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ECONOMIC REFORM PROGRAMME

OF

MONTENEGRO
(2020-2022)

COMMISSION ASSESSMENT

The Economic Reform Programmes (ERP) were submitted around end-January 2020 and the present Commission assessment was finalised shortly thereafter in February 2020, supported by a fact-finding mission in mid-February.

The Covid-19-related economic crisis has in the meantime rendered the macro-fiscal scenarios presented in the ERP and in the Commission assessment largely obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the Covid-19 crisis, in its spring economic forecast in early May 2020.

While the short-term macro-fiscal outlook has profoundly changed, the present Commission assessment also identifies structural reform challenges and priorities, including in the area of fiscal governance, which remain largely valid. Addressing these structural issues will be essential to ensure a sustained economic recovery after the crisis. The Joint Conclusions to be adopted at the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey will accordingly focus this year on the short-term priorities to mitigate the socio-economic consequences of the Covid-19 crisis and on the medium-term priorities to strengthen the foundations of a sustained recovery thereafter. While the Commission assessment does not address weaknesses in the public health system and issues in the social protection system are assessed only as far as they are linked to the key structural challenges, these two areas will feature more prominently among the issues identified in the policy guidance.

Contents

1. EXECUTIVE SUMMARY

Montenegro's Economic Reform Programme (ERP) projects a baseline scenario of moderate growth. The maturing of the investment cycle had a dampening effect on economic output in 2019. The ERP expects economic growth to accelerate in 2020, supported by a rebound in private investment and government consumption, that appears somewhat optimistic. Economic expansion is set to moderate in 2021 and 2022, with growth rates slightly below potential according to ERP calculations. Total export growth, in particular from tourism, is projected to outpace the growth of imports, resulting in a positive contribution of net exports to growth. The completion of the first section of the Bar-Boljare highway would ease imports needs in the outer years, narrowing the current account deficit. Credit activity is expected to remain moderate as banks are occupied with asset quality reviews. The major risks for this scenario would be a slowdown of investment and tourism.

The fiscal strategy projects a significant reduction of the public debt ratio through budget surpluses, but fiscal targets have been relaxed compared to the previous programme. The 2019 general government budget recorded a lower than planned deficit of around 2% of GDP, supported by strong revenue performance, but also capital underspending. For 2020, the programme targets a balanced budget. However, there is some doubt as to whether this target is realistic, due to ad hoc spending decisions such as further wage increases after the adoption of the budget, uncertainties about the effects of cuts in 'unproductive spending', and a slightly optimistic revenue plan. The medium-term fiscal scenario is largely determined by the sharp reduction in capital spending resulting from the completion of a major section of the Bar-Boljare highway, rather than by new consolidation measures. Budget surpluses in 2021 and 2022 are expected to contribute to continued public debt reduction. Overall, there is room to improve the quality of public finances by gradually shifting the structure of spending towards a more growth-enhancing pattern. Given the prevalence of ad hoc decisions and the vulnerability of fiscal performance to the electoral cycle, there is a need to further strengthen fiscal frameworks and independent fiscal surveillance.

The main challenges facing Montenegro include the following:

- **Improving the quality of public finances and supporting consolidation efforts calls for containing current spending, in particular on the wage bill.** Long-term sustainability of public finances require maintaining a commitment to and compliance with budget and debt reduction targets. However, the public sector staff optimisation plan failed to achieve significant results, delaying the rebalance of current expenditure.

- **Recurrent budget slippages and fiscal risks point to the need to reinforce fiscal governance and capital investment management**. Strengthening fiscal governance would require strengthening fiscal oversight and the process of capital expenditure, in particular by subjecting investment plans to sound cost-benefit analyses, to support more efficient use of public funds.

- **Strengthening the regulatory environment requires long-term, continuous commitment from the state and local authorities.** Discretionary behaviour and inconsistencies in interpreting and implementing laws need to be addressed more forcefully. The authorities need to be continuously engaged with public consultation processes, and the consultations need to become stakeholder-oriented. E-procurement rollout and simplification of taxation should be prioritised. Fairness of the State as a regulator needs to be upheld.

- **Tackling the large informal sector continues to be an important structural challenge.** The government is yet to rethink and adopt a more comprehensive action plan to reduce informality in the economy. Priority needs to be given to preventive and educational actions, as well as incentives for the formalisation of businesses and labour. Ensuring full cooperation between central and local-level authorities is paramount.

- **Unfavourable labour market outcomes in Montenegro encompass several aspects that undermine potential growth and the improvement of living standards.** Improvements on the labour market continued; however, low activity and a high unemployment rate reflect structural issues. Women, youth and vulnerable groups such as the low skilled need better employment assistance. The labour market needs increased flexibility and effective action to fight undeclared work. A new labour law should introduce greater flexibility, though its impacts will need to be closely monitored. After important reforms introducing practical learning in vocational and higher education, no comprehensive monitoring mechanism has been established

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2019 has been partially implemented. The absence of any major privatisation or concession fee revenues could not mitigate public debt reduction. Moreover, reinforcing tax revenue measures were postponed to 2021. The implementation of the public sector staff optimisation plan had been delayed and the public sector wage bill to GDP ratio has not been reduced. However, there was some modest advancement with medium-term budgetary planning, programme budgeting and the reduction of arrears at local level. An options paper on establishing a fiscal council was prepared. Although non-performing loans have been reduced further, impaired debts residing outside the banking system have not been fully addressed yet. Preparation for a comprehensive asset quality review of domestic banks is in progress, and measures to curb the expansion of cash unsecured consumer loans were introduced. Provisioning the deposit insurance fund is under way but the process may take some time.

The structural reform measures were implemented only to a limited degree. There was limited progress on ensuring consistent application of laws affecting businesses. A comprehensive strategy to reduce the informal economy is in the conceptual phase and wider cooperation between central and local authorities is yet to be achieved. A new legislative framework for public procurement was adopted, but the implementing secondary legislation is still lacking, with actual implementation expected to advance only from 2021. Focus on practical learning in vocational education has been prioritised and implemented continuously, while further efforts are needed in higher education. More efforts are needed to improve the quality of education at all levels, including pre-school and adult education. There has been no improvement in the provision and design of active labour market policies. The outcomes of cooperation between employment offices and social work centres and the social protection information system are limited.

The ERP is broadly aligned with the reform priorities identified by the Commission, but the reform process has lost momentum. The macroeconomic and fiscal frameworks are sufficiently comprehensive and integrated with the overall policy objectives, providing an adequate basis for policy discussions. However, the budget and public debt baseline projections lack ambition. On structural reforms, the ERP presents a mix of measures from previous years and of new or recalibrated reforms. Some of the recurring measures (on tourism and trade) are mature and relevant, while others (industry, energy) present weaknesses in the analysis and measuring of impacts. New measures (e.g. on transport and informality) are mostly in the early development stage; these present significant gaps in analysis and are often vague on expected outcomes.

2. ECONOMIC OUTLOOK AND RISKS

The maturing of the investment cycle had a dampening effect on GDP growth in 2019. Economic growth eased to 3.6% y-o-y, in 2019, down from 5.1% a year earlier. Despite this, the economy expanded faster than the 2.8% estimate of the previous programme, due to the strong performance of tourism, boosting services exports and sustained growth of private consumption.

The ERP projects moderate growth in the medium term, which is slightly stronger than forecasted in the previous programme. In the baseline scenario, GDP growth is set to accelerate to 3.4% in 2020, supported by a temporary rebound of investment and government consumption, before easing to 2.8% and 3.2% in 2021 and 2022 respectively. Overall, export growth is seen outpacing the growth of imports, resulting in a positive net export contribution to GDP in the two outer years. On the supply side, the services sector (particularly tourism-related activities) would increasingly become the key engine of growth. After the closure of the positive output gap in 2020, the programme projects the economy to grow slightly below potential. The envisaged completion of major infrastructure works in 2020 induces a deceleration of employment growth in 2021, while the unemployment rate is projected to record a gradual decline.

The medium-term growth scenario is broadly plausible, but output growth in 2020 could turn out to be lower than projected. GDP growth projected for 2020 is one percentage point higher than estimated in the previous programme, and 0.4 percentage points higher than the Commission Autumn Forecast. The projection of government consumption for 2020 appears slightly overestimated, but it cannot be discarded in an electoral year. The estimated rebound of investment in 2020 seems at odds with a simultaneous large reduction in public capital spending. The programme includes a partial estimate of the impact of some reforms on the macroeconomic scenario. Accordingly, five projects related to public works in 2015-2022 would increase GDP growth and the labour force by an additional 5.6 and 1.4 pps respectively by the end of the seven-year period.

