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ECONOMIC REFORM PROGRAMME

OF

MONTENEGRO
(2019-2021)

COMMISSION ASSESSMENT

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Contents

1. EXECUTIVE SUMMARY

Montenegro's economic growth is expected to decelerate. After recording several years of strong growth, the Economic Reform Programme (ERP) projects a reasonably cautious baseline scenario of moderation in public investment and consumption, which would dampen output growth to around 2.5% on average in 2019-2021. Lower domestic demand and the subsequent decline of import needs are projected to reduce the very large current account deficit, which is expected to remain financed to a large extent by foreign direct investment inflows. Financial sector indicators improved but the position of some smaller domestic banks remains difficult.

Fiscal policy targets have been softened, but the end of spending related to the building of the Bar-Boljare highway is expected to swing the budget into surplus and reduce public debt from its peak of more than 70% of GDP. Supported by fiscal consolidation measures adopted previously, the budget deficit declined significantly in 2018, but spending overruns caused the deficit target to be missed by a broad margin. The ERP's medium-term consolidation path is less ambitious than in last year's programme, but sufficient to ensure a relatively fast pace of debt reduction towards the fiscal rules' threshold of 60% of GDP. Total expenditure is set to decline markedly thanks to the fall in capital spending related to the highway. However, important reforms of the public sector and the pension system have been delayed or postponed, making it more difficult to restrain current expenditure.

The main challenges in these respects include the following.

- **Maintaining commitment to debt reduction targets is key to lowering vulnerabilities and rebuilding fiscal space.** The envisaged decline of the debt ratio and improvement of the budget balance relies mainly on completing one major investment, on restraining public consumption and on improving tax compliance. However, contingent liabilities and spending overruns may threaten fiscal consolidation efforts. Ensuring long-term sustainability of public finances would require strengthening fiscal governance including oversight and compliance with budget targets and fiscal rules at central and local level.

- **The banking system is overall well capitalised and liquid, but the performance of small local banks is uneven and requires close monitoring.** Small domestic banks are predominantly confronted with having to resolve non-performing loans and cope with high overhead costs, resulting in poor profitability. Improving the current situation would require implementing close and decisive supervision by the central bank.

- **Institutional and regulatory framework on the micro level is underperforming.** The authorities should focus in particular on achieving consistent, non-arbitrary law enforcement, on the efficiency and quality of public administration at the state and local level, on the areas of public procurement and public-private partnerships, and on issues related to local taxation and para-fiscal burdens. The law-making process would require more effective and pro-active communication strategies targeting the stakeholders from the outset of the process and inclusive public consultation early enough during legislative procedure. More focus is also needed on the timely adoption and implementation of secondary legislation, with proper public scrutiny.

- **The large informal sector persists as an important structural challenge.** The proportion of the informal economy to total GDP is estimated at around 28% to 33%, while over 20% of work is informal. Weaknesses in the institutional and regulatory environment, including the labour market, corruption and high tolerance for tax non-compliance are the key issues that need to be tackled. Improving the capacities of local and state bodies and cooperation between them, and a more systematic approach focusing on root causes of the phenomenon rather than on fighting its consequences would lead to reduction in the informality.

- **Very low activity and employment remain a key challenge, particularly affecting young people, women and the low skilled.** Labour costs and labour market rigidities are relatively high and affect labour market mobility. Complexities in social support coupled with undeclared work create additional obstacles for formal employment. Skills mismatches, low educational outcomes and insufficient opportunities for reskilling affect transitions to and from employment. Besides low activity and employment rates, the ageing of the population has an additional negative effect on the labour market, and consequently on the sustainability of the pension system.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2018 has been implemented to a limited extent. The 2017 fiscal strategy has been implemented to a large extent. However, some of the new excise duties were withdrawn due to poor performance. No additional measures were adopted to achieve fiscal targets, but payments related to unfavourable court cases are now accommodated in the budget. Important government initiatives such as reforms of the public administration and the pension system, were delayed or put on hold. There was limited progress on broadband rollout and coverage, while no broadband cost reduction measures were implemented. Work on legislation regulating public private partnerships and concessions has progressed, but the legislation is due for adoption only in Q2-2019. Independent rail regulatory authorities have yet to be created and will not reach operational capacity before 2020. The development of curricula and apprenticeships with employers has been prioritised and has been implemented continuously. However, more efforts are needed to improve the quality of education at all levels, including pre-school and adult education. Draft labour market legislation is being prepared. While participation in active labour market policies increased, their targeting and coverage continue to be low, and there is still no review of their effectiveness. The outcomes of cooperation between employment offices and social work centres and social protection information system are limited.

Overall, the ERP partially matches the reform priorities identified by the Commission. The programme's macroeconomic and fiscal frameworks are sufficiently comprehensive and coherent, providing a good basis for policy discussions. However, the pace of fiscal consolidation is less ambitious and the fiscal policy scenario entails significant risks in controlling public spending. On structural reforms, the previous year's focus on reform measures in the areas of energy, RDI and private sector development through fiscal and non-fiscal incentives was complemented by the series of new and recalibrated reforms targeting the business environment and the informal economy. Measures on education and skills are a continuation of reforms initiated in previous years. They are relevant for improving education outcomes and can contribute to transition from school to work. However, employment and social policy measures are not sufficiently developed and are either too limited in scope or do not address the key structural challenges.

2. ECONOMIC OUTLOOK AND RISKS

Economic growth was higher than expected in 2018, driven by public and private investment. Real GDP is estimated to have increased by 4.1% in 2018, 1.1 pps faster than forecast in last year's ERP. Gross fixed capital formation increased by some 20%, while export growth also surprised on the upside due to a good tourism season. However, higher-than-forecast domestic demand also led to a faster pace of import growth.

The ERP expects growth to moderate in 2019-2021 along with a gradual rebalancing of growth drivers. The programme projects a sharp slowdown in investment growth in 2019-2020, followed by a contraction in 2021 after the completion of the first section of the Bar-Boljare highway. In the ERP's baseline scenario, private consumption is set to remain subdued due to weak growth in employment and an assumed decline in real wages, mitigated by some additional support for consumer spending from household borrowing, remittances and tourism. In line with medium-term budget planning, government consumption is projected to contract by 0.5% each year until 2021. New capacities in the tourism and energy sector are expected to sustain a moderate expansion of exports. Import growth, by contrast, is seen as declining in parallel with the turn in the investment cycle. Consequently, a growing positive contribution of net exports to GDP growth is expected to start as of 2019. Overall, annual output growth is forecast to decelerate to 2.5% on average in 2019-2021.

On the production side, the ERP projects that key economic sectors (tourism, construction, agriculture, manufacturing and mining) will contribute to growth based on their average historical performances and some investment in new capacities. The ERP sees Montenegro's potential growth rate as reaching 3.3% in 2018-2021, with the main contribution coming from capital accumulation, while total factor productivity is expected to remain negative, reflecting the low technological endowment of Montenegrin companies. The current positive output gap is –according to the ERP– expected to be closed by 2021.

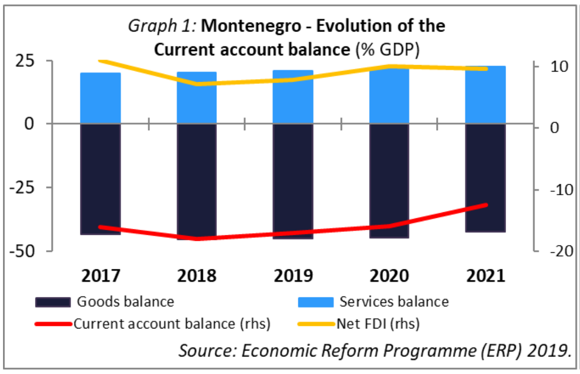
Table 1:
Montenegro - Comparison of macroeconomic developments and forecasts

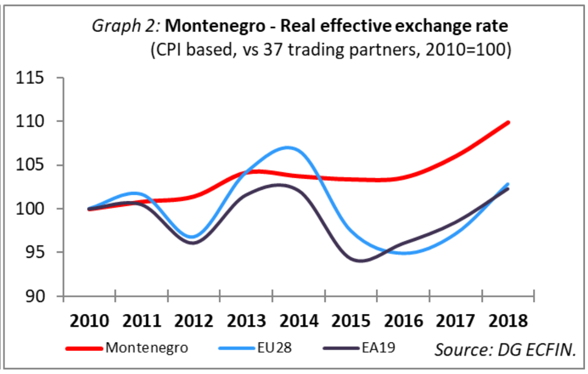
	2017		2018		2019		2020		2021	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	4.7	**4.7**	3.9	**4.1**	2.8	**2.8**	3.1	**2.3**	n.a.	**2.4**
Contributions:										
- Final domestic demand	7.4	**7.4**	6.7	**6.7**	4.9	**2.0**	2.7	**1.3**	n.a.	**-0.9**
- Change in inventories	1.9	**1.9**	-0.2	**-0.1**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-4.6	**-4.6**	-2.6	**-2.7**	-2.1	**0.8**	0.4	**1.0**	n.a.	**3.3**
Employment (% change)	3.4	**2.1**	2.0	**2.2**	1.6	**1.0**	1.8	**0.9**	n.a.	**0.5**
Unemployment rate (%)	16.1	**16.1**	15.5	**14.8**	14.9	**14.5**	14.6	**14.0**	n.a.	**13.8**
GDP deflator (% change)	3.8	**3.8**	2.7	**2.9**	3.0	**1.2**	2.0	**1.2**	n.a.	**1.2**
CPI inflation (%)	2.8	**2.4**	2.9	**2.9**	2.5	**1.8**	1.9	**1.8**	n.a.	**1.9**
Current account balance (% of GDP)	-16.1	**-16.1**	-16.5	**-18.1**	-17.4	**-17.0**	-14.5	**-15.9**	n.a.	**-12.5**
General government balance (% of GDP)	-5.5	**-5.3**	-2.7	**-2.7**	-1.6	**-2.2**	2.4	**0.9**	n.a.	**2.9**
Government gross debt (% of GDP)	63.7	**63.2**	70.0	**70.0**	67.8	**67.0**	62.7	**64.6**	n.a.	**60.4**

Sources: Economic Reform Programme (ERP) 2019, Commission Autumn 2018 forecast (COM).

