improve statistical surveys' quality.

Since Tourism Satellite Accounts (TSA) are an extremely important set of data enabling the measurement of economic effects of tourism, it would be necessary to continue activities on improving statistics in this area. To wit, after publishing data of the TSA pilot project for Montenegro in 2011 (with 2009 data), it is necessary to improve the existing statistics and introduce new surveys which would enable the creating of quality input for TSA compilation pursuant to the Regulation (EU) 692/2011.

In parallel, it would be necessary to compile and process some indicators disseminated in the primary TSA tables to enable more quality calculation of GVATA (Gross Value Added of Tourism Industries), DGVATI (Direct Gross Value Added of Tourism Industries) and DTGDP (Direct Tourism Gross Domestic Product).

Agricultural statistics should be continuously improved with the establishing of agricultural accounts and agro–monetary statistics that should present the complete agricultural production. Despite obvious progress in agricultural statistics, it would be necessary to work on economic accounts in agriculture. The production on individual farms and total corporate production, and appropriate price statistics would be the basis for quality indicators necessary for the calculation of GVA in the agricultural sector. Therefore, it would be necessary to use the IPA project assistance started in May 2013, which would result in the strengthening of agricultural statistics by improving sample based surveys, agro–monetary statistics, forestry statistics and the like. This is of particular importance since the agricultural industry (full title – agriculture, forestry and fishing) accounts for some 8 percent of the GDP structure, and the largest part of this sector’s GVA (some 80 percent) is assessed using the available statistical data in this area.

In 2012, GDP was compiled at current and constant prices for 2011 (for 2010 only at current prices), using the EC’s new classification of economic activities (NACE Rev.2). Preliminary results of quarterly GDP for 2012 and Q1 2013 were published in 2012 and H1 2013, and they are subject to changes until annual GDP data are being published. Calculations are made at current and constant prices on the production side applying indirect method pursuant to new NACE Rev.2 classification. At the same time, activities on implementing SNA 2008 methodology were started. Monstat has noted main changes into new methodology relative to SNA’93 methodology and it has defined priority changes to be implemented in the upcoming period. Since the system of national accounts – the compilation of GDP – is a part of very complex and complete statistics, all monthly, quarterly and annual statistical surveys should continuously be improved.

This will contribute to improving the calculation of annual and quarterly GDP at both current and constant prices by activities on the production side and consumption categories on the consumption side of GDP.

The project that started in improving statistical information system in Montenegro started in May 2013 mostly included national accounts statistics (Project component 2). The foreseen activities of the project will affect further harmonisation of national accounts and price statistics with EU standards by improving annual and quarterly compilations and adjusting methodological changes harmonised with the application of ESA 2010. At the same time, Monstat should work on compiling GDP by income approach, thus completing the compilation of total GDP under all three approaches – methods (production, consumption and income).

## **2. Accounting and auditing standards and their application in Montenegro**

### ***Current status***

Despite significant organisational and management efforts and improvements in 2013, the application of international accounting and auditing standards and international financial reporting standards (IAS, ISA, IFRS) in the Montenegrin companies remains insufficient. Amendments to the existing accounting-auditing regulations conducted in 2013 should provide a higher compliance level of national legislation with the *acquis communautaire* and increase data quality, particularly in the area of transparency, comparability, permanence and consistency in (fair) disclosing accounting balances and policies. The implementation of these standards is a practical guideline for regulating the accounting practice that can be uniformly applied to countries with different economic characteristics on one hand, while supporting Montenegro's aim to meet the necessary EU accession criteria in this area on the other hand.

The World Bank's team visited Montenegro in 2006 and prepared the Report on the Observance of Standards and Codes (ROSC<sup>26</sup>) on accounting and auditing in Montenegro. The ROSC sets out interconnected and consistent recommendations aimed at continuous quality increase and financial reporting aligning in Montenegro. The ROSC recommendations have had positive economic (indirect) importance to Montenegro's economy (domestic savings activation, more foreign

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<sup>26</sup> ROSC - Report on the Observance of Standards and Codes.

direct and portfolio investments, easing the availability of loans to SMEs, corporate management strengthening, transparency, accounting ethics, continuation in accounting-auditing education, fair treatment, obeying accounting policies, comparability, and the like).

The Ministry of Finance of Montenegro and stakeholders competent for improving the financial reporting quality in Montenegro (Ministry of Economy, Monstat, Central Bank of Montenegro, Securities and Exchange Commission, Commercial Court of Podgorica, Institute of Certified Accountants and Auditors of Montenegro) accepted the World Bank's recommendations. Moreover, the Ministry of Finance of Montenegro established the National Council for Accounting and Auditing with the aim of strategic improving the accounting-auditing practice, management and accounting arranging of companies in Montenegro according to IAS, ISA, and IFRS. The strategy and Action plan of operational and step-by-step reforms have been prepared, including the stakeholders' activities on improving the legislative framework, institutions and accounting business and improving business and ethical culture. These changes are aimed at raising the quality of micro and macro financial reporting to lead to the harmonisation of the Montenegrin regulatory framework of account and other financial reporting with the *acquis*. This included working on preparation of consolidated financial statements and legislation for regulating the operations of auditing firms, centralisation of annual statements database, publishing of financial statements and improving their quality, electronic accounting practice, working on financial classification of companies to small, medium and large companies, and the like.