The ERP presents a clear view of economic risks and uncertainties, developing an alternative macroeconomic scenario based on some of their implications. The programme acknowledges major risks related to geopolitical and trade tensions, as well as a slowing down of foreign investment. Domestic risks stem mainly from a slower-paced implementation of fiscal consolidation, and weather conditions. The alternative macroeconomic and fiscal scenario gauges the effects of external shocks affecting investment and tourism. A 4 pps of GDP contraction of FDI in 2020 would result in a sharper fall (by some 6 pps) in gross fixed capital formation, while a reduction by half of revenue from tourism would result in a rapid and long-lasting decline of private consumption and a marked drop in employment. This would lead to a 2 pps lower growth rate in 2020. Strong negative base effects from government consumption and investment would reduce GDP growth in 2021 by 1.3 pps compared to the baseline. The negative consequences of the shocks would continue in 2022 too, with private and government consumption stagnating. This, combined with a slight contraction of investment, would result in a decline of imports. As a result, the positive contribution of net exports would be the only driver of GDP growth in 2022, expanding by 1.1% over the year.

Table :

Montenegro - Comparison of macroeconomic developments and forecasts

	2018		2019		2020		2021		2022	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	5.1	**5.1**	3.1	**3.1**	3.0	**3.4**	2.8	**2.8**	n.a.	**3.2**
Contributions:										
- Final domestic demand	8.5	**8.5**	3.8	**3.6**	2.9	**4.0**	2.2	**0.6**	n.a.	**1.1**
- Change in inventories	-0.3	**-0.3**	0.0	**-0.7**	0.5	**-0.6**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-3.1	**-3.1**	-0.8	**0.2**	-0.4	**0.0**	0.7	**2.2**	n.a.	**2.1**
Employment (% change)	2.3	**3.2**	3.0	**2.8**	1.1	**1.2**	2.1	**0.5**	n.a.	**1.3**
Unemployment rate (%)	15.5	**15.5**	14.7	**14.9**	14.3	**14.6**	13.9	**14.3**	n.a.	**14.0**
GDP deflator (% change)	3.2	**3.2**	0.8	**0.2**	1.4	**0.9**	1.8	**1.0**	n.a.	**1.2**
CPI inflation (%)	2.9	**2.6**	0.5	**0.5**	1.3	**1.0**	1.6	**1.0**	n.a.	**1.5**
Current account balance (% of GDP)	-17.0	**-17.0**	-16.6	**-17.1**	-15.8	**-16.3**	-13.3	**-13.3**	n.a.	**-10.4**
General government balance (% of GDP)	-3.7	**-4.6**	-2.6	**-2.0**	1.0	**0.0**	2.5	**1.3**	n.a.	**1.3**
Government gross debt (% of GDP)	70.1	**69.2**	77.8	**78.7**	71.5	**72.3**	62.7	**65.1**	n.a.	**62.5**

Sources: Economic Reform Programme (ERP) 2020, Commission Autumn 2019 forecast (COM).

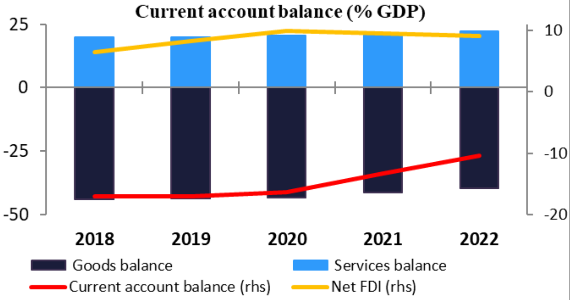
Inflation is expected to remain low. Consumer inflation has been low or moderate for several years, largely reflecting international oil price dynamics and low wage growth. In 2019, inflation averaged just 0.5%. The ERP envisages a very moderate increase of inflation in the medium term, in particular for 2021, on the assumption of stable food and oil prices, while aggregate demand would be the main factor driving inflation during the programme period. Overall, considering historical trends and catch-up (Balassa-Samuelson) effects, the inflation rate seems somewhat underestimated, in particular in the outer years. The fact that the ERP's inflation projections remain the same for the low-growth scenario seems to support this view.

External imbalances are expected to remain very high in spite of a sizeable improvement. Montenegro's trade deficit is structural, resulting from a narrow domestic production base and a high import dependence for investment and consumption goods. However, the ERP expects the trade deficit to fall by more than 6 pps between 2019 and 2022, to reach 10.4% of GDP, reflecting the reduction of investment and the resulting lower needs for imports of equipment and construction materials. At the same time, exports of goods and services are expected to expand by some 3.4% in real terms in 2020-2022. The negative output gap and the fiscal consolidation path should support the narrowing of external imbalances in the outer years too. The combined surplus on the primary and secondary income balances would increase slightly, to some 8% of GDP by 2022. Overall, despite also improving substantially, the current account deficit would remain very high, at above 10% of GDP in 2022. Competitiveness and productivity recorded some gains in recent years, thanks to a period of moderate inflation and GDP growth outstripping employment growth during this period. The ERP covers very briefly the issue of the external sector sustainability, but fails to include any assessment of the relevance of the ERP's measures and policy actions on the evolution of external imbalances. The programme focuses instead on the composition and financing of the deficit as key vulnerability, given the strong reliance of the Montenegrin economy on foreign investment.

Large foreign direct investment inflows are expected to continue and help finance the current account deficit. Net FDI inflows picked up to 7% of GDP in 2019, covering less than half of the current account deficit, the rest being financed by net inflows from portfolio investment and loans. FDI inflows are a key factor for Montenegro's economy.

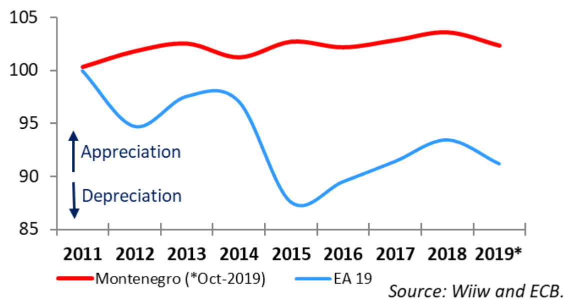
Most of these inflows are directed towards tourism, real estate and intercompany debt. Foreign investors benefit from a favourable tax environment, including tax breaks and free capital movement. The ERP also relies on a development programme offering citizenship to up to 2,000 foreigners in return for investments. However, investors' interest seems modest so far. The ERP's assumption of continuing strong FDI inflows over the next few years seems plausible if supported by continued macroeconomic stability and economic reforms. The Central Bank of Montenegro released in June 2019 (for the first time) data on the net international investment position (NIIP), estimated at a very high -169% of GDP at the end of 2018, a marginal improvement from -176.9% of GDP in 2016. The share of FDI in Montenegro's net international investment position declined from 62% in 2016, to 59% in 2018, while the share of loans increased in the same period by 5 pps to 50% (42% of these loans corresponding to public debt). Since FDI can be considered a more stable source of funding, this trend increases vulnerabilities to external shocks.

Graph : **Montenegro - Evolution of the Current account balance (% GDP)**



Source: Economic Reform Programme (ERP) 2020.

Graph : **Montenegro - Real effective exchange rate (CPI based, 2011=100)**



Source: Wiiw and ECB.

The financial sector is gaining in resilience after the resolution of two small troubled banks and the strengthening of the legislative framework in 2019. Overall, the sector appears stable, liquid and well capitalised. The sector-wide solvency ratio reached 17.7% in December 2019, well above the statutory minimum of 10%, while the ratio of non-performing loans (NPLs) to total loans fell to 4.7%. Moreover, NPL coverage with regulatory reserves is 99.1%, and banks with high NPLs are subject to special supervisory scrutiny. Profitability indicators remain positive. In 2019, the aggregate profit of banks totalled EUR 50.6 million. Return on assets and on equity were 1.5% and 9.0%, respectively. Credit activity is expected to remain moderate in the period 2020-2022, growing annually at above 3%.

Table :

Montenegro - Financial sector indicators

	2015	2016	2017	2018	2019
Total assets of the banking system (EUR million)	3 472	3 790	4 182	4 407	4 603
Foreign ownership of banking system (%)	77.6	75.5	73.0	74.3	79.7*
Credit growth	0.8	1.3	11.8	8.5	4.5
Deposit growth	13.7	9.4	13.8	5.9	0.5
Loan-to-deposit ratio	0.9	0.8	0.8	0.8	0.9
Financial soundness indicators					
- non-performing loans	14.8	11.5	8.4	7.4	4.7
- net capital to risk-weighted assets	15.5	16.0	16.4	15.6	17.7*
- liquid assets to total assets	24.8	24.5	25.3	22.6	24.3*
- return on equity	-0.7	1.5	7.6	8.5	12.6*
- forex loans to total loans (%)	1.5	1.1	0.7	0.5	0.4*

* September 2019

Sources: National Central Bank, Macrobond.