Overall, the baseline growth scenario appears plausible in the current context. While the projected trajectory appears reasonably cautious, steady output deceleration in 2019-2021 might be prevented by stronger-than-expected investment activity well into 2020, as the completion of the main highway section is delayed by a year. However, the positive effect on GDP growth will be mitigated by the high base effect and the significant import content of big infrastructure investments. Moreover, consumer spending might grow faster than projected, especially in 2020, in the context of sustained bank lending and declining unemployment. For this reason, the Commission's most recent forecast projected the same GDP growth (2.8%) as the ERP for 2019, but foresees a 0.8 pps higher expansion for 2020. Consensus and international institutions' forecasts similarly assume higher growth in 2020. In addition to the baseline projection, the ERP presents an alternative 'low-growth' scenario. In this pessimistic scenario, shocks to investment and oil prices cause the baseline projection to shift downwards by 1.4 pps of GDP in 2019, and by additional 0.5 pps in each of the two outer years, due to knock-on effects on imports, employment, wages and tax receipts. The baseline and the low-growth scenarios were developed using the new macroeconomic model of the Ministry of Finance.

Inflationary pressures are likely to remain subdued. The annual average of the consumer price index rose by 2.8% in 2018, driven by rising VAT and excise tax rates. Otherwise, in Montenegro's small euroised economy, headline inflation largely reflects the impact from the external environment, in particular from oil and food prices. Despite the estimated positive output gap, stagnating nominal wages did not generate upward price pressures domestically. The ERP expects inflation to remain practically constant throughout 2019-2021, at around 1.8% on average.





The projected narrowing of the large current account deficit appears reasonable. Montenegro has a very narrow production base, resulting in a large structural deficit on the trade balance for goods. This situation has recently been further exacerbated by imports of large volumes of construction material and equipment to keep pace with investment. On the other hand, the current account benefits from strong tourism exports and to a lesser extent from income and remittances by Montenegrins working abroad. The very high current account deficit is expected to have peaked at 17.2% of GDP in 2018, up from 16% a year before. This was mainly due to a fast growing merchandise trade deficit, as the volume of imports largely outpaced the growth of exports. The ERP projects the current account deficit to gradually decline over the programme period to 12.5% of GDP in 2021. The key determinants in reducing the external gap are the expected growth of exports of goods and services (4% annually, in real terms), combined with declining import needs once large infrastructure investments are completed. This scenario seems plausible considering how far advanced the highway works are and given the weakening domestic demand, and the strong import dependence of both of these factors. However, if upside risks to domestic demand materialise, it might result in higher-than-projected import growth and hence a higher current account deficit.

FDI has a major impact on the external deficit and on its financing given the scarcity of domestic savings. In 2018, net FDI plunged by 32.4% year-on-year, driven by high outflows from the repayment of inter-company debt and the withdrawal of equity investment following the sale of the electric company shares by its foreign owner. As a result, net FDI financed 41.3% of the current account deficit, the rest being covered by net inflows of portfolio investment and loans. The ERP projects that net FDI will gradually recover and remain strong and broadly stable at between 8% and 10% of GDP in 2019-2021. Net FDI is expected to finance on average some 63% of Montenegro's current account deficit during that period. The ERP recognises that FDI inflows associated with large projects about to be completed in the energy and tourism sectors, will diminish, but also expects new FDI-financed projects, supported by the new public-private partnership framework, and an economic citizenship programme in return for investment. Gross external debt (according to IMF estimates, as Montenegro does not publish yet external debt statistics) stood at 166% of GDP at the end of 2018, remaining broadly constant since 2013. Around 35% of the long-term debt is owed by the government, while most of the rest consists of inter-company lending between direct investors and subsidiaries. Although the external debt is large, its composition means that it does not give rise to immediate concerns. Official reserves cover about 5.2 months' worth of imports of goods and services, providing a safeguard against adverse shocks.

Table 2:

Montenegro - Financial sector indicators

	2014	2015	2016	2017	2018
Total assets of the banking system (EUR million)	3 136	3 472	3 791	4 182	4 407
Foreign ownership of banking system (%)	82.7	80.4	79.4	80.4	84.2
Credit growth	-1.9	0.8	1.3	11.8	8.5
Deposit growth	10.0	13.7	9.4	13.8	5.9
Loan-to-deposit ratio	1.0	0.9	0.8	0.8	0.8
Financial soundness indicators					
- non-performing loans	15.9	12.6	10.3	7.3	6.9
- net capital to risk-weighted assets	16.2	15.5	16.0	16.4	15.6
- liquid assets to total assets	22.2	24.8	24.5	25.3	22.6
- return on equity	5.4	-0.9	1.2	7.0	5.4
- forex loans to total loans (%)	1.6	1.6	1.1	0.7	0.6

Sources: National Central Bank, Macrobond.

The stability of the overall financial system has not been affected as overall bank deposits have been growing since the intervention by the central bank, but a swift and efficient resolution remains key to minimising contagion risks. At the aggregate level, the banking sector is well capitalised, highly liquid and has a reduced stock of non-performing loans, but small banks are confronted with poor profitability and some face capital shortfalls. The ratio of non-performing loans (NPLs) to total gross loans totalled 6.9% at the end of 2018, or 0.4 pps lower than a year earlier, thanks to loan restructuring, write-offs and factoring agreements. The declining NPL ratio is positive for bank lending to the business sector. However, credit to the corporate sector has only gained pace of late (i.e. since December 2017). Financial intermediation is constrained by the high level of informality in the real sector, as well as by weaknesses in contract enforcement and collateral recovery. Overall, the banking system maintains adequate buffers to absorb shocks as capital adequacy and liquidity ratios exceed regulatory requirements. Profitability has also been improving. However, out of 15 banks in 2018, the four largest account for 95% of total profits while some smaller banks have been struggling. In December 2018, Montenegro's central bank put two small non-systemic banks (accounting for 1.1% and 5.8% respectively of total banking-sector assets) under temporary administration due to lower than required capital and liquidity ratios. In the meantime, one of them entered bankruptcy proceedings, while the other is awaiting recapitalisation in order to continue operating. The stability of the overall system has not been affected as overall bank deposits have been growing since the intervention by the central bank, but a swift and efficient resolution remains key to minimising contagion risks and maintaining confidence on the stability of the financial sector.

3. PUBLIC FINANCE

In 2018, fiscal outcomes improved compared to a year earlier, but the deficit target was missed. The general government deficit improved from 5.3% of GDP in 2017 to 3.8% of GDP in 2018. Revenues as a percentage of GDP increased by 1.3 pps while the share of expenditure declined by 0.3 pps. The 10% year-on-year growth in revenues was supported by higher VAT and excise tax rates, improved collection of tax arrears, and an unplanned dividend payment (worth 0.8% of GDP) by the newly re-nationalised power company. However, revenues from excise on tobacco significantly underperformed the initial plans as the rate rise boosted informal trade, which prompted the authorities to reverse the rate increase during the mid-year budget rebalance. Overall, total revenue was 0.6% of GDP higher than planned in last year's ERP. Total expenditure increased by 6.5% year-on-year, but was almost 2.7% of GDP higher than initially planned, as under-execution of capital spending being more than offset by a higher-than-expected wage bill, the repayment of liabilities from previous years, and a surge in transfers to education and health institutions. Overall, the deficit targets of the original budget (1.6% of GDP) and the revised budget (2.2% of GDP) were both missed by a large margin. The ERP estimated that the primary deficit contracted from 3.2% of GDP in 2017 to 0.6% in 2018, an optimistic projection compared to the more negative outcome of 1.8% of GDP recorded in 2018.

The 2019 budget suggests stability in fiscal policy, but postpones the previous ambition of further consolidation. The Montenegrin Assembly adopted the 2019 state budget on 28 December 2018. Fiscal plans assume that GDP will grow by 2.8% in 2019, the same rate as projected in the Commission's autumn 2018 forecast. The budget deficit target of 2.2% of GDP is lower than the realised deficit in 2018, but deviates significantly from the marginal (0.1% of GDP) surplus projected in last year's ERP. Compared to the 2018 outcome, the budget projects an increase in total revenue of 4.6%. Discretionary measures are limited to some new fees and the introduction of an excise duty on coal. Revenues from VAT, excise and social security contributions are expected to rise thanks to economic growth and the expected broadening of the tax base, including through a continuing reduction in tax arrears. A substantial increase in grants anticipates the disbursement of EU funds for public administration reform and other projects. Compared to the budget outcome for 2018, total expenditure is projected to increase by 0.9%. The expenditure increase is seen as being largely driven by capital spending, surging by 17.1% y-o-y, reflecting the combined result of under-execution of the capital budget in 2018 and the need to intensify works to complete the first section of the Bar-Boljare highway. The planned current expenditure is, by contrast, expected to decline by 1.9% y-o-y, indicating a very modest annual adjustment in non-discretionary expenditure (i.e. wages, pensions and social benefits).

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

	2017	2018	2019	2020	2021	Change: 2018-21
Revenues	41.5	42.6	43.0	42.6	41.7	-0.9
- Taxes and social security contributions	35.0	35.6	35.4	35.3	34.8	-0.8
- Other (residual)	6.5	7.0	7.6	7.3	6.9	-0.1
Expenditure	46.8	45.3	45.2	41.7	38.8	-6.5
- Primary expenditure	44.4	43.3	43.1	39.8	37.1	-6.2
of which:						
Gross fixed capital formation	6.9	6.8	7.8	5.5	3.5	-3.3
Consumption	16.2	16.0	15.6	15.0	14.6	-1.4
Transfers & subsidies	13.2	12.5	12.3	12.2	12.0	-0.6
Other (residual)	8.0	8.0	7.4	7.1	7.1	-0.9
- Interest payments	2.4	2.0	2.1	1.8	1.7	-0.3
Budget balance	-5.3	-2.7	-2.2	0.9	2.9	5.5
- Cyclically adjusted	-5.8	-3.6	-2.6	0.8	2.9	6.5
Primary balance	-3.2	-0.6	-0.1	2.8	4.6	5.3
- Cyclically adjusted	-3.4	-1.6	-0.5	2.7	4.6	6.2
Gross debt level	64.2	70.0	67.0	64.6	60.4	-9.6

Sources: Economic Reform Programme (ERP) 2019.