There was a significant delay in the implementation of the Action plan pillars referring to the establishing of a public body for oversight of auditors' work in 2013. At the same time, the adopted amendments to the 2011 Law on accounting and Auditing set out the obligation of submitting annual financial statements to the Tax Administration. Although the existing legal provisions enable submitting annual financial statements both in hard copy and electronic format, the possibility of electronic submitting into the single database is still not used.

Moreover, there was a significant progress in 2013 on educating accountants and auditors by the Institute of Accountants and Auditors through seminars, courses, publications, and the like, thus strongly contributing to the higher quality of accounting and auditing practice in applying IAS, ISA, and IFRS in Montenegro. Additional education on computerising the accounting should be directed to companies in municipalities that still do not practice it.

### ***Main risks***

- Inconsistent application of passed amendments to the 2011 Law on Accounting and Auditing referring to full and timely implementation of the IAS and their translation, as well as the IFRS and the ISA.
- Insufficient institutional cooperation and insufficient volume of control mechanisms for quality in work of accountants and auditors.
- Untimely submission of annual financial statements to the Tax Administration.
- Insufficient attention paid to quality in filling the forms submitted to the Tax Administration.
- Inadequate and non-synchronised approach in the development of accounting and audit, particularly due to irregular meetings of the Council for Accounting and Audit, and untimely reporting on accomplishing the implementation of the Action Plan for improving accounting and auditing standards.
- Disrespecting requests for financial reporting pursuant to the IFRS, which would meet the obligation that all shareholding companies at the stock exchange's listing timely submit financial statements with adequate quality, pursuant to the *acquis*.
- Inconsistent application of the report on company management performance, which is contrary to the EU Directive on transparency.
- Lack of audit independence.
- Inadequate attention paid to financial reporting by small and medium enterprises.

### ***Strategic development aims***

- Work on further professional strengthening of accounting-auditing expertise and practice by strengthening institutional and legal framework to accomplish satisfactory quality, application of ethical standards and codes and even and coherent reporting quality using the IAS.
- Work actively on the application of adopted amendments to the Law on Accounting and Auditing, particularly in part referring to meeting deadlines and the reporting format (hard copy and electronic formats) for submitting annual financial statements to the Tax Administration.
- Provide coherent international and domestic cooperation with adequate institutions. Pay special accent to cooperation with IFAC and the World Bank in realisation of technical assistance, translation of IAS and inclusion

into the work of relevant bodies and institutions dealing with accounting-auditing practice.

- Develop mechanisms for supervising the quality of accounting and auditing practice and the institutional framework for external controlling the quality of annual financial statements.
- Educate accounting staff, introduce good accounting practices and standards, and the ethical code into curricula of relevant faculties.
- Implement new technical and technological solutions to provide better quality connections of entities required to submit financial statements, and enable on-line submission of annual financial statements to the Tax administration.
- Work on the IAS implementation and focusing in SMEs that are quantitatively dominant in the Montenegrin economic practice.

### ***Operational measures***

In 2014, it would be necessary to continue implementing the Strategy and the *Action plan for improving quality of financial reporting in Montenegro*. Moreover, it would be necessary to invite ROSC delegation to review the application of, i.e. the implementation of the May 2007 recommendations and thus assess the progress in accounting and auditing practices in Montenegro.

To be harmonised with the *acquis*, auditors' independence needs strengthening in public companies by requiring rotation of the key auditing partners every four to seven years (at maximum).

Continue reporting on the corporate governance progress in joint stock companies in Montenegro and on managers dealing with accounting practice, so that relevant authorities get proper and create necessary measures to improve this area.

Standards should be fully implemented. Currently, the audit reports are contained in the ISA framework but the ISA are not fully translated (the IFAC Manual) and adopted in Montenegro.

Activities started under the REPARIS projects aimed at improving standards for education and certification of accountants and auditors under relevant national bodies should be continued.

Annual electronic financial reporting database should be developed primarily on the websites of the Tax Administration, the Ministry of Finance and the Securities and Exchange Commission.

Regional cooperation, and institutional and supervision connections in accounting and auditing should be strengthened, particularly in translating and interpreting the IAS and the IFRS. Relevant institutions should establish an institution for supervising auditing and accounting firms. Relevant bodies should strengthen organisational units to work on the compliance of financial reports with the legislation.

Provide a higher level of operational transparency and company reporting, and information on board of directors' members, particularly in their participation in ownership structure, and compensations to management. Moreover, the publishing of (semi)annual financial reports of joint stock companies quoted at the market SEC's website should be initiated.

The state should impose a stricter control and sanctions to companies that do not submit annual financial statements within set deadlines.