The financial soundness of the banking sector should be further reinforced in 2020, following an asset quality review of domestic banks, and the preparation of plans for potential adjustment of any capital shortfall. The ERP identifies key risks, and measures are frontloaded in close cooperation with the European Central Bank (ECB), European Banking Authority (EBA) and international financial institutions.

3. PUBLIC FINANCE

The 2019 budget balance improved, supported by strong revenue performance and capital underspending. The 2019 general government budget recorded a lower than planned deficit of 2% of GDP, half the size of 2018's deficit. The fiscal stance was broadly neutral in 2019. No significant revenue or savings measure was adopted, apart from the annual increase of excise rates, while social security contributions were reduced by 2 pps in July to compensate for the impact on labour costs of the 15% increase in the minimum wage. Nevertheless, a good tourism season and employment growth boosted social security contributions and income from indirect taxes, in particular VAT. On the expenditure side, the bankruptcy of two small banks and a dispute about municipal utilities triggered the unplanned activation of state guarantees worth 0.8% of GDP, offset by public investment underspending.

Table :

Montenegro - Composition of the budgetary adjustment (% of GDP)

	2018	2019	2020	2021	2022	Change: 2019-22
Revenues	42.2	44.2	46.2	42.4	41.4	-2.8
- Taxes and social security contributions	37.4	39.1	36.2	35.3	34.7	-4.4
- Other (residual)	4.8	5.1	9.9	7.1	6.8	1.7
Expenditure	46.2	46.2	46.2	41.1	40.1	-6.1
- Primary expenditure	44.0	43.9	44.1	39.1	38.4	-5.5
of which:						
Gross fixed capital formation	6.8	6.8	6.0	3.2	3.4	-3.4
Consumption	17.0	17.3	16.8	16.5	16.0	-1.3
Transfers & subsidies	12.4	12.3	12.4	12.3	12.1	-0.2
Other (residual)	7.8	7.5	8.9	7.1	6.9	-0.6
- Interest payments	2.2	2.3	2.1	2.0	1.7	-0.6
Budget balance	-3.9	-2.0	0.0	1.3	1.3	3.3
- Cyclically adjusted	-4.5	-2.1	0.0	1.4	1.4	3.5
Primary balance	-1.7	0.3	2.2	3.3	3.0	2.7
- Cyclically adjusted	-3.1	0.1	1.4	3.9	3.8	3.7
Gross debt level	69.2	78.8	72.3	65.1	62.5	-16.3

Sources: Economic Reform Programme (ERP) 2020.

The stated goal of the fiscal strategy is to strengthen the long-term sustainability of public finances by means of budget surpluses and a significant public debt reduction. Fiscal consolidation is expected to rely on spending restraint, with the expenditure-to-GDP ratio falling by 6.1 pps between 2019 and 2022. A large part of this reduction is related to the completion of works on the first section of the Bar-Boljare highway. Government consumption is also decreasing steadily as a percentage of GDP. Other expenditure and tax revenue items are set to remain stable or record some slight nominal increase over the medium term, resulting in real declines over the programme period. The budget balance and the primary balance are projected to register the biggest improvement in 2020, boosted also by one-off revenues (see below). Overall, compared to the previous ERP, the fiscal targets are less ambitious, aiming at a balanced budget in 2020, instead of a 0.9% of GDP surplus, and a lower surplus of 1.3% of GDP in 2021, compared to the more ambitious goal of 2.9% in last year's programme. Still, the budget surpluses, in combination with GDP growth rates, are projected to drive the public debt-to-GDP ratio down rapidly, by more than 16 pps in 3 years.

In 2020, one-off revenues and declining capital spending are expected to offset current expenditure hikes. The central government budget for 2020 envisages a deficit of 1% of GDP, assuming real GDP growth of 3.4% and an inflation rate of 1%. Local government' budgets are planned to register an aggregated surplus of 1% of GDP in 2020, resulting in an overall balanced general government budget. Compared to the previous year, the 2020 budget plans for a nominal increase in both revenue and expenditure of some 4.5% of GDP each. The revenue side would be supported by a one-off increase in fees from the airport concessions as well as revenue from a citizenship-in-return-for investment programme. Higher revenue from VAT and social security contributions reflect the projected stronger economic activity and collection of tax arrears. As from 2020, the 'crisis tax' (an upper personal income tax bracket of 11% for above average wages), will be removed, leaving a single flat-tax-rate of 9%. Despite this, the ERP projects this tax to yield a slight revenue increase, thanks to sustained economic growth. The main expenditure savings will come from the capital budget, contracting by 0.8 pps of GDP over the year as the highway works end. However, several expenditure increases, totalling some 3.4% of GDP, are planned. These take the form of: (i) transfers to public institutions, pensions and public sector wages, (ii) postponed commitments from previous year highway works, and (iii) a significant boost in reserves and subsidies for investment and for consolidating the national air carrier.

Reaching a balanced general government budget in 2020 appears to be an optimistic target. The ERP's sanguine GDP growth forecast, if not realised, could compromise the revenue outcome. The planned 1% of GDP budget surplus from municipalities seems optimistic. On the revenue side, the expected payment of fees from the concession of the airports seems highly probable, given high investor interest following the conclusion of the preselection tender. Conversely, interest in the economic citizenship programme seems modest, and revenues from this initiative are likely to turn out lower than projected. On the expenditure side, the support to the national airline to pay its debt to the State would have a limited net impact. The 9% wage increase for health and education workers was included in the budget. However, an additional 4% increase was later agreed with health sector trade unions, which may increase spending by an additional 0.3% of GDP not provided for in the budget. Moreover, the lack of progress on the public administration optimisation plan, hindered by the absence of proper functional analyses and registers across the public sector, prevents savings on the wage bill in the 2020 budget. The programme mentions further efforts to reduce unproductive expenditure, but does not provide information on the possible budgetary impact. The effects from such consolidation efforts have proved rather modest in the past and may thus not yield significant budget savings in the future.

Box: The budget for 2020

Parliament endorsed the budget on 27 December 2019 after it had amended the government proposal by raising both revenue and expenditure by an additional EUR 66 million, or 1.3% of GDP, while maintaining the same deficit target.

The reason for the expenditure increase was the allocation of funds for investment in Montenegro Airlines (MA). This expenditure increase was offset with a similar increase in revenues. Half of the income revision corresponds to dividends from the state-owned electricity company and to Montenegro Airlines' repayment of debt to the national airports. The rest of the increase relates to the recovery of social security contributions, also from Montenegro Airlines.

Table: Main measures in the 2020 budget*

Revenue measures	Expenditure measures
• Airport concessions **(1.4% of GDP)** • Economic citizenship programme **(0.3% of GDP)** • Revenue from capital (dividends from EPCG and MA debt reimbursement to Montenegro Airports) **(0.9% of GDP)** • Collection of tax arrears from Montenegro Airlines **(0.5% of GDP)** • Repayment of loans from Montenegro Airlines to the State **(0.2% of GDP)** • Increase of excise rates on coal and tobacco **(0.1% of GDP)**	• Support to Montenegro Airlines **(1.7% of GDP)** • Public health and education wage increase **(0.4% of GDP)** • Transfers to institutions (health, education, transport, army) **(0.6% of GDP)** • Carryover from 2019 highway costs **(0.7% of GDP)** • Unproductive expenditure savings **(N/A)**
Total revenue effect (+3.4 % of GDP)	**Total expenditure effect (+3.4% of GDP)**

* Estimated impact on general government revenue and expenditure.
Source: ERP2020

The end of highway-related spending is expected to lead to budget surpluses. The programme expects a budget surplus of 1.3% of GDP in both 2021 and 2022. The main novelty on the revenue side would be the introduction in 2021 of the electronic monitoring of fiscal cash registers, which is planned to lead to higher tax revenue of some EUR 15 million per year. Other measures present in 2020 are to be maintained in the following years too, notably the regular increase of the tobacco excise rate, a further reduction of tax arrears in the context of the Law on rescheduling tax receivables, and the continuation of the economic citizenship programme. A new legislation on games of chance should enter into force in 2021, slightly increasing non-tax revenue. On the expenditure side, capital spending would plunge to some 3.3% of GDP per year after the conclusion of the first section of the Bar-Boljare highway in 2020. In 2021, a further 3% increase of salaries for education and health workers is planned. Overall, public spending is set to decline significantly, from some 46% of GDP in 2020 to 40% of GDP in 2022.