After the fiscal adjustment carried out in the last two years, the budget is expected to move to a large surplus in the medium term as spending related to the Bar-Boljare highway is phased out. After frontloading a major fiscal adjustment (with the Budget Deficit and Public Reform Recovery Plan adopted at the end of 2016, the 2017 Fiscal Strategy and the 2018 Public Debt Strategy), fiscal policy now relies on a gradual decrease in the capital expenditure-to-GDP ratio to reach in 2021 an overall budget surplus of 2.9% and a primary surplus of 4.6%. Compared to last year's ERP, the new programme attenuates and postpones fiscal consolidation, as the targeted fiscal balance for 2019 and 2020 is lower by 2.3 and 4.5 pps respectively. The revised fiscal path reflects to a large extent: (i) the one-year delay completing works on the main section of the Bar-Boljare highway (completion is now expected in 2020 instead of mid-2019); (ii) a higher than previously projected wage bill; and (iii) the inclusion above the line (i.e. as current expenditure) of planned arrears repayment related to court cases. The new fiscal targets are expected to be achieved through a combination of slightly declining revenues (by 0.9 pps between 2018 and 2021) and a cutback in expenditure (by 6.6 pps over the same period) relative to GDP. The decline in the revenue ratio is the result of comparatively faster GDP growth. No new tax hikes are planned except for the gradual alignment of excise dueties with EU rates. The decline in the expenditure ratio is planned to be achieved primarily by a 4.3 pps of GDP reduction in capital spending between 2019 and 2021. The projected paths for the fiscal deficit and for nominal GDP growth would allow the debt-to-GDP ratio to decline quickly to 60.4% in 2021 from 70% in 2018. Overall, although the government's planned fiscal stance has become less ambitious compared to last year's ERP, it would still bring about a significant reduction in the debt ratio.

After 2019, the main fiscal measures underpinning the programme consist of broadening the tax base, strengthening local public finances and containing current spending. Montenegro plans to roll out electronically monitored cash registers (see also

Chapter 4, Structural Reforms) from 2020. These are expected to reinforce budget revenue by some 0.36% of GDP, once fully implemented. The tax administration will continue efforts to reduce tax debt and monitor taxpayers who reschedule tax liabilities. Another measure aims to strengthen the revenue side of local governments' budgets. The implementation of the Law on Local Self-Government Financing would strengthen municipalities' income by increasing the share of personal income tax allocated to them, generating an additional EUR 12 million per year (or 0.25% GDP). The law also aims to strengthen budget discipline at local level, which remains weak despite improvements. On the expenditure side, implementation of the public administration optimisation plan, which targets staff cuts at central and local level of 5% and 10% respectively by 2020, is expected to produce savings of some 0.9% of GDP in 2021 compared to the 2019 wage bill. Draft amendments to the law on Pension and Disability Insurance have been prepared with a view to making the pension scheme more sustainable, but failed to be accompanied by a detailed analysis of the fiscal impact of such amendments. The reform was put on hold in 2019 due to disagreement between the social partners.

Box: Debt dynamics

The debt ratio is expected to have peaked at 70.8% of GDP in 2018. The large increase in 2018 was driven by additional borrowing to build up 6% of GDP worth of deposits to service upcoming financial obligations. In the medium term, the significant improvement in the primary balance will drive the fast pace of debt reduction. The overall implicit interest rate is expected to decline slightly, from 3.4% in 2018 to 2.8 in 2021. Stock-flow adjustments will be markedly negative in 2019, as maturing debt is paid back using the deposits built up in 2018. Possible cost overruns from the highway are a major risk for the planned debt trajectory in 2020.

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

	2017	2018	2019	2020	2021
Gross debt ratio [1]	**64.2**	**70.8**	**67.0**	**64.6**	**60.4**
Change in the ratio	0.8	6.6	-3.8	-2.4	-4.1
Contributions [2]:					
1. Primary balance	**3.2**	**1.8**	**0.1**	**-2.8**	**-4.6**
2. "Snowball" effect	**-3.1**	**-2.5**	**-0.4**	**-0.4**	**-0.6**
Of which:					
Interest expenditure	2.1	2.0	2.1	1.8	1.7
Growth effect	-2.9	-3.0	-1.9	-1.5	-1.5
Inflation effect	-2.3	-1.5	-0.6	-0.8	-0.8
3. Stock-flow adjustment	**0.7**	**7.4**	**-3.4**	**0.8**	**1.0**
Memorandum item					
Gross financing needs	13.9	20.5	12.0	10.6	6.1
Highway loan [3]	4.1	4.9	4.4	0.5	0.0

[1] End of period.
[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).
The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.
[3] Includes loan and government own contribution.
Source: Economic Reform Programme (ERP) 2019, ECFIN calculations.

The public debt ratio is expected to have peaked in 2018 at a high level, entailing significant risks. At the end of 2018, Montenegro's general government debt[1] stood at 70.8% of GDP. Partly because of frontloaded public borrowing in 2018 to smooth debt rollover in 2019-2021, the debt ratio was 7.1 pps higher than at the end of 2017 and marked 11 consecutive years of growth. It was also substantially higher (by 4.8 pps) than projected in last year's ERP. Almost all of the public debt is owed by the central government. In 2018, thanks to liability management operations, the authorities have been able to significantly lengthen the average maturity of the public debt stock and reduce the share of variable rate instruments. This shifting in debt composition means that rollover and interest rate risks have been lowered. Around 83% of the debt is denominated in euro and 15% in US dollars. In a benign interest rate environment, the

[1] Excluding public guarantees and including deposits to service financial obligations in 2019-2021.

debt generated interest payments were worth 2.0% of GDP in 2018, down from 2.4% in 2017. However, investor sentiment towards emerging economies is volatile, making further debt reduction essential to mitigate debt-related vulnerabilities and rebuild room for policy manoeuvre.

The ERP's medium-term budgetary projections entail a number of risks, which could be mitigated by implementing further reforms. The sustainability of public finances relies, on the expenditure side, on controlling the costs of the large non-discretionary items of the budget (i.e. wages, pensions and the health and social care system). However, Montenegro's track record on containing such expenditure points to downside risks. Some of the measures envisaged under the public administration optimisation plan (which covers local governments enterprises but not central government state-owned ones) have an unrealistic timeframe and their costs are not specified, putting at risk the objective of reaching a balanced budget. The failure to adopt the pension reform postpones the aim of reducing the pension scheme's funding gap. Possible cost overruns for the section of highway are an additional risk, while financing the remaining sections, either through public-private partnerships or directly by borrowing, risks creating additional major liabilities for the state budget. On the revenue side, risks stem mainly from failure to meet targets for collecting tax arrears and enlarging the tax base. Finally, there are continuing risks in local authorities' financial management: their planned annual budget surplus of 0.8% of GDP might turn out to be overly optimistic. Upside risks for the budget come from one-off revenues from the concession of airports and unspecified revenues from the recently launched economic citizenship programme.

There are plans to strengthen several aspects of the budgetary framework. The current fiscal rules mandates a public debt and deficit ceiling of 60% and 3% of GDP respectively. The rules are relatively soft as they requires the government to adopt a strategy to correct any excess within a five-year deadline. The debt threshold was exceeded in 2015. However, the ERP now envisages reducing the debt ratio to 60.4% by 2021, a year longer than laid down in the fiscal rules. Formal compliance with the fiscal rules is monitored by the State Audit Institution. Authorities are preparing a study on possible options for establishing a Fiscal Council as an independent body to reinforce fiscal oversight. The ongoing public finance management reform includes plans to improve the budget planning IT system and introduce a system of centralised payroll calculation in 2019 to enhance control and management of wages in the public sector. The formal introduction of three-year budgeting has been postponed to 2020. Staff numbers have been reinforced at the Ministry of Finance to take over the implementation of accrual accounting, which is a prerequisite before the introduction of the European System of Accounts (ESA 2010). All these projects heavily rely on technical assistance and financing by international institutions.

4. STRUCTURAL CHALLENGES AND REFORM PRIORITIES

The comparative advantage of Montenegro is built on its geographical location, its climate and landscape. Its small and open economy is service-oriented and largely focused on tourism as the principal source of income. Services account for nearly 80% of total exports, while foreign tourists alone generate over 20% of the country's GDP. Tourism potential is still far from being fully realised, with the mountainous northern region harbouring some of the last primary forests in Europe and unspoiled nature, as well as good snow coverage in winter. At the same time, given the country's reliance on one sector and its small size, the economy remains vulnerable to external shocks and climate change challenges.

The Commission has conducted an independent analysis of the Montenegrin economy to identify the key structural challenges to competitiveness and inclusive growth, drawing on Montenegro's ERP itself and other sources. This concise analysis shows that despite progress achieved in some areas, the country experiences several structural and cross-cutting weaknesses across many sectors. However, the main challenges in terms of boosting competitiveness and securing long-term, inclusive growth are (i) increasing labour market activity, (ii) strengthening the regulatory environment and (iii) formalisation of the economy. This assessment therefore focuses on these three challenges.

4.1. Key challenges

Key challenge #1: Increasing labour market activity

Key obstacles to growth and competitiveness remain structural. Recent positive labour market developments are a reflection of favourable economic developments rather than structural reform efforts. Low activity is an overarching challenge and the consequence of several bottlenecks. Weak job creation, skills mismatch, strict labour market regulation and relatively high labour taxation, and undeclared work negatively affect employment, particularly among young people, women and the low skilled. The gender employment gap is significant and has been increasing. Low participation in early childhood education and care affects low female labour market participation and potential long-term education outcomes of children. In addition, the overall education system performance is weak. Low outcomes in primary education affect performance in the later stages of education, while weaknesses in secondary (vocational) and higher education create obstacles to transitions from school to work. Insufficient adult education and employment activation hinder and/or do not assist labour mobility and transitions onto the labour market. Demographic changes and shorter working lives put further pressure on the labour market and the sustainability of pension system. With high poverty rates, the social protection system does not target effectively the needs of the most vulnerable sections of the population, which at the same time can create disincentives to work.

Key challenge #2: Strengthening the regulatory environment

The Montenegrin government's focus on macroeconomic stability and fiscal consolidation in recent years has created a more predictable business environment; however, the institutional and regulatory framework at the micro level can be further improved. Businesses are adversely affected by inconsistent and arbitrary law enforcement, inefficiencies and weak capacity in public administration, as well as issues related to local taxation and para-fiscal charges.

The main business complaint for years has been related to the interaction with the authorities. The perception is that the conduct of business is undermined by the slow pace of administrative responses, lack of deadline compliance and the lack of deadlines for some procedures. There is also a poor and conflicting interpretation of laws between different decision-making authorities, between state and municipal level, as well as between local authorities. Other serious concerns include poor practical inclusiveness, often bordering on disregard for business voices in the public consultation processes, non-enforcement of court decisions and inconsistency or arbitrariness in case-law.

The deficiencies in the regulatory environment are exacerbated by the weaknesses in the procedures for adopting and implementing laws. The regulatory framework is perceived as unstable and unpredictable, owing notably to poorly explained and not sufficiently consulted amendments to laws affecting businesses and employees, and to generally slow and often erratic law implementation. Many legislative proposals would require more effective and proactive communication strategies targeting the stakeholders from the outset. Inclusive public consultations should be carried out early enough in a legislative procedure. More focus should be put on the timely adoption and implementation of secondary legislation, which is often delayed - sometimes by several years - compared to the main law and usually adopted without effective public scrutiny, even though it usually contains crucial provisions and practical regulations affecting the businesses.