Although public debt is set to decline markedly, the pace of debt reduction is slower than assumed in the previous ERP. The public debt stock is now planned to decline to 65% of GDP by 2021, compared to 60% in last year's ERP. The main reason for this delay is the relaxation of the budget surplus targets compared to last year's ERP. Debt refinancing risks are low, as the use of accumulated deposits, together with a highway-related credit line with China, would cover financing needs in 2020 and 2021. However, there is a risk that part of these deposits might be used for other purposes than debt repayment. Currently, some 77% of the public debt is in euros. However, the drawdown of the Chinese loan to finance the highway construction adds each year between 2% and 3% of GDP worth of additional USD-denominated debt. To reduce the related currency risk, authorities are negotiating a hedging arrangement with a group of banks. Interest rate risk is also low, as 78.6% of the total debt has been issued at a fixed rate. Overall, the medium-term debt management strategy for 2018-2020 successfully addressed refinancing risks thanks to liability management operations, which took advantage of favourable market conditions.

Box: Debt dynamics

Stock-flow adjustments are largely dominated by liability management operations. In particular, the issuing of eurobonds in 2018 and 2019 boosted the gross public debt stock with the purpose of building government deposits to repay maturing debt in 2019 and 2020. The use of these deposits will reverse the sign of stock-flow adjustment in 2020 and 2021. Decreasing investment related to the highway will result in large primary surpluses as of 2020, further contributing – together with a favourable snowball effect – to debt reduction. Debt repayments in 2022 would require additional borrowing to close the financing gap, adding to 1.6% of GDP stock-flow adjustment.

Table :

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

	2018	2019	2020	2021	2022
Gross debt ratio [1]	**69.2**	**78.7**	**72.3**	**65.1**	**62.5**
Change in the ratio	5.9	9.5	-6.5	-7.2	-2.6
Contributions [2]:					
1. Primary balance	**1.8**	**-0.3**	**-2.2**	**-3.3**	**-3.0**
2. "Snowball" effect	**-2.9**	**0.0**	**-1.2**	**-0.7**	**-1.1**
Of which:					
Interest expenditure	2.2	2.2	2.1	2.0	1.7
Growth effect	-3.1	-2.1	-2.6	-2.0	-2.0
Inflation effect	-2.0	-0.1	-0.7	-0.7	-0.8
3. Stock-flow adjustment	**7.0**	**9.9**	**-3.1**	**-3.2**	**1.6**

[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.

Source: Economic Reform Programme (ERP) 2020, ECFIN calculations.

Fiscal plans are subject to sizeable risks. The matrix presents several risks, of political or economic nature. A less favourable external environment would have a negative economic impact, with knock-on effect on the budget. There are also additional risks associated with further delays in implementing the public administration optimisation plan, mounting fiscal pressures in the context of the electoral cycle, or the potential financing options (which include a public-private partnership scheme) for the next sections of the highway.

Box: Sensitivity analysis

The programme contains a sensitivity analysis of fiscal trends with respect to changes in key parameters based on the macroeconomic 'low-growth' scenario. According to this scenario, external shocks on investment and tourism would have a limited impact on public expenditure, given the high proportion of non-discretionary spending in the budget. However, external shocks would have almost no impact on the revenue side in 2020, due to frontloaded one-off measures. Nonetheless, the low-growth scenario seems to overestimate budget revenue in 2021 and 2022, which appear implausibly higher than in the baseline. The robustness of the country's fiscal position is undermined by the downwards revision of budget and debt targets compared to last year's programme.

There is room to improve the quality of public finances by developing a more growth-supporting structure of spending. However, the 2020 budget saw further increases in salaries and corporate subsidies. The government justifies the wage increase, primarily in the education and health sectors, by the need to improve human capital and contain the brain drain. However, compared to peer countries, Montenegro's public sector wage bill is relatively high, pointing to underlying inefficiencies. Overall, while wage increases for certain professions may well be justified, the need to contain the public sector wage bill to GDP ratio calls for rapid implementation of the public sector optimisation plan, embedded in a wider public administration reform based on functional reviews and a systematic overhaul of the public sector wage system. Unfortunately, so far those reforms have progressed slower than expected. Initial reform plans to contain pension expenditure (the second largest item in the budget) have been put on hold.

Montenegro's budgetary framework keeps making slow but steady progress. Several projects are being implemented in an attempt to align the draft 2021 budget with medium-term planning and capital budgeting practices, in line with EU standards. Work is ongoing to introduce accrual accounting in line with ESA2010, but progress is slow. For the first time since the introduction of fiscal rules in Montenegro in 2014, the general government cash deficit was in 2019 lower than the 3% of GDP threshold. However, reducing the public debt below the 60% of GDP cap is not expected before 2023. An options paper on establishing an independent body for fiscal oversight (i.e. a fiscal council) was adopted by the government.

4. Key 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 offering significant opportunities for further growth. 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) improving labour market outcomes, (ii) strengthening the regulatory environment and (iii) formalisation of the economy. This assessment therefore focuses on these three challenges.

Montenegro also needs to tackle corruption, improve the rule of law and strengthen institutions in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for a successful transformation of the economy. The Commission is closely following the issues of strengthening the rule of law and fighting corruption in the annual Montenegro report.

Key challenge #1: Improving labour market outcomes

Low labour market outcomes in Montenegro encompass several aspects of the labour market that undermine potential growth and living standards. Addressing structural challenges on the labour market requires effective design and implementation of employment measures, linked with interventions in education and social policies. Despite moderate economic growth, the labour market in Montenegro continued to improve compared to the previous year. The unemployment rate (15-74) continued to decrease (15.2% in Q3 2019), but remains more than double than in the EU-28 (6.3% in Q3 2019). The employment and activity rates (15+) remain very low at 50.9% and 60% respectively (Q3 2019) both compared to the EU-28 and the Western Balkan region. An estimated 33% of workers engage in undeclared work (UNDP, see key challenge 3).

Women, youth and vulnerable groups such as the low skilled remain most vulnerable groups and need better employment assistance and activation. The gender employment gap has not improved. The employment gender gap stood at 13.7 pps in Q3 2019. This is partly due to women's traditionally lower presence on the labour market, past disincentives for women to work, and the burden of child and family care.

The situation for young people has improved, but remains challenging as reflected in the high youth unemployment rate (22% in Q3 2019) and the very low employment rate (33%). This reflecting is above all the persistence of a skills mismatch and difficulties with entering in the labour market. Long-term unemployment continues to represent the majority of overall unemployment (80%) and the low skilled have the highest chance of becoming inactive. Geographical disparities are large and disproportionately affect the northern region (the unemployment rate in the northern region is up to nine times higher than in the coastal region). At the same time, the Coastal region relies heavily on tourism sector and seasonality.

The labour market struggles with low transitions to and from employment. The labour market requires increased flexibility and effective action to fight undeclared work (see key challenge #3) in order to improve transitions to and within formal labour market. The persistence of the informal sector is also linked to stricter labour market regulation; it affects mostly the young, the low skilled and older workers. The new labour law, adopted in December 2019, introduces greater flexibility and brings the Employment Protection Index for Montenegro closer to the OECD average (World Bank Montenegro Second Fiscal and Financial Sector Resilience PBG, 2020). Its monitoring will be crucial to see the desired outcomes and adapt solutions. So far, a monitoring mechanism is still pending. There have been limited changes to labour taxation. *Reform measure 17 (Adoption of the National Employment Strategy for the period 2021-2024)* in the ERP is relevant when it comes to setting a stronger and comprehensive framework to tackle key structural challenges on the labour market. This will involve in particular integrating the principles of the European Pillar of Social Rights and focusing on the implementation of the new labour legislation.

The skills mismatch continues to be a key challenge for labour market integration. It affects both those with secondary and higher education attainment and is a result of high levels of transition from VET to higher education programmes, enrolment in less labour market-relevant programmes, as well as overall insufficient quality of education programmes. An important step was made towards a more labour-market driven provision of skills training by implementing dual education. However, more efforts are required to enhance tracer studies and to address mismatches between education and skills.

Increasing performance in primary education is key to improving the performance of students in higher levels of education. The 2018 OECD PISA report showed limited progress; Montenegro's performance average compared with its regional peers. The occupational mismatch (i.e. over qualification) is higher for those with tertiary education (ETF 2019). Adult education programmes and up- and re-skilling measures are included in active labour market policies (ALMPs), but they are insufficiently targeted and their design is not appropriate to meeting the goal of getting jobseekers into employment and equipping them with relevant skills. Considering the very high level of long-term unemployment, such measures are essential for getting this category of workers into the labour market.

The number of enrolled VET students in dual education continued to grow rapidly. It reached 848 students in the 2019/2020 school year (compared to 277 in the first year of enrolment for the programme in 2017/2018). The decreasing number of those enrolled in third year could correlate to the requirement for employers to pay student wages in this grade. There is a lack of quality and transparency standards for employers delivering practical training. The majority of in-company trainers do not have the sufficient pedagogical training. Around half of employers consider that the dual education programme fully matches their needs and those of the labour market. Around 50% of those who finish the dual education programme find employment, but in absolute numbers this means only 26 students. In this context, *reform measure 15 "Establishment of a system of continuous monitoring of the quality of practical education at employers"* in the ERP is relevant to the goal of improving education outcomes and contributing to the transition from school to work in VET.

Practical learning was introduced in higher education in its third year of implementation. A comprehensive monitoring mechanism has yet to be defined to assess impact and results. Implementation of the programme of professional training for higher education graduates continued with a significant rate of graduate retention in employment, mostly in the private sector.

Active labour market policies (ALMPs) are still not adequate to help jobseekers find sustainable employment, and employment activation remains weak. Comprehensive monitoring and impact assessment of effectiveness of ALMPs has been absent for years, and it is not clear what the revised legislation introducing new ALMPs would bring. The public employment service's capacity for job mediation and implementing ALMPs is also weak as it is its capacity to provide sufficient tailor made and targeted services.

Reform measure 16 (Increased participation in the labour market, particularly of sensitive groups of unemployed persons) aims to target groups vulnerable on the labour market and improve provision of ALMPs by implementing new legislation adopted already in 2019. It is uncertain, however, what this measure's practical will be in terms of improved quality of ALMPs, particularly those intended to improve the skills of the unemployed. The expected number of participants in these programmes will be reduced due to lower funding.

The public employment services and social work centres have started developing individual activation plans, but their impacts have been limited and are insufficient to tackle structural challenges. The piloting of a welfare-to-work programme to support the activation of young people is planned with the ILO. A planned review of the social protection in collaboration with Unicef has potential to strengthen both activation and social protection and inclusion. The non-transparent and complex provisions of social benefits and services, combined with widespread undeclared work, may create disincentives for people to work and contribute to high inactivity and low formal employment. However, the review is not included as a measure in the ERP.

Employment remains the best exit out of poverty and the best chance to improve the social situation of the population. The at-risk-of-poverty rate is the lowest for employed people (6.1% in 2018) while almost half of the poor are unemployed (47.5%) though both have increased somewhat. This is why activation and employment support are ever more important when it comes to improving the social situation. Satisfaction with living standards in Montenegro is substantially lower than in the EU, as almost 60% find it difficult to make ends meet. In addition, the number of respondents who are not able to afford basic items is twice as high as in the EU (Eurofound 2019). The risk of poverty is higher in the northern region. On the positive side, the Gini equality coefficient decreased to 34.8% in 2018 (from 36.7% in 2017).

The social situation in Montenegro has been stagnating after some improvement. The average disposable income increased by 2.6% in 2018 and amounted to €353 per month. Child poverty continued to increase to 32.4% in 2018, while the rate of young people (18-24) at risk of poverty decreased by 2.8 pps (25% in 2018). However, the poverty line also rose in 2018, reaching €189 for a single person and €397 for households with four members. The at-risk-of-poverty rate remained almost stagnant (up slightly by 0.2 pps) at 23.8% in 2018, while the rate of those at risk of material deprivation only decreased marginally (by 1pp) at 12.9%. The share of low wage earners is high in Montenegro, and wage distribution is highly condensed close to the minimum wage at €222, which was raised by 15% from €193 in July 2019.

Short working lives and increasing old-age dependency are putting pressure on the labour market and the pension system. The employment rate of older workers (55-64 years) improved to 53.5% (Q3 2019), though inactivity for this age group remains very high at 42.2%. The average duration of working lives in Montenegro is low at 30.5 years. Dependency ratio was 1:1.73 in December 2019. The replacement rate is around 55% and the average pension stands at around €288 per month. There have been no reforms to the pension system. The share of persons who report difficulties to making ends meet is highest among those aged 65+ (Eurofound 2019).

Reform measure 18 (Development of day-care services for the elderly) aims to improve the social situation of the elderly. However, its scope has been too limited to bring broader impacts.

Social dialogue remains weak in Montenegro, in particular in the private sector. The Social Council meets regularly and there have been efforts to improve social partners' capacities in cooperation with the ILO. Nonetheless, the level of trust and meaningful dialogue remain limited. Social partners' actual contribution to the design and implementation of legislation and policies, including the ERP, remains weak. Stronger functioning of social dialogue could contribute to improving the design and implementation of relevant policies and legislation to address this key challenge.

Key challenge #2: Strengthening the regulatory environment

Improving the institutional and regulatory environment in Montenegro requires a long-term commitment from the state and local authorities. The government has taken in the past years a number of initiatives to improve the business environment, reduce overall administrative burdens and support businesses. Despite this progress, as seen by investors and businesses, has so far been limited. Businesses complain about inconsistent and arbitrary interpretation and enforcement of the law by public authorities, lack of proper public consultations and insufficient transparency in decision-making. Other complaints refer to inefficiencies and delays when dealing with administration, as well as the excessive complexity and administrative burden of local taxation and para-fiscal charges. Companies underline that these deficiencies lead to unpredictability in the regulatory environment at central and local level and hold back Montenegrin economy.

Routine administrative relations between the business community and authorities are not centred on the needs of businesses. Conducting business is often undermined by the slow pace of administrative responses or lack of deadlines for some administrative procedures. The authorities seldom provide a rationale or feedback behind decisions affecting businesses, and when such decisions are questioned the authorities tend to invoke business secrecy rather than provide free access to information to the interested party. On top of this, there are regular reports of conflicting interpretation of laws between different decision-making authorities, between the state and municipal level, and between local authorities.

Policy guidance 4 (PG4), agreed by the EU and Montenegro in May 2019, invited the authorities to develop 'publicly available guidance on the practical implementation of each law that affects the business environment' and 'ensure consistent application of the provided guidance' by different public bodies. The government has requested expert assistance for this task; the guidance is to be developed by the end of June 2020. However, no guidance is planned on already existing laws and no measures have been taken yet to ensure a consistent application of the laws by different authorities, including at local government level. So far, the Ministry of Finance provides guidance to other ministries when a new law is adopted.

Public consultation processes would benefit from a more inclusive and stakeholder-oriented approach. Many legislative proposals require effective and proactive communication strategies targeting the stakeholders from the outset. Inclusive public consultations should be carried out early enough in a legislative procedure. Businesses and the organisations representing their views are natural partners of the public authorities; their input is necessary to assess the impact of new laws and regulations on the economy. However, public debate appears to be often restricted in scope and time, resulting in very limited feedback from the business world and social partners. Consultation processes tend also to be formal, focusing on procedures rather than the substance. The authorities' low responsiveness, insufficient transparency and lack of continuous engagement in the public debate processes is another issue to be addressed.

Businesses are also affected by the lengthy processes related to the adoption of secondary legislation. Frequent delays between the time of adoption of primary laws and their implementing legislation are another source of instability and erratic decisions by the public administration at the central and local level.

In 2019, the government of Montenegro made efforts to improve the quality of public consultations in some key areas, for example in preparing the 2020-2022 ERP and in the public debate on the labour law. Still, consultations in other relevant areas, such as e-fiscalisation and public procurement law raised criticism among businesses and social partners due to a lack of responsiveness and regular communication on the part of the government. The practice of consultations seem to differ not only between ministries and administrative bodies but also depending on the topic discussed. Therefore, it is too early to note a significant qualitative change in this field.

The area of public procurement and concessions is undergoing significant transformation. Efficient, competitive, transparent and non-discriminatory public procurement procedures are an integral part of a business-friendly regulatory environment. Public procurement in Montenegro amounts to 11-12% of the country's GDP and is generally working, although, as noted in the European Commission country reports, some weaknesses are evident in the preliminary selection procedures and in particular in the remedies (appeals) stage. The ongoing, high-profile airport concessions tender is seen as a test of the government's capacity and willingness to act in accordance with the EU standards.