The area of public procurement and concessions shows weaknesses in both preliminary selection process and appeals stage. Public procurement procedures are often affected by rigidity in eligibility criteria, imprecise requirements or a lack of document specifications, unforeseen delays and often changes in technical specifications and criteria. The procurement procedure outcomes can initially be positively reviewed by the State Commission, but are then often successfully contested in the Appeals Court. Suspicions of corruption are often voiced by the business community. There are significant deficiencies in the transparency and quality of public consultations, and little publicly available information on ongoing concessions procedures. The planned adoption in 2019 of the new public procurement and public-private partnership laws is expected to bring gradual improvements, provided that relevant secondary legislation is adopted in good time and implemented effectively. The same is true for the recently initiated project to roll out e-procurement.

Taxation is another area where considerable improvement is needed. Different and often unpredictable taxes, fees and charges on businesses and investors are seen as arbitrary, confusing and often non-transparent for potential investors and businesses. More than 1500 para-fiscal burdens have been identified on a national level by a survey jointly organized by ILO and The Montenegrin Employers Federation (MEF) in 2017. In addition, according to the Montenegrin government, there were 659 different local taxes, fees and charges in Montenegro in 2017. The law on administrative fees, adopted in March 2019, aims to simplify, restructure and reduce some local fees and charges, but the number of taxes and para-fiscal charges after the reform will remain significant. Planning the payment of tax commitments remains difficult due to the frequency of payments and law changes, making this another area for improvement.

Key challenge #3: Formalisation of the economy

Reliable monitoring and assessment tools are needed to address the informal economy challenges. The proportion of the informal economy to total GDP is estimated at 28 to 33%. Over 9000 small businesses declare that they employ only one person, despite most of these being registered in the accommodation and food service activities. However, there are no reliable benchmarking tools to provide for a continuous monitoring and assessment of the country's informal economy. The size of undeclared and informal work is estimated by various sources at a minimum of 22-25% of employment and up to 33-35% of employees when accounting for workers paying only part of their due tax and other social contributions (UNDP National Human Development Report and World Bank data).

The persistence of the informality is closely related to the identified structural and regulatory challenges. Corruption, regulatory burden, weak enforcement capacity, difficult access to finance, weaknesses of the labour market and high tolerance for tax non-compliance are among the root causes of informality. Low level of awareness of the societal impacts of the informal economy and the willingness to engage in informal transactions add to the complexity of the picture. In addition, tax non-compliance correlates with the perception that the taxation system remains unfair and the quality of public services is low, as assessed by the EU-OECD joint initiative Support for Improvement in Governance and Management (SIGMA).

The high level of informality in the economy has far-reaching consequences. It hinders the efficient allocation of state and business resources, reduces tax revenues, slows down economic development and has negative long-term outcomes for workers. In the Montenegrin context the impact of unfair competition from the informal sector is particularly heavy on local SMEs and microenterprises, which dominate the economy.

The government has taken some action to address informality, but it has been limited in scope and has not addressed the root causes of the problem. An action plan to combat the grey economy was finally adopted in 2017, and a government commission was appointed to better coordinate different actions. The ERP includes a measure on electronic fiscal invoices, which, when implemented, should help address one aspect of informality. However, reducing the informal economy is heavily dependent on certain reforms in the regulatory environment, which have been postponed to 2019 or later. Achieving greater formalisation is also dependent on improvements in the capacities of, and the cooperation between, local and state bodies, which are currently lacking, and on a more systematic approach, including better estimations of the size and dynamics of the informal economy.

4.2. Labour market, education and social policies

Labour market developments

Positive trends on the labour market have continued, but significant gaps remain compared with the EU. The unemployment rate continued to decrease from 16% (2017) to 15.2% (2018), but remains well above the EU average. This is a result of sustained, yet mild improvements in activity and employment rates (64.7% and 59.8% respectively), which nonetheless also remain particularly low and significantly below the EU average. Long-term unemployment also decreased, but still represents over 70% of total unemployment. Regional disparities are considerable, with unemployment disproportionately high in the north of the country. Roma and persons with disabilities also have particular difficulties integrating into the labour market.

Low activity and employment are a particular challenge for Montenegro, both compared to the EU and to the region. The activity rate of women is particularly low (57.2% compared to 72.3% for men), with the employment gap at almost 15 pps and increasing. This is partly due to past social disincentives for women to work and the high burden for family care. The rate of young persons not in education, employment, or training (NEETs) is the lowest among the enlargement countries (16.7%), but remains well above the EU average and is coupled with high youth unemployment (29.4%). The low-skilled are another group far from the labour market and represent almost 40% of the inactive population. An estimated 22% of workers engage in undeclared work and 10.4% of formally employed receive envelope wages. However, regular collection of reliable data in this area has not yet been established. The prevalence and risk of this phenomenon is higher among young and older people (UNDP National Human Development Report and World Bank data). While job creation is weak, there is also a shortage of skills, resulting from the skills mismatch and weak reskilling opportunities.

Provision of employment services and active labour market policies (ALMPs) insufficiently covers jobseekers and their needs. This is partly due to low funding (0.18% of GDP for ALMPs) and the low capacities of the Public Employment Service (PES). While coverage has been increasing, there is still no comprehensive evaluation of their effectiveness. Direct job creation measures are prevalent, and are particularly aimed at the low skilled, with less attention given to reskilling or education programmes. To improve activation and incentivise employment, PES and social work centres started a new cooperation approach, but its impacts on transition to employment have not materialised clearly so far. New legislation aiming for better provision and targeting of ALMPs is foreseen to be adopted in 2019, but it is not clear yet what its impact will be.

Interventions to improve labour market outcomes have not yet had substantial effects on increasing employment. Obstacles to greater labour market participation are structural. Disincentives to work are highest for low-wage earners and wages are condensed towards the minimum wage. Participation in undeclared work has been linked with labour market rigidity, high wage taxation and a low standard of living (Katnic and Williams 2018). The adoption of the new labour law is planned for 2019, and aims to improve labour market flexibility and ease transfer to formal employment. However, no follow-up mechanism on monitoring its effects – once adopted – is envisaged so far.

Social dialogue remains weak in Montenegro. The tripartite Social Council is in place, but the practice of meaningful dialogue, addressing conflicts and systematic consultation are not yet well developed. New laws on the Social Council and representativeness of trade unions were adopted recently, but the consultation on the preparation of measures (including the Economic Reform Programmes) is still often limited.

Box: Monitoring performance in light of the European Pillar of Social Rights

The European Pillar of Social rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion to benefit citizens in the EU. Since these 20 principles are essential for countries if they are to achieve fair and well-functioning labour markets and welfare systems, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' "Declaration on improving social policy in the Western Balkans" (6 November 2018) confirms that they will use the Pillar to guide the aligning of their labour markets and welfare systems with the EU's.

Montenegro faces challenges over a number of Social Scoreboard[2] indicators measuring compliance with the principles of the European Pillar of Social Rights. This is notably the case for equal opportunities and access to the labour market. There is also an issue of poor data availability concerning social protection and inclusion. While unemployment has decreased and employment improved, Montenegro still faces low activity rates, including a high share of young people not in employment, education or training (NEETs). The gender employment gap remains significant and has increased in recent years. Activation measures are still insufficient to contribute substantially to formal employment, while labour reform is still pending. Montenegro has a high share of people at-risk-of poverty or social exclusion. Nonetheless, the share of early school leavers is very low and significantly better than the EU average.

MONTENEGRO		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU average, improving
	Gender employment gap	Around EU average, deteriorating
	Income quintile ratio (S80/S20)	Worse than EU average, no change
	At risk of poverty or social exclusion (in %)	Worse than EU average, improving
	Youth NEET (% of total population aged 15-24)	Worse than EU average, improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-74)	Worse than EU average, improving
	GDHI per capita growth	N/A
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU average, deteriorating
	Children aged less than 3 years in formal childcare	Worse than EU average, improving
	Self-reported unmet need for medical care	Worse than EU average, trend N/A
	Individuals' level of digital skills	Worse than EU average, trend N/A

Insufficient job creation, coupled with informal work opportunities and weak employment support, contributes to low activity and employment. This is accentuated by skills mismatches and is reflected in the very high share of long-term unemployed people. The risk of poverty and social exclusion is particularly high for vulnerable families, the unemployed and children. Employment remains the best way out of poverty. While safety nets exist, the social protection system is not well equipped to target and assist those in need. To improve transitions from school to work, work-based learning and traineeship programmes have been implemented or introduced both in higher education and in VET. However, their effects and impacts need to be systematically monitored and evaluated.

Demographic structure and trends pressure the labour market and the pension system. The dependency ratio has been steadily increasing, while the employment rate for older workers (55-64 years) is 43.7%. This, coupled with general high inactivity and low employment, indicates the clear need for prolonging working lives. There is a pension reform proposal in preparation, but it is unclear whether it will sufficiently address the financial sustainability and adequacy aspects of Montenegro's pension system.

There is a further need to strengthen the collection of timely and reliable data in Montenegro. The responsible institutions' financial and administrative capacities are limited due to inadequate resources. Several indicators remain unavailable, particularly those on social protection and inclusion. In addition, several statistics are not harmonised with EU standards or are not systematically sent to Eurostat. However, Montenegro published the results of its first Statistics on Income and Living Conditions (SILC) survey in December 2019.

Social protection system

The risk of poverty and social exclusion in Montenegro has been declining, but remains high. The country's first Statistics on Income and Living Conditions (SILC) survey found that in 2016 the at risk of poverty and social exclusion rate was at 34.6% (2016), still well above the EU average of 23.5%, but the lowest among the enlargement countries. Particularly high are the rates for children (0-17 years) and young people (18-24), which amount to 30.9% and 29.6%, and these have even increased since 2013. The low skilled are the most at risk of poverty and social exclusion, and this affects their children as well. The north of the country and rural areas have double the risk of poverty and social exclusion. Income inequalities have declined somewhat, but remain at the higher end compared to the EU, although lower than in most enlargement countries.

Income support schemes are in place, but their targeting is insufficient to cover those in need. The share of low wage earners is high in Montenegro, and wage distribution is highly condensed close to the minimum wage at EUR 193 (which might also be to some extent due to underreporting of salaries). The at-risk-of-poverty line was approximately EUR 175 for a single household and EUR 367 per month for a household with two adults and two children below 14 years of age in 2017. In-work poverty in Montenegro is low, but has increased in recent years. To improve targeting of social support and incentivise work, the social card system and social activation between centres for social work and PES have been established. However, the results are not yet visible.