Gradual improvements to procurement procedures are expected to result from the new public procurement and public-private partnership laws, as well as the concessions law, adopted in December 2019. However, the laws still need to be supplemented by the relevant secondary legislation, which would likely delay the implementation stage. The proposed ERP *reform measure 6 (Implementation of new regulatory framework for public procurement and public-private partnership policy)* addresses this area. The measure is appropriate and credible, but it is only in the early stage of development. It requires further work and focus on desirable outcomes, beyond the immediate adoption of the secondary legislation and of a new strategy in 2020. The intended outcomes are not reflected in the design of result indicators, which focus on the administrative processes and outputs. The planned activities, while important for capacity building and institutional planning, will also not automatically result in successful implementation and improvements for businesses and make the economy more competitive. Potential risks are yet to be elaborated. Overall, the practical implementation of the new legal framework by public procurement officers and contracting authorities is the true key to the success for this measure.

The legal changes are also essential for the rollout of the electronic procurement system, which is expected in 2021. The e-procurement system should provide an answer to a long-standing complaint of businesses about the ease of access to the information on tenders from all contracting authorities. It should also improve the procedures' transparency. The proposed *reform measure 7 (Introduction of electronic public procurement system)* is credible, appropriate and expected to contribute to the increased transparency of public procurement processes in Montenegro. On the technical side, potential risks for the project are not sufficiently described (in particular as regards the training for businesses and possible migration delays). As for the measure on public procurement, discussed above, practical implementation by public procurement officers and contracting authorities will be the key to the success of the project and its ultimate impact on the country's competitiveness and long-term growth potential.

Local taxation, transparency and the fairness of the State as a regulator should remain in the focus of authorities. While the income tax for companies at state level remains low at a rate of 9%, local government taxation is seen as a major obstacle for investment in Montenegro. Taxation's legal framework is based on at least 10 different laws, adding complexity. According to the Montenegrin government, there were 659 different taxes, fees and charges in Montenegro in 2017. This leads businesses to perceive the system as arbitrary, unpredictable, confusing and non-transparent. Planning the payment of tax commitments remains notoriously difficult due to the frequency of payments and legislative changes, making this another area for improvement.

Moreover, the business community is questioning the general tax implementation, denouncing tax discrimination between local and foreign-owned companies, and between small and large companies, citing the government's leniency towards some large local debtors. Financial advantages, subsidies or aid provided to some enterprises increase the perception of unequal treatment and unfair advantages enjoyed by politically connected businesses. In particular, the recent *lex specialis* on Montenegro Airlines is bound to have long-lasting negative effects on the perception of the regulatory environment and on the perception of the State as an unfair regulator.

The laws on administrative fees and on local communal fees, adopted in March 2019, aim to simplify, restructure and reduce some of the local fees and charges. This constitutes the first effort in years to simplify and harmonise business taxation. Some 7% of administrative fees have been abolished, another 11% reduced and 9 out of 12 legal bases for setting local communal fees have been banned, while maximum caps for fees have been introduced for the remaining 3 legal bases. However, the implementation of these new laws by municipalities is delayed. By the end of 2019, less than 30% of 24 Montenegrin municipalities adapted their fiscal systems to the new legal requirements. Even after the reform is finalised, the number of fees and para-fiscal would remain significant.

The development of transactional electronic government services is a way to support Montenegro's regulatory environment. The digitalisation of the public sector can greatly enhance the business environment, in addition to the obvious gains in efficiency and transparency of relations between businesses and public authorities relations. Ongoing efforts to set up e-registration for businesses, e-cadastre and introducing full e-procurement procedures are prime examples of the potential for change. The implementation of e-government services for businesses could also lead to a significant reduction in possibilities for corruption and the unequal treatment of different businesses.

Overall, the Montenegrin authorities, following publication of the Commission ERP assessment in 2019, have undertaken a number of actions to improve the business environment. However, the impact of these changes is expected to become more tangible only within the next few years, provided the implementation of the different actions does not lag behind. Discretion and inconsistencies in interpretation and implementation of laws will need to be addressed more forcefully. An independent, efficient and effective judicial system will be key for creating and maintaining an attractive business environment.

Key challenge #3: Formalisation of the economy

The informal economy is estimated to account for around 30% of GDP. Informality has many different causes and is closely linked to other key challenges discussed in this document. Montenegro's sizeable informal sector is fuelled by deficiencies in the institutional and regulatory environment, weaknesses in the labour market, insufficient enforcement capacity of the public authorities, corruption and high tolerance for tax non-compliance. Another layer of complexity is added by social and cultural factors, low awareness of the negative societal impacts of the informal economy and the high importance of extended family links and personal connections, as these tend to increase the acceptance and willingness to engage in informal or undeclared work, economy and informal transactions.

Yet another dimension of informality could be traced to the Montenegrin diaspora and large remittances flowing to the country through formal and informal channels. These payments support family incomes, which could partly explain the very high level of cash transactions in the economy, and fuel a largely informal market in housing construction and renovation.

Policies aimed at reducing informality need to be broad and comprehensive due to the diverse causes of the phenomenon and the complex relationship between labour market structures, the institutional and regulatory environment, taxation, social policies and cultural factors. They need to create incentives and conditions for the formalisation of businesses and labour, apply strong disincentives and sanctions for those economic operators that remain in the informal sector and unfairly compete with legitimate businesses and act decisively in order to close any gaps in the legal and institutional system that are subject to abuse. The authorities need to employ a wide spectrum of different instruments to combat informality effectively.

The high level of informality in the economy has far-reaching consequences. It hinders the efficient allocation of state and business resources, reduces the revenues of companies and of state and local budgets, 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 SMEs and microenterprises, which dominate the economy. The smallest companies, which constitute over 90% of Montenegrin businesses and serve the local market, perceive informal competition as the most costly obstacle for doing business. An equally important concern is that the costs of informality and corruption are higher for innovative companies.

The presence of informality is also reflected in the labour market. Informal or undeclared work is estimated at some 30% of employment (UNDP). Employment is under-reported in the tourism sector and agriculture. The labour taxation system and structural challenges on the labour market may create disincentives for formal employment, with adverse implications for informal workers, the budget and the social security system. The new labour law, adopted at the end of 2019, is also expected to have a positive longer-term impact on informality and undeclared work by improving flexibility on the labour market and improving formal employment.

Reducing the scale of the informal economy has become a priority for the government. An action plan to combat the grey economy was initially adopted in 2017, and a Government Commission for the Suppression of the Grey Economy, chaired by the deputy prime minister for economic policy, was appointed in 2018 to better coordinate different actions, encourage cooperation between government bodies and assist local authorities. The Commission includes representatives of the Ministry of Finance, the tax administration, customs administration, police administration and administration for inspection affairs. Its work focused so far on checks and suppressive action on businesses through different inspection services, with the focus on the tourism sector and undeclared work.

One of the weakness in the current approach is the legal framework, which does not allow inspectors or other state agents to enter the private premises of individuals or suspected unregistered businesses unless there is evidence of criminal activity. A new law on inspections has been prepared to address this situation, but is not yet adopted. On top of this, the institutions responsible for enforcing the rule of law and competition continue to suffer from limited capacity, which means that even detected informal business practices continue largely unchallenged. Furthermore, the existing action plan does not even consider preventive and educational action that could be used to target micro and small enterprises. Moreover, the plan does not allow for assessment and monitoring of the tax gap resulting from informality and does not provide the necessary tools to analyse, monitor or react to developments in the informal economy.

In order to step up efforts to reduce informality, the 2020 ERP features a new *reform measure 8 (Enhancement and implementation of measures for suppression of informal economy)*. This measure is also in response to policy guidance 5 (PG5), agreed by Montenegro and the EU in May 2019. However, the measure is at an early stage of development, lacks a proper description, has considerable gaps in its analysis, and offers no choice of intervention areas and details at this stage. While the measure lacks details and any substantial analysis behind it, once implemented it seems at least to have potential to impact on informality and the competitiveness of the economy. However, given the lack of concrete information, the scale of this impact is not possible to predict at present. The bulk of planned activities for 2020-2021 focus on internal reorganisation and rethinking the approach to informality, while implementation of concrete actions (still to be clearly defined) is only due to start in earnest in 2022. The result indicators do not seem to be correctly developed and it is not clear on which basis they were selected. There is also no budget indicated for any activities in the 2020-2022 period.

The fight against the informal economy requires sustained efforts and planning to achieve tangible results. The government action plan to fight against informality still requires updated and more concrete actions to better coordinate the efforts of different institutions at central and local level and to address additional areas that could contribute to reducing informality, for example actions incentivising the use of electronic payments. Other important aspects of informality that require the government's attention relate to closing the gaps and inconsistencies in the law that facilitate the development of informal activities. This can often be achieved through the public sector's use of IT and electronic services, an action referred to under the key challenge on strengthening the regulatory environment. In this context, the government carried out three important initiatives in 2019. The first of these was the introduction of new excise duty stamps supported by smartphone applications allowing for online verification of authenticity of excise goods. The other two were e-fiscalisation (supporting proper taxation of all cash register transactions) and the tax administration's introduction of an integrated revenue management system (IRMS).

The latter two projects are being developed under the proposed reform *measure 9 (Suppression of informal economy by reforming tax administration).* Once implemented, this measure could contribute significantly to raising the country's competitiveness and long-term growth potential. The reform of tax administration and establishment of a highly automated tax system should lead to increased transparency in the payment of due taxes, and thus reduce the space for informal economy practices. However, while the measure is generously funded, the benefits for the state and local budget have not been estimated and quantified and their timeframe is unclear. Some elements of the planned reform measures require further clarifications and analysis, e.g. the planned introduction and role of the tax police. Furthermore, the plans seem to underestimate the risks involved, in particular the potential for delays and the complexity of introducing both e-fiscalisation and IRMS. Implementation of e-fiscalisation initiative has already been postponed until at least 2021.

At the same time, reducing unfair competition and informality is heavily dependent on the successful implementation of reforms to the labour market and regulatory environment, as these address the some of the most pertinent causes of informality. Progress is also dependent on: (i) improving the capacity of, and cooperation between, local and state bodies, which is currently too limited; and (ii) taking a more systematic approach, including better estimations of the size and dynamics of the informal economy. Reliable monitoring and assessment tools are still to be developed to address the challenges posed by the informal economy.

In summary, the Montenegrin government undertook several important steps in 2019 to reduce informality in the economy and, importantly, recognised the need to address the diverse causes of this phenomenon by initiating some reforms in the institutional and regulatory environment. Nonetheless, progress achieved in this area is so far difficult to measure. Many of the described actions are yet to be implemented, while legal changes are still to be adopted. The impact of changes that have been already made is to a very large degree dependent on their proper and steadfast implementation over the coming years and on the determination of the public authorities to enforce the new rules through administrative and judicial means.

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 for the benefit of citizens in the EU. Since the 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 those of the EU.

Montenegro faces challenges with regard to a number of indicators of the Social Scoreboard[1] supporting the European Pillar of Social Rights. This is the case for equal opportunities and access to the labour market. While improvements in employment and unemployment rates have been maintained, structural challenges on the labour market persist, such as low activity, high long-term unemployment, gender gaps and regional disparities. There has been some improvement in recent years as regards the share of young people (15-24) not in employment, education or training (NEETs), even though the figure remains well above the EU-28 average (16.2% in Montenegro v. 10.5% in EU-28).

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	Worse than 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 15-64)	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, improving
	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, no change
	Individuals' level of digital skills	Worse than EU average, trend N/A

High youth unemployment, significant gender gaps and a high share of the low-skilled in inactivity, coupled with a high incidence of undeclared work, point to weak transitions within and into employment. The adoption of the new labour law aims to increase labour market flexibility and contribute to reducing of undeclared work. Skills mismatches and weak provision of adult learning affect school-to-work transitions and result in insufficient adaptability of workers to find appropriate and sustainable employment.

Employment remains the best way out of poverty. The social protection system is not well equipped to target and assist those in need. In addition, it is insufficiently linked with labour market activation to encourage and facilitate employment. The country's demographic structure puts pressure on both the labour market and the pension system. Relatively high inactivity and low employment rates highlight the need for supporting longer working lives.

Collection of timely and reliable data needs to be sustained and strengthened. The results of the first Statistics on Income and Living Conditions (SILC) survey from 2018 were updated in 2019. Efforts should continue to harmonise the employment and social statistics even further with EU standards and send them systematically to Eurostat.

[1] 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, with one small adjustment for the age bracket for the unemployment rate (reducing the upper age bracket to 64 instead of 74 years) due to data availability. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around the EU-28 average, generally 2018 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2016-2018 are used and can be found in Annex A.

5. Overview of the Implementation of the Policy Guidance Adopted at the Economic and Financial Dialogue in 2019

Overall: Partial implementation (39.7%)[2]

2019 policy guidance	Summary assessment
PG 1:	There was **limited implementation** of PG 1:
Use windfall gains, such as proceeds from privatisation and airport concessions, to accelerate the reduction of the general government debt ratio.	1) **Limited implementation:** The concession of the airports did not take place yet. The 2019 budget recorded some EUR 14 mn from privatisation and sale of property. However, there is no reference to the share of privatisation or concession revenue allocated for debt reduction.
Broaden the tax base by introducing an electronic fiscal invoice system.	2) **Partial implementation**: In July 2019, the Parliament adopted the new Law on fiscalisation for transactions in products and services, enabling the introduction of an electronic fiscal invoice system. However, the law was amended, postponing its implementation to January 2021.
Reduce the public sector wage bill as a share of GDP by fully implementing the public administration optimisation plan at the central and local self-government level, including a system of centralised payroll calculation.	3) **No implementation:** The targets in the public administration optimisation plan were missed, and there were no wage bill savings in 2019. However, the project to establish centralised payroll calculation started in December 2018. The first version of the system should be tested during 2020.
PG 2:	There was **partial implementation** of PG 2:
Reinforce fiscal governance by introducing medium-term budgetary planning and programme budgeting.	1) **Partial implementation:** A project started in 2019. In 2020, preparation of the 2021 budget should formally introduce multi-annual (3 years) budgeting. The key elements of programme budgeting will be introduced gradually.
Advance the reduction of arrears at local level, including those of municipal companies.	2) **Partial implementation:** The Law on rescheduling of tax receivables was adopted to secure the collection of tax arrears. In 2019, under this programme, the tax administration recovered EUR 6.3 million from municipalities (public companies and institutions).
Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultation with stakeholders, including the EU.	3) **Full implementation:** The options paper was prepared in December 2019.
PG 3:	There was **partial implementation** of PG 3.
Strengthen efforts to resolve the remaining stock of non-performing loans, including those held outside the banking system, and address obstacles hindering resolution outside the responsibility of the central bank.	1) **Partial implementation**: Non-performing loans resolution is continuing facilitated by central bank measures. However, a holistic approach to facilitate resolution of non-performing debts, particularly encompassing areas outside the supervisor's remit, is lacking.
Conduct a comprehensive asset quality review of the financial sector in line with international best	2) **Partial implementation**: Preparations for launching the asset quality review by May 2020 are

[2] 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.

practices and publish the results. Closely monitor risks related to the consumer loan segment, deploying appropriate micro- and macro-prudential policy tools if needed, and consider measures to bolster the resources at the disposal of Montenegro's deposit insurance fund.	ongoing. 3) **Substantial implementation**: Macro-prudential measures against the riskiest forms of consumer lending have been deployed and the deposit insurance fund is in the process of being fortified.
PG 4: Improve the regulatory environment by developing publicly available guidance on the practical implementation of each law that affects the business environment. Ensure consistent application of the provided guidance.	There was **limited implementation** of PG 4. 1) **Limited implementation:** The government has agreed to expert support to develop guidance on the practical implementation of legislation affecting the business environment. The guidance is to be developed by end-June 2020. However, no guidance is planned for already existing laws. In the interim period, the Ministry of Finance provides guidance to other ministries when a new law is adopted. 2) **No implementation:** While guidance is provided to the different ministries, no particular mechanism exists to ensure that it is applied, in particular by local government.
PG 5: Develop a comprehensive strategy providing reliable benchmarking tools allowing for the continuous assessment and reduction of the informal economy, including undeclared work. Ensure close cooperation between central and local authorities to reduce the informal economy. Adopt and implement the new legislative framework on public procurement, public-private partnerships and concessions.	There was **limited implementation** of PG 5. 1) **Limited implementation.** The government recognised the necessity to develop a more comprehensive strategy on informality on the basis of existing action plan from 2017. However, the conceptual work has only just started and the strategy or revised action plan on the suppression of the grey economy is to be developed only during 2020. No progress has been made on the development of benchmarking tools. 2) **Limited implementation.** Cooperation between central and local authorities continues at the same pace and is so far limited to the exchange of administrative data. A framework for enhanced and strategic cooperation is to be included in the new strategy/revised action plan, but is yet to be developed. 3) **Partial implementation.** The public procurement law and a new public-private partnership law were adopted by Parliament in December 2019. However, the work on implementing legislation, including e-procurement, defence procurement and central purchasing, is still ongoing and expected to continue well into the second half of 2020. The implementation of new laws will start only in January 2021.
PG 6: Increase labour market participation, in particular for youth, women and the low skilled, by strengthening employment activation measures, including through better provision of upskilling and reskilling measures.	There was **limited implementation** of PG 6. 1) **Limited implementation**: Labour market participation of youth, women and the low-skilled has improved. However, the increase seems to be following the trend of general economic growth rather than being due to structural reform. There are ALMPs in place but they have not changed significantly in recent years and there is still no comprehensive monitoring and evaluation of their effectiveness. The impact of the new Law on mediation in employment is also yet to be seen.