Despite improvements, the coverage of early childhood education and care remains low. Montenegro sustained the increase in participation in child-care services (0-5 years), which has improved by more than 10 pps since 2011. However, at 46% it remains well below the EU average. This is somewhat a result of low capacities, both in terms of funding and provision, as well as traditional low availability linked to the role of women in family care and their low participation on the labour market.

Low activity rates, short working lives and increasing old-age dependency are putting pressure on Montenegro's pension system. The employment rate of older workers (55-64 years) was 43.7% in 2017, which is below the EU average (57.1%). The average duration of working lives in Montenegro is also low, at 30.5 years, facilitated by optioning for early retirement. While currently the pension system covers most elderly people, it might be affected in the future given the dependency ratio of 1:1.7. The gross replacement rate at the standard retirement age is about 37%. The average pension stands at around EUR 280 per month (55% of the average net wage), while the minimum pension is EUR 125 (44% of the average pension and 25% of the average wage). The at-risk-of-poverty rate for older workers (54-64) is 20.3%, while for the elderly (65+) it is 16.1%. Montenegro has announced further pension system reform for 2019, but this has been put on hold.

[2] The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The 12 indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around EU-28 average) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2014-2017 are used.

Education and skills

The performance of Montenegro's education system is of limited quality and relevance for the labour market. Investment in education has increased somewhat in recent years and accounts to around 4% of GDP. Nonetheless, PISA results from 2015 highlighted underachievement in reading, mathematics and science (the results from the 2018 testing are still pending). Only 20% of the population has completed tertiary education, despite the commitment for reform efforts. On the other hand, the rate of earlier leavers from education has traditionally been low in Montenegro (4.6% in 2018), better than the EU average, and has even been decreasing.

The skills mismatch is manifested on secondary and higher education levels. This is a result of high levels of transition from vocational to higher education programmes and enrolment in less labour market-relevant programmes. Occupational mismatch (i.e. over qualification) is higher for those with tertiary education, although it is decreasing. In contrast, for those with secondary education it has been increasing (ETF forthcoming).

There is a lack of result-oriented indicators and defined monitoring and evaluation tools to adjust and develop reform measures. Tracer studies have been carried out at higher education level and one has started for VET. However, a labour market information system fit to produce information on medium- to long-term skills needs is not yet fully developed. The development of qualifications has been prioritised: since 2014, Montenegro has referenced its national qualifications framework to the European Qualifications Framework with continuous support from the EU. Sector committees, featuring education and labour market representatives, are in place and an extensive list of qualifications has been reformed. However, there is no review of the rollout to VET schools and other education providers; this means that it is not possible to assess its relevance for the overall reform progress and employability of students.

Some reforms have advanced, including the focus on work-based learning, particularly in VET. The revised VET law introduced a practical learning and apprenticeship system, which has seen increased enrolment and engagement by employers. The revised higher education law also introduced 25% practical learning, which complements the ongoing programme for professional training of graduates. Comprehensive analysis and evaluation of the implementation, effectiveness and first results of the introduction of practical learning in VET and higher education is still pending. Given the absence of programme performance, its impact on the school-to-work transition is unclear.

Less reform consideration is being given to adult learning and the upskilling and reskilling of the working-age population. Participation in lifelong learning at 3.3% (2018) remains far below the EU average, though it has increased compared to the previous year (2.8%). There is a lack of information on the availability and quality of measures for upskilling and reskilling. In 2018, the government adopted its adult learning strategy. Currently, the priority is to carry out quality assessment of providers and to extend the provision. While adult education and upskilling and reskilling measures are included in ALMPs, they make up a small proportion of such policies and are often insufficiently targeted.

4.3. Competitiveness and sectoral issues

Business environment

Montenegro continues to improve its business environment at a slow rate, but major qualitative achievements are yet to materialise. Despite a number of ongoing initiatives to improve the business environment, reduce overall administrative burdens and support businesses, progress as seen by investors and businesses has been rather slow over the last 5 years. Recent examples of progress include electronic access to land registry data and business licensing, the Law on administrative fees and the SME development strategy and action plan. However, the Montenegrin Foreign Investors Council Index for 2018 increased only slightly to 6.49 points (0-10 rating), vs 6.30 in 2013. This indicates that serious progress is still needed to make the country truly business-friendly and attractive for investors. Similar conclusions can be drawn from the World Bank Doing Business Report 2019, in which Montenegro's overall position was 50 out of 190 countries, Montenegro and the latest World Economic Forum Global Competitiveness Report, in which it ranked 71 out of 140 economies surveyed. Access to finance is an exception to the overall picture, as this is an area where Montenegro has been gradually improving. However, this improvement has been less pronounced for SMEs and microenterprises, which battle with generally weak financial literacy and entrepreneurial skills.

Effective application of the rule of law is key for improving the business environment. Effective and independent judicial systems are a prerequisite for creating an environment that is investment- and business-friendly as they instil confidence throughout the entire business cycle. Montenegro's business environment could benefit from effective measures to further strengthen the rule of law, ensure adequate and timely contract enforcement and increase the transparency of legal changes, which in turn could lead to an increase in productivity and competitiveness. If corruption is not forcefully addressed, it will make Montenegro a less attractive place for doing business.

Research, development and innovation

Public and private investments in research, development and innovation (RDI) are low. The RDI sector also suffers from a low number of researchers and weak links between academia, research institutes and business. The number of researchers per capita is only 20% of the EU average, while over 90% of research staff is employed by the government and the higher education sector. With a rate of only 0.32% of GDP invested in R&D (2016), Montenegro needs to make continued efforts to reach its 2020 target of 0.60%, which is already considerably lower than the Europe 2020 target of 3%. There are few innovative enterprises, and research institutions have limited commercial and legal expertise. This is reflected in a very low number of patent applications (10 in 2016, WTO) and an insignificant number of domestic industrial design applications (only 3 out of 228 applications registered in Montenegro in 2016, WTO).

On the other hand, the main government funding scheme for RDI significantly increased during 2018 and most of the new projects are now based on the principle of business co-financing. However, there is no data yet to substantiate an increase of private sector funding. A new programme to strengthen human resources and research capacities in scientific research institutions has been launched, with one of its aims being to facilitate the employment of researchers in the private sector. The development of a smart specialisation strategy (S3) for the country is at an advanced stage. Montenegro plans to implement such a strategy and promote an innovation culture through the 'Tehnopolis' innovative-entrepreneurial centre in Nikšić and the planned science and technology park at the University of Montenegro in Podgorica. Furthermore, a programme for supporting innovative start-ups was adopted - cofinanced by the Policy Support Facility of Horizon 2020 – aimed at creating the right conditions for innovative businesses to emerge, develop and grow. At the same time, the lack of robust and up-to-date R&D and innovation statistics impedes access to reliable research data. The quality of R&D statistics needs to be improved by widening the coverage and frequency of surveys. The development of innovation statistics that would meet the requirements for inclusion in the EU Innovation Scoreboard is currently in the pilot stage.

Digital economy

Access to broadband networks is seen as key to the further digitalisation of the economy. Montenegro's information society strategy sets an ambitious goal of 100% household coverage with high-speed broadband (above 30 Mbit/s) by 2020. However, despite intensive efforts, legislative and infrastructure hurdles are likely to significantly delay this process, with 28% of all households and 40% of rural households still without any internet access in 2017. The process of mapping existing telecommunication infrastructure is ongoing and will be completed only by the end of 2019. The legislative framework for high-speed broadband development is also not yet adopted. Low population density increases costs of private broadband deployment and discourages investment by existing private operators in less populated areas, resulting in the slow connection speeds. The government should consider financial and policy incentives for rural broadband and invest in a digital skills development programme. This would promote digital economy jobs and increase business use of ICT, the absence of which being one of the factors that undermines Montenegro's competitiveness. A more proactive approach on issues such as cross-border data transfers and data protection and cyber security would also be advisable.

Investment activity

Public and private investments remain one of the main drivers of GDP growth. This trend will likely continue in the near future. The government has announced strategic investment plans in four areas (tourism, transport, energy and agriculture), with investment expected to reach around EUR 2.75 billion in 2018-2021. Public investment is already at an all-time high, with several large projects such as the undersea interconnection power cable with Italy and the first section of the Bar-Boljare highway nearing completion in 2019-20. Private investments, in particular in hotel and tourism infrastructure, focus mainly on the coastal area, while the north of the country attracts little funding aside from investment in two ski resorts. New investments in the production of aluminium and renewable energy plants are forecasted to boost export capacities in the future and contribute to reversing negative trends in trade.

Foreign direct investment (FDI) decreased in 2018, but remains high compared to regional peers. The FDI per capita indicator for the last 10 years averaged around 19% of GDP. FDI contributes significantly to Montenegro's current account deficit financing. Net inflows of FDI decreased to 8.6% of GDP by September 2018 due to large outflows related to inter-company debt payments and following the sale of stakes in the electricity company EPCG by its Italian owner. The main sources of FDI investment are EU Member States and Russia. Due to the high general government debt-to-GDP ratio further financing of large projects through the state budget is hardly possible. However, increased EU and international funding and the expected adoption of the public-private partnership law in mid-2019 should contribute to maintaining the current level of investment in the mid-term future.

Trade performance

The trade deficit remains high, reaching 32.2% of GDP in 2018, despite a significant surplus achieved in the trade of services. The trade deficit in goods widened by 10.2% year on year in 2018. The export of goods remains modest due to low diversification and a predominance of low value added products and crude materials in its structure. Imports, meanwhile, are dominated by manufactured goods, construction materials, machinery, transport equipment and food. The trade in services balance recorded another big surplus and a year-on-year increase of 9.9% by the end of 2018, driven mostly by tourism activities.

EU Member States dominate both exports and imports, accounting for 44% and 48% of all trade in 2018. Serbia and China (with Hong Kong) are the main trade partners outside the EU, accounting respectively for 19.3% and 10% of imports and 23% and 3.5% of exports. Trade openness remains relatively high at 110.6%, while tariffs are low and non-tariff barriers relatively low, due to the EU accession process and WTO membership. There is significant potential for greater intra-regional trade within the Central European Free Trade Agreement (CEFTA) framework and with the EU, as trade preferences allowing for access to the EU market without customs duties apply for 98.6% of Montenegrin products.

Montenegro is encouraged to implement all the aspects of the Regional Economic Area Multi-Annual Action Plan (REA MAP). The REA MAP is based on EU standards and will facilitate country's integration in regional and European value chains. It will also help increase the attractiveness of the economy for FDIs in tradable sectors. Improved connectivity with neighbouring countries in transport and energy will facilitate access to the regional markets. The creation of a regional digital space and of more integrated labour markets with neighbouring economies will open new possibilities for the country's youth, which is also important in light of the high youth unemployment.

Energy

The energy market needs to improve its infrastructure and efficiency. Montenegro covers close to 40% of its electricity consumption through imports. Energy transmission losses amounted to over 17% of electricity consumption in 2017, five times higher than the EU average. The reliability of the electric power supply in rural areas also needs to improve. However, the use of renewable energy sources is high and increasing. In 2017, some 40% of the country's electricity production (significantly above the EU average of 31.8% in 2017) came from renewable sources, mostly hydropower and biomass. The energy legislation is aligned with the third energy package for electricity and gas, but a natural gas market does not exist because there is no access to gas pipelines. The wholesale and retail electricity markets in Montenegro are open for competition, but new providers are yet to come.

Energy production and cross-border trade in energy should significantly increase in the coming years. New energy production capacities are being created with the launch of a wind farm and the granting of licences for the construction of several solar power plants, including a large 250 MW solar plant in Briska Gora. The construction of the undersea energy link towards Italy is progressing as planned and will enable energy export from Montenegro and the entire Balkan region to Italy. Integration into the regional electricity market should also improve in the future through new energy interconnectors with Serbia and Bosnia and Herzegovina as part of the Trans-Balkan Corridor of the Energy Community.

Transport

Montenegro's long-term sustainable economic development would benefit greatly from further developing and improving transport infrastructure and from ensuring a good connection with European transport corridors. The country's geographical situation makes better transport links with the wider region and the rest of Europe particularly important. In the World Economic Forum Global Competitiveness Report

2018 Montenegro scores very low on road, airport and shipping connectivity. Transportation services accounted for 4.1% of gross value added (GVA) in 2017 (below the EU average), and provided employment for 5.3% of the workforce. The number of road accident fatalities (per 1 million inhabitants) is almost twice the EU average and is increasing.

There is slow progress on improving and modernising sections of the road and rail networks, but sufficient funding for the current maintenance of rail and road network remains an issue. Further steps are also needed to open the rail market up to competition. State funding is largely focused on the construction of the Bar-Boljare highway, but works on the priority section are suffering from delays and cost overruns. Upcoming tender for a concession to maintain and upgrade two main airports aims to address, in the near future, the issue of limited accessibility by air transport. Efficiency of border-crossing procedures (and customs) is a related area where improvements are needed.

Agriculture

Significant investments are planned to develop the agricultural sector (including forestry and fishery), which currently faces a number of challenges. The government is expecting to invest EUR 122 million in the next 3 years, mainly from EU funds, which will facilitate progressive modernisation. Agricultural land in use accounts for 18% of the country's territory, although 94% of such areas are pastures and meadows. Agriculture contributed 8.4% to the country's GVA in 2017 and 8% of employment. It is also the main or partial source of income for close to 50 000 households. With the exception of a few larger agricultural enterprises, agricultural production is fragmented and characterised by small, often family-run parcels with high production costs, limited organisation and a lack of adequate equipment. The problem is exacerbated by limited skills and poor access to credit and markets.

Montenegro is a net importer of food, reaching EUR 500 million annually in imports and only EUR 50 million in exports. Wine tops the exports list. Neighbouring Western Balkan countries, and in particular Serbia, account for over 80% of the trade in agricultural goods. The Stabilisation and Association Agreement gives Montenegro unrestricted access to the EU market for nearly all agricultural products. However, agricultural exports to the EU remain mostly unexploited due to the limited scale of agricultural production and because of the necessity to fulfil the EU veterinary and phytosanitary requirements.

Industry

Montenegro's industrial base remains modest and hampered by low product diversification and low labour productivity. Industry and construction made up 19.4% of GVA in 2017 and 17.1% of employment. New investments in the energy and aluminium production (which are the country's top exports) are aimed at improving the competitiveness of these sectors, but modernisation efforts in other areas are less pronounced. The production of higher value added products remains limited and local industry is characterised by low participation in European and global supply chains. The government's efforts focus on SME support and SME policy, a natural choice in a small economy. Industrial policy receives support from the Investment and Development Fund of Montenegro (IDF) among others, but access to finance still remains a significant obstacle for SMEs. Effective working structures still need to be created to help Montenegrin applicants prepare their applications for EU funding under Europe's programme for small and medium-sized enterprises (COSME). Montenegro is currently revising its industrial policy.

Services

The services sector remains the most important sector of the Montenegrin economy, providing 72.1% of GVA and employing three quarters of the workforce. Retail and wholesale trade and tourism are the main contributors to GVA and employment in the services area; ICT, financial and professional services remain less developed. Services — in particular tourist services — are the country's main export and accounted for 78% of total exports in 2017. Spa and congress tourism are possible niches that could be exploited, and would also help to offset the high seasonality of the current tourism trends. Further diversification of the services sector beyond the current focus on tourism would reduce the economy's vulnerability to external factors such as geopolitical risks, intense competition for tourism in the Mediterranean region and weather conditions.

ANNEX A: IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2018

Overall: Limited implementation (34.1%)[3]	
2018 policy guidance	**Summary assessment**
PG 1:	There was **partial implementation** of PG 1.
Fully implement the July 2017 fiscal strategy.	1) **Substantial implementation:** The strategy was to a large extent implemented, but the new excise duties on tobacco products and carbonated water with sugar were withdrawn in July 2018, due to low performance and an increase in informal trade.
Take additional fiscal measures if necessary to achieve the debt and deficit targets as outlined in the 2018 ERP.	2) **No implementation:** Additional non-planned expenditure took place during 2018. However, no additional fiscal measure was implemented and the deficit target was missed. The deficit and debt targets for 2019 and 2020 have also been softened compared to the previous year's ERP.
Establish adequate budget allocation to accommodate contingent liabilities related to unfavourable court cases.	3) **Full implementation:** In the second budget revision in July 2018, the Ministry of Finance increased budget reserves by an additional EUR 17 million, reducing the planned surplus of local government budget by the same amount. To improve budget execution performance, the budget heading for repayment of liabilities from previous period will be part of budget expenditure as from 2019.
Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultation with stakeholders, including the EU.	4) **Limited implementation:** Montenegro requested in October 2018 the EU's technical assistance for the preparation of an options paper and support for the establishment of a fiscal council and its operations. The grant application for this IPA project was approved in February 2019.
PG 2:	There was **limited implementation** of PG 2.
Gradually reduce public spending on wages and pensions as a share of GDP.	1) **Partial implementation:** There was some reduction in the relative share of wages and pensions in 2018, although the wage bill turned out higher than expected in nominal terms. The plan is for both items to decline slightly as a percentage of GDP over the programme period. This is expected to be achieved thanks to the economy growing faster than the regular indexation of pensions and any possible public sector salary increases.
implement the new optimisation plan of the public administration reform, including local self-government and public institutions	2) **Limited implementation:** The public administration reform is being implemented but has been delayed. There was some net reduction of staff, but the target for 2018 was missed. Moreover, the administration hired additional staff before the optimisation plan was adopted in July 2018, undermining the results of the reform.
and prepare pension reforms that would change the valorisation and indexation of pensions and tighten eligibility for early retirements.	3) **No implementation:** Draft amendments to the law on Pension and Disability Insurance have been prepared. However, the reform of the pension system

[3] For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en.

	was put on hold because the draft amendments were strongly challenged by the trade unions, resulting in changes to the initial draft that would have run counter to the aim of improving the financial sustainability of the pension scheme.
PG 3: Continue efforts aimed at NPL resolution and corporate debt restructuring, focusing also on loans held outside the banking sector and underlying obstacles outside the remit of the central bank.	There was **partial implementation** of PG 3. 1) **Partial implementation:** The legal framework guiding voluntary debt restructuring has been extended to May 2019. In addition, the CBCG intends to intensify its supervision of banks with the aim to monitor their compliance with the amended decision on minimum standards for the management of credit risks, which also includes the monitoring of the implementation of their strategies to resolve non-performing exposures. Both measure may help to further reduce the stock of non-performing loans on the balance sheets of banks. Apart from that, efforts outside the immediate remit of the CBCG that may facilitate the resolution of non-performing debt appear not to form part of the priority reform measures presented in the ERP by the authorities.
Establish a framework for the recovery and resolution of credit institutions.	2) **Limited implementation:** The adoption of the Law on Resolution of Credit Institutions, implementing Directive 2014/59/EU on Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms, is planned for 2019, followed by the preparation of all necessary secondary legislation.
Consider conducting asset quality reviews in the banking sector	3) **Limited implementation:** The ERP assigns a low priority to conducting an asset quality review (AQR), but signals to consider to perform an AQR for vulnerable banks in 2019. The CBCG indicated its intention to implement an AQR from 2019Q2 onwards with its scope, however, yet to be decided.
and options for enhancing the emergency liquidity assistance framework.	4) **Partial implementation:** The CBCG Council passed a decision detailing the conditions under which banks can access the CBCG's (emergency) liquidity facilities, which started the process of improving the framework.
Enhance the accountability and transparency of macroprudential policy by publishing a document outlining the central bank competences, objectives and instruments in this area.	5) **Full implementation:** The CBCG adopted a macroprudential policy framework in June 2018 and published it on its website (https://www.cbcg.me/slike_i_fajlovi/eng/fajlovi/fajlovi_naslovna/macroprudential_policy _framework.pdf). It largely follows the recommendations of the European Systemic Risk Board on intermediate objectives and instruments of macroprudential policy.
PG 4: Based on a mapping of infrastructure and analysis of market interests, develop a comprehensive action plan on broadband roll out and coverage,	There was **limited implementation** of PG 4: 1) **Limited implementation:** Mapping of the telecommunication infrastructure is ongoing and should be finalised in 2019. Adoption of the national action plan on broadband roll out and coverage is foreseen for 2020.
and implement the broadband cost reduction measure in line with EU Directive 2014/61.	2) **Limited implementation:** A draft law (Law on Access to and Deployment of a High-Speed Electronic Communication Network) has been prepared and consulted with the Commission, but its adoption is delayed until Q4 2019. The Law will be fully implemented only in 2021.

Ensure the collection and delivery of statistical data on research and development, and innovation. Develop a model for the introduction of fiscal incentives for the research and innovation sector in line with EU state aid rules.	3) **Limited implementation:** No improvement on R&D statistics. First Innovation survey done in 2018 for the 2014-2016 period. Second Innovation survey planned for 2019 for the period 2016-2018. 4) **No implementation**: The model has not been developed.
PG 5: Adopt legislation on concessions and public private partnerships in line with EU rules and best practices accompanied by an action plan for institutional capacity building in this area. Ensure effective, efficient and independent rail regulatory and safety authorities to implement the full opening of the rail market.	There was **limited implementation** of PG 5: 1) **Limited implementation**: The new Law on Public-Private partnership and amendments to the Law on Concession are announced to be adopted during 2019. However, laws are currently still in the drafting phase, thus their adoption is again postponed. 2) **No implementation**: Trainings for line institutions, local governments and the private sector are envisaged for 2020, and only partially in 2019 (with donor support). No comprehensive action plan for institutional capacity building is developed. 3) **Limited implementation**: The new law on railway was announced as the key measure to address this policy guideline. However, the law is still in the drafting phase; its adoption is postponed to 2019. Though the new law would resolve the status of the Railway Directorate, to act as authority for regulatory and safety activities, its administrative, financial and technical strengthening will deserve particular attention.
PG 6: Review active labour market policies in order to improve their coverage and effectiveness, in particular for youth, women and the long-term unemployed. Ensure better coordination between employment activation measures and social benefit schemes. Increase enrolment in vocational and higher education corresponding to labour market needs.	There was **limited implementation** of PG 6: 1) **Limited implementation**: While participation in active labour market policies has increased, there has still been no assessment and evaluation of their effectiveness. The Law on mediation in employment is planned for adoption in 2019, but its impact on better provision, design and targeting of ALMPs and employment services is unclear. A new integrated database on employment should be made operational to provide for better monitoring of the labour market and its programmes. 2) **Limited implementation**: The Employment Office of Montenegro and centres for social work have put in place a 'coordinated activation approach' to developing individual activation plans. However, the approach has yet to be utilised to improve service quality. An integrated database including Ministry of Labour, Education, Employment Office and social centres is not operational yet. There is a proposal to carry out a social protection review in cooperation with Unicef, but the funds have not been secured yet. 3) **Partial implementation**: Tangible progress was made in the area of VET. The dual education programme saw significant increases in student enrolment and employer participation. However, it remains to be seen whether employers' involvement (and consequently sustainability of the dual system) will continue, particularly with an increased transition to employers' own co-financing of apprenticeships. The effects on higher education are not available and it is too early to establish impacts on school-to-work transitions.

ANNEX B1: ASSESSMENT OF THE STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP

Measure 1: Improving the ownership, managerial and organisational structure in electrical power companies with state-dominant ownership

The measure to improve the ownership, managerial and organisational structure of electrical power companies with state-dominant ownership is new and has the potential to have a longer-term effect on the Montenegrin economy and its competitiveness. However, its immediate and direct effects have not been demonstrated. Activities planned for 2019 appear to be too ambitious in timing, whereas those for 2020 and 2021, focusing on implementation, appear too spread out. The financial allocation for the measure's implementation (EUR 100 000 from the state-owned enterprises and EUR 30 000 from the national budget) might have been underestimated. If implemented properly, in the longer run the measure could lead to improved competitiveness in the energy sector, which is an important pillar of the Montenegrin economy.

Measure 2: Improving the legislative/regulatory and institutional framework for integration into the regional electricity market

The measure to improve the regulatory and institutional framework for Montenegro's integration with the regional electricity market is rolled over from the previous ERP and directly linked to the connectivity reform agenda agreed at the 2015 Vienna Summit. There was limited implementation of the 2018 activities, which focused on aligning national legislation with the relevant EU *acquis*, and most of the 2018 activities have been rolled over into 2019. Although 2020 and 2021 activities have now been included, they have not been well prepared. While the focus of this measure does now include implementation of the relevant legislation under the third energy package, important details are lacking.

Measure 3: Creating an efficient and independent rail transport regulatory and safety authority

The liberalisation of the transport market is deemed to be key in raising the country's competitiveness and long-term growth potential. Limited implementation of activities in the previous year for this measure did not generate the expected results as required amendments to the Law on the railways are still in the drafting phase and have been postponed until 2019. While the planned legislative amendments provide for alignment with the EU *acquis*, the consecutive implementation and re-focusing of the Rail Directorate towards safety and regulation in rail transport is a major undertaking. The measure recognises some of the risks associated with the new regulatory responsibilities. However, the magnitude of required training, mentoring and twinning is underestimated. The adequacy of the resources allocated to this measure (EUR 315 000 annually) is yet to be verified against the planned changes. This measure alone is not sufficient to achieve the complete opening of the railway market. More time and complementary measures are needed to increase transparency, facilitate economic activity and create the confidence needed to attract private sector investments.

Measure 4: Supporting investment to develop and modernise the industrial sector

This measure, which was already part of the ERP in 2016, 2017 and 2018, aims to ensure continuous improvement of industrial development. It is a combination of two measures under industrial sector development laid down in the 2018-2020 ERP. In 2019, support is envisaged under two discrete components, the first focusing on creating new jobs, and the second on investment in manufacturing equipment. While the second component contributes to industrial modernisation and thus to greater competitiveness, the first component is not linked to any increase in productivity or efficiency and its very sustainability is questionable. The expected impact on competitiveness and increase in the industrial production would stem almost exclusively from the second component.

Measure 5: Supporting investments in the food production sector in order to reach EU standards

The measure to invest in the food production sector to help companies achieve EU standards is essential for the agricultural sector to become more competitive. The level of public support in this area is steadily increasing, and Montenegro has prepared measures to provide more farmers with access to credit, which will help the support scheme to be effective. Montenegro is also encouraged to make faster progress in obtaining EU export accreditation for exports of animals, products of animal origin and food products. While it is important to reduce import dependency and increase exports, Montenegro has identified tourism as an important market for its agricultural products. The additional IPARD measure on diversification of agricultural activities, including agro tourism, will contribute to achieving this goal.

Measure 6: Diversifying tourist products

The priority measure to diversify the tourism sector was rolled over from 2018 and the description of the measure remains (almost) the same. The measure remains formulated as an objective rather than as a reform with clear and targeted activities. The planned activities now make sense following last year's clarification that the measure aims to present a regular grant scheme that would mobilise local-level initiatives to make tourism in the north of the country more attractive. However, some segments (implementation, expected impacts) require further clarification. The introduction of key performance indicators (e.g. increase number of tourists and overnight stays) tries to establish a correlation with the expected impact (which depicts tourism employment trends as a whole), but more work on the indicators is needed. The budgeting of the measure is unclear when compared with the much higher amount allocated (but mostly unspent) from last year.

Measure 7: Strengthening prudential oversight and the bank resolution framework

Montenegro presented this measure as the response to Policy Guidance 3 specified in the Joint Conclusions of the Economic and Financial Dialogue of May 2018. However, it is *de facto* a rollover of refocused measures from the 2018-2020 ERP. The measure is relevant and important, but it is not clear why the adoption of the Law on credit institutions and the Law on rehabilitation of credit institutions have been delayed and why secondary legislation for these laws is expected to be adopted only in 2020. A clear framework for the implementation check at the credit institutions level would be recommended.

Measure 8: Implementation of the new regulatory framework for PPP policy and amendments to the Law on concessions

This measure is a follow-up to Policy Guidance 5 specified in the Joint Conclusions of May 2018. The adoption of the two laws is planned for 2019. The implementation of these laws will have a very significant impact on the long-term competitiveness of the economy and growth potential. It would create a basis for further development, making it easier for Montenegro to target projects for which state institutions and bodies would transfer responsibility to the private sector, thus boosting the economy's attractiveness. To make these laws more effective, Montenegro should adopt a comprehensive legislative and strategic framework in this area. In addition, a human resources needs assessment should be developed as expertise in this area is lacking. Sufficient funding and time are needed to train both the public and private sector in this field in a way that goes beyond simple introductory training.

Measure 9: Adoption and implementation of the Law on administrative charges

This new measure represents one of the most significant developments in the area of business environment in the last several years. For years, all business associations have been stressing that high, numerous and often-changing administrative taxes negatively affect the predictability of the business environment. If adopted in the proposed form, the Law would contribute to creating a better environment for existing and new businesses, eventually making the economy more competitive. The Law also provides the legal basis for the electronic payment of administrative taxes and the electronic submission of proofs of payment. Out of 659 local taxes, 7% will be abolished, while 11% will be decreased. This is an important step in improving the overall context of doing business in Montenegro.

Measure 10: Adoption of the Law on electronic fiscalisation in the sale of products and services and the implementation of the electronic fiscal invoice system

This measure was already part of the ERP in 2016, 2017 and 2018. The draft of the law was prepared in 2018 and a public debate was organised, but no further steps were taken due to potential issues over technical implementation. The measure is relevant for competitiveness and should lead to a reduction in the informal economy, as data from electronic cash registers will be linked with data on taxes and contributions paid. Taking into account the assistance provided to Montenegro through a project funded by the World Bank loan, there is a good chance that this measure will finally start to be implemented in 2019, with the adoption of the Law. Full implementation is planned for 2021.

Measure 11: Improving support for the micro, small and medium enterprise sector

This measure was already part of the ERP in 2016, 2017 and 2018. It is relevant and important for increasing the competitiveness of Montenegrin SMEs and the entire economy, as well as for economic growth. In 2019, support to the MSME sector is to include further improvements in the provision of financial assistance to: (i) strengthen innovation and cluster development; (ii) introduce international standards; (iii) strengthen support for business creation; and (iv) reduce the number of failed businesses. In addition, the Investment and Development Fund of Montenegro plans to implement credit guarantees under the LGF COSME programme and to promote and strengthen the investment readiness of innovative start-ups in order to improve the use of the Enterprise Innovation Fund within the Western Balkans Enterprise Development and Innovation Facility. The key performance indicators should focus on expected outcomes rather than output (number of grants, trainings etc.).

Measure 12: Improving the legislative and regulatory framework with aim to reduce the costs of deploying high-speed electronic communications networks

The measure has been rolled over from the 2018-2020 ERP and responds to Policy Guidance 4 of the Joint Conclusions of May 2018. Montenegro advanced its preparations for legislative alignment with Directive 2014/61/EU, but adoption of the law has been delayed until the end of 2019, while full implementation is planned only for 2021 and is dependent on the timely implementation of the Law on spatial planning and construction of structures. A discrepancy remains between the planned entry into force of the respective national law in 2021 and Montenegro's 2020 goal of 100% broadband availability, even if partial implementation could be envisaged earlier on the basis of mapping national broadband infrastructure.

Measure 13: Strengthening the national innovative ecosystem

The measure to strengthen the national innovation ecosystems includes four components offering financial and non-financial support for research and innovation for businesses and the scientific community. The measure responds to Policy Guidance 4 of the 2018 Joint Conclusions. The grant scheme, which is designed to stimulate cooperation between scientific and business sector, is likely to bring benefits to the Montenegrin economy as it is comparatively well resourced (i.e. the budget complements the contribution by external donors) and such measures have proven relatively successful in the past as they address a genuine need. The Podgorica Science and Technology Park is fundamentally a good idea as long as it is managed competently and supported by the authorities to ensure it attracts users through various incentives. The support to innovative start-ups and regional centres of excellence is much more difficult to assess as the description provides only limited information on what is actually intended and how it will be implemented. The key performance indicators could become more specific and oriented towards the desired outcomes. Overall, the budget contributions and policy orientations are in line with national and EU-level sector policies.

Measure 14: Implementing the trade facilitation measures set out in the WTO Trade Facilitation Agreement and in CEFTA Additional Protocol No. 5

The measure defines more narrowly the trade facilitation measures laid down under CEFTA Additional Protocol 5 and the 2018 national trade facilitation strategy from the more general 2018-2020 ERP measure. In particular, it focuses on reducing customs clearance procedures, relying primarily EU funding, both national and regional. While implementation of the measure in terms of the procurement of the necessary IT equipment looks realistic, the implementation of the Authorised Economic Operator (AEO) programme may face some delays as the new decree is yet to be adopted, and needs to be followed by validation missions for the mutual recognition of the AEO programme. The measure rightly identifies the main bottlenecks in the area, but overly relies on the ongoing and planned EU assistance projects. Apart from that, success of the measure greatly depends on beefing up capacities in the customs administration, but also on private sector flexibility.

Measure 15: Development of qualifications and education curricula in accordance with the labour market needs

The measure is relevant for improving education outcomes. However, the measure continues the actions carried out in previous past years (development of new curricula and teachers training), without building- /following-up on its results. No focus is placed on monitoring and evaluation, which is a persistent weakness. Given that the measures are a continuation of previous years, there is no build-up on their implementation in terms of upgrading and proceeding based on outcomes, results and monitoring. The limited application of forecasting tools for future skills and employers' needs, as well as career guidance and counselling continue to be a bottleneck for fast transition between school and work.

Measure 16: Implementation of apprenticeships with employers

The measure is relevant for improving the school-to-work transition. Under the measure, apprenticeships in vocational education and training (VET) would continue within the newly introduced dual education system. However, there is no planned mitigation of risks, particularly for the possibly lower numbers of students enrolled in the programmes and the potential diminished interest among employers. The number of students expected seems overly optimistic. Career guidance services for learners should also be highlighted and incorporated into the reform, in order to provide independent professional counselling to students.

Measure 17: Support for self-employment and strengthening of local employment initiatives

The measure is appropriate as an employment support measure and active labour market policy measure but does not constitute a structural reform measure addressing a key structural challenge on the labour market. The measure provides for self-employment grants planned under the IPA 2015-2017 sector operating programme. The description of activities is weak, while the key performance indicators focus on output rather than performance, and the question of effectiveness and contribution to growth is very difficult to assess. While the diagnostic behind the measure focuses on the lack of job creation, it is unclear how the measure will address this (as the lack of financing is only one of many structural obstacles).

Measure 18: Development of day-care services for the elderly

The measure addressing the needs of the elderly is certainly relevant and commendable from a poverty reduction and social welfare policy perspective. However, it is likely too narrow to have any comprehensive impact on poverty rates among older people or on the deinstitutionalisation of social care provision. There is no link between the diagnostic and the measure proposed; therefore, it is also not clear what structural bottlenecks are meant to be addressed. The rationale behind the measure’s contribution to the labour market as a job generator is questionable.

Measure 19: Incentive for including children in sports activities

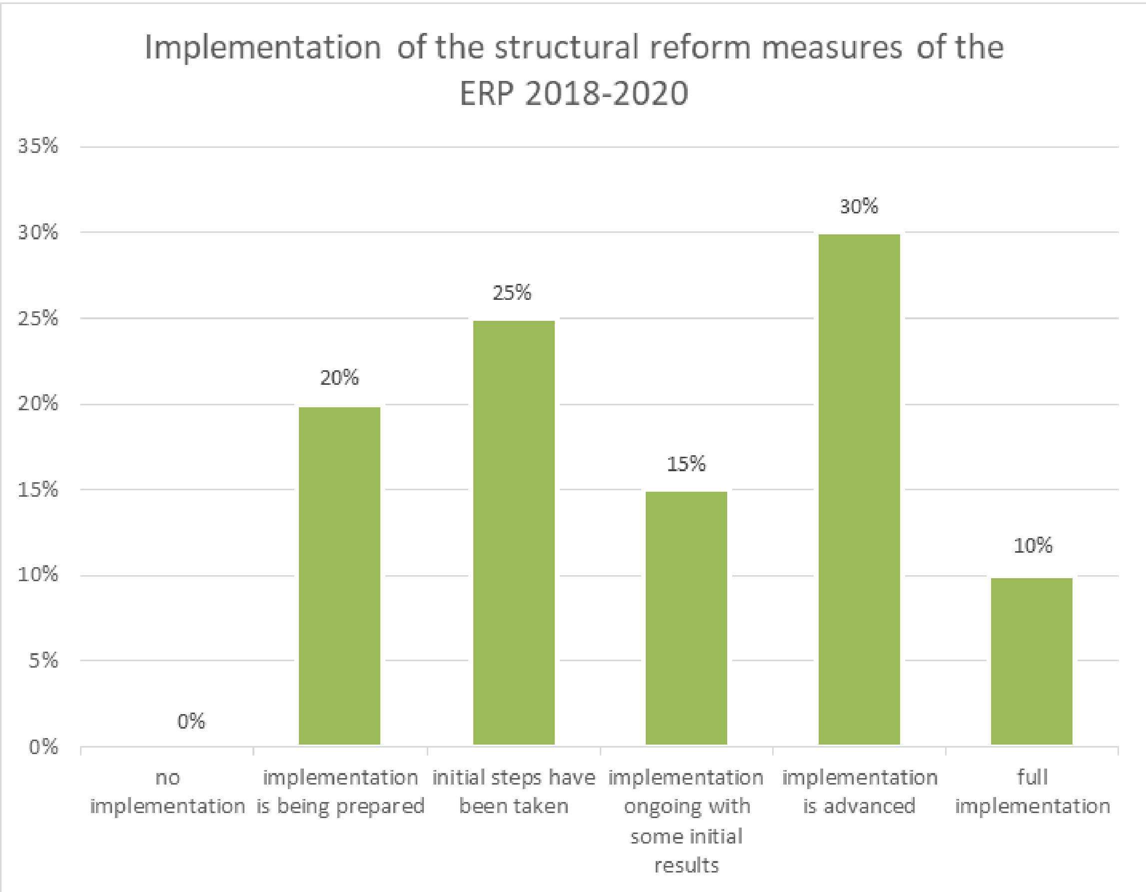
The measure promoting sports activities among young people is commendable for its intended effects on the wellbeing of the young. However, its effective impact on overall competitiveness and social inclusion will most likely be limited. There is no link between the diagnostic and the measure proposed and it is unclear in what way the measure represents a structural reform measure addressing a key structural challenge in social policy.

ANNEX B2: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2018-2020

There was a moderate progress on implementing the measures in 2018, with an average score of 3.1 out of 5. The reporting on the activities is mostly of a good quality. As partial or complete scores were missing for three priority reforms, these have been calculated by the Commission. To provide a fair picture of the level of implementation, some adjustments to the scoring of activities were made for five other reforms, based on the description of the implementation and explanations covered by the table, as well as the Commission's own research.

Implementation has been stronger for some measures, such as measure 6 on supporting the development and modernisation of the industrial sector, and measure 13 on improving non-financial support to SMEs.

Implementation has been weaker for other measures, such as measure 2 on improving regulatory and institutional framework for integration into the regional electricity market, and measure 7 on supporting investments in the food production sector. Implementation was particularly weak for measures 3 and 15 — adopting secondary legislation on a single window for formalities in maritime transport and establishing a Science and Technology Park in Podgorica.



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Montenegrin Government adopted the 2019-2021 Economic Reform Programme on 24 January 2019 and submitted it to the Commission on 31 January 2019.

Inter-ministerial coordination

The preparation of the 2019 ERP was centrally coordinated by the Office of the Prime Minister and the Ministry of Finance. An inter-ministerial working group involved all relevant ministries. The high-level Competitiveness Council, chaired by the Prime Minister, continued to monitor the implementation of the ERP structural reform measures and the joint policy guidance.

Stakeholder consultation

A draft ERP was made available online from 12-31 December 2018 for a public consultation. The authorities organised a roundtable discussion on 24 December. No business associations or civil society organisations participated in this event. Annex 3 includes the comments provided by one stakeholder, the Union of Free Trade Unions of Montenegro. The ERP was not discussed separately in the Social Council. There was also no prior consultation on the design and selection of measures. The draft ERP was discussed in the Parliamentary Committee for Economy, Finance and Budget on 27 December.

Macro framework

The programme presents a reasonably comprehensive picture of past developments. The information provided is concise and well structured. The quality of translation has improved too. Statistical tables are more complete than in the past with almost all the relevant data covered, but weaknesses remain, for instance on the balance of payments' capital and financial account table. The macroeconomic framework is coherent, consistent and sufficiently comprehensive, and provides a good basis for policy evaluation and discussions. Overall, the quality of this part of the ERP has improved compared to previous years' programmes.

Fiscal framework

The fiscal framework is detailed, in line with stated policy objectives, and consistent with the macroeconomic framework. The factors behind projected revenues are presented clearly, but the expected effect on the budget of economic growth, discretionary measures and tax administration reform are not sufficiently quantified. There is scope for better description of expenditure measures and their anticipated budgetary impact. Fiscal reporting standards remain weak and do not meet ESA2010 requirements.

Structural reforms

The structural reform Sections (4, 5 and 6) follow the guidance note. The overall reporting on the implementation of the Policy Guidance for 2018 is vague and some of the recommendations are not addressed at all. Reporting on the structural reform measures from the 2018-2020 period is generally both sufficient and up-to-date, albeit with some errors and important details missing. The number of reform measures in 2019-2021 ERP is limited to 19 and the page limit for Section 4 is respected. The structure of the reform measures is good in terms of scope and timeline and, to some extent, in terms of budget for activities planned. Some of the proposed key performance indicators focus on measuring administrative output rather than the results of the proposed measures. Tables 9-11 of the annex have been submitted and are filled in appropriately.

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