Improve coordination between employment and social services.	ALMPs on acquiring qualifications and skills exist but their coverage is limited as they do not cover sufficient numbers of job seekers. 2) **Limited implementation**: The public employment service and centres for social welfare continue to implement a 'coordinated activation approach' through which they develop individual activation plans, but the plans' impacts are limited. An integrated database including data from the Ministries of Labour and Education, public employment service and social welfare centres is not operational yet. The Ministry of Labour plans a social protection review in cooperation with Unicef, but no further information is available. There are plans to pilot welfare-to-work programmes with the ILO in 2020-2021.
Establish a solid monitoring and evaluating mechanism on the implementation and results of practical learning at vocational and higher education.	3) **Partial implementation**: Enrolment in VET has been gradually increasing, though it has decreased for students in in their final year of studies. The ERP measure on education provides for establishment of a comprehensive evaluation mechanism for dual education in VET. Ther first evaluation of dual education system in cooperation with the ETF and the ILO has already taken place. The student tracer study has also not been finalised and the database monitoring students' labour market situation has not been set up.

6. ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2020-2022 ERP

Research, development and innovation

Public and private investments in research, development and innovation (RDI) are low. The RDI sector suffers from a low number of researchers and weak links between academia, research institutes and business. Only 2.2% of Montenegrin SMEs invest in R&D (compared to 22% at regional level) and over 90% of research staff are employed by the government and the higher education sector. With a rate of 0.37% of GDP invested in R&D (2017, last available data), Montenegro is unlikely to reach its 2020 target of 0.60% of GDP spending. By comparison, EU R&D spending in 2017 amounted to 2.07% of GDP.

On the other hand, the government is actively supporting development of an innovative ecosystem, most notably through implementation of its smart specialisation strategy (S3) – adopted in June 2019 – that aims to strengthen sectoral policies through innovation and science. Other measures include: (i) a programme of support to innovative start-ups and innovation initiatives through smaller-scale support schemes; (ii) support for pre-acceleration of start-ups; (iii) a collaborative grant scheme to engage young researchers and PhDs and (iv) support for intensive education and training programmes for professionals in S3 fields. Two new centres of excellence (covering food science and biomedical science) started operating in January 2020. Overall, statistics gathering in the R&D field remains an important issue to be addressed.

Measure 12: Improving the legislative and institutional framework for innovation

The measure to improve the legislative and institutional framework for innovation is one of three specific reform measures earlier envisaged in response to the obstacles identified in the area of research, development and innovation. The areas covered by the measure include development and adoption of an appropriate smart specialisation strategy (S3) (2019-2024) and action plan (2019-2020). Through this, the government confirmed its aspiration to build and strengthen a sustainable research and innovative system, which, if implemented effectively, could have a significant impact on the country's economic growth and development. The S3 assessment, undertaken by the Joint Research Centre, led to a conditional positive opinion from the European Commission (December 2019) and was accompanied by technical recommendations for follow-up. Changes at strategic level conditioned changes in the institutional framework for innovations. As a result, the government established the Council for Innovation and Smart Specialisation, presided over by the Prime Minister, as a first step in establishing the coordination of innovation policies. The Council's role includes proposing a national S3 implementing body ('innovation fund') through amendments to the Law on innovation activities, while a new Law on incentives for research and innovation development is also being prepared. The adoption and application of both laws is expected by end-2020. The timely implementation of these activities, including the use of expert support on new legal solutions, is highly important.

Measure 13: Improving the system of support to innovation and strengthening human resources

This measure covers financial support for innovation and the strengthening of human resources to implement activities in this area. As in previous years, the measure envisages appropriate grant support, with focus on: (i) the development of technological innovation; (ii) integration of stakeholders into the innovation system, especially scientific research institutions, and (iii) the economy. New support instruments launched in 2018 also include grants for centres of excellence, doctoral research scholarships and support for post-doctoral students. All the activities envisaged in the following 3 years might have a positive impact on competitiveness. The Ministry of Science plans to evaluate the results of grant support to determine impact and effectiveness.

Digital economy

Access to broadband networks is seen as key to the further digitalisation of the economy. Montenegro's information society strategy set an ambitious goal of 100% household coverage with high-speed broadband (above 30 Mbit/s) by 2020. However, this has been delayed. Fixed broadband services, and in particular the optical fibre sector, show strong growth, but mainly in the larger towns. In 2019, 25% of households still had no internet access, with the figure increasing to 37% in rural areas. The process of mapping existing telecommunication infrastructure is ongoing since 2018 and will be completed only in 2020. 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 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, data protection and cyber security would also be advisable.

Measure 11: Enhancement of the legislative-regulatory framework and further development of infrastructure for broadband internet connection

This is a redrafted measure, building on the previous 2019 ERP reform *'Enhancement of legislative-regulatory framework in order to reduce costs of deployment of high-speed electronic communication networks'*. In principle, the new version refocuses on the development and, as of 2022, implementation of the national plan to develop the broadband internet connection and coverage of the population by next-generation access networks. The measure is certainly useful and supports balanced regional development, but in comparison with the 2019 ERP, finalisation of the national plan has been postponed until 2021, while planning and funding for the implementation has not been allocated and is planned only from 2022. This measure responds to policy guidance 4 of the Joint Conclusions of May 2018; Montenegro undertook to reduce the cost of high-speed broadband deployment (in line with the EU *acquis*), but to date no deadline has been set for completion of this task. Overall, the government's efforts to improve the legislative and regulatory framework and further develop broadband internet infrastructure are lagging further and further behind the initial plans, and there is no information on any substantial progress achieved over the last year. 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.

Investment activity

Public and private investment growth is slowing down as large infrastructure projects, including first section of the Bar-Boljare highway, are being completed. Public investments, which remained at record high levels in the past 2 years, are likely to decelerate further. Nonetheless, strategic investments in the priority sectors of the economy (transport, energy, agriculture and tourism) will continue at a more sustainable pace. Private investments focus mostly on hotel and tourism infrastructure in the coastal area. Efforts are being made to incentivise investment in the north of the country, including through the citizenship scheme.

Foreign direct investment slightly increased in 2019 and remains high in comparison to regional peers. The net inflow of foreign direct investment (FDI) into Montenegro rose to €344.7 million in 2019, from €322.5 million in the previous year. The FDI per capita indicator for the last 10 years averaged around 19% of GDP, while the EU contribution to FDI in Montenegro averaged 33% over the same period. FDI contributes significantly to Montenegro's current account deficit financing.

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 the country's integration in regional and European value chains. It will also help increase the attractiveness of the economy for FDI 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 young people, which is also important in light of the high youth unemployment.

Measure 14: Implementation of Measures for Trade Facilitation under WTO Trade Facilitation Agreement and CEFTA Additional Protocol 5

The measure focuses on the trade facilitation measures laid down under CEFTA Additional Protocol 5 and the 2018 national trade facilitation strategy. It was introduced in the 2019-2021 ERP (a more general measure existed already in the 2018-2020 ERP). The focus is on trade facilitation, i.e. (i) reducing the time and cost of customs clearance procedures; and (ii) better coordination between different involved administrative bodies, including information systems connection (between customs and different inspections). The measure is well defined and credible, with the potential to positively impact on the competitiveness of the Montenegrin economy. Its success and sustainability greatly depend on the improvement of capacities in the customs administration and on private sector flexibility when new procedures are introduced. The impact on the environment has not been assessed properly, as paperless clearance procedures will be introduced with the implementation of the new computerised transit system.

Energy

The energy market needs to improve its infrastructure and efficiency. 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. 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. The interconnection of the electricity network with Italy was established in November 2019 and contributed to the completion of the national electricity transmission ring, strengthening the robustness of electricity supply and setting the basis for extending it to neighbouring countries. Several wind, solar and hydropower projects are under way.

Measure 1: Enhancement of ownership and managerial structure of electric power companies with state-dominant ownership

While this is a rolled-over measure from the 2019-2021 ERP, it is still in an early phase of development, with gaps and weaknesess across the measure description. The initial sector analysis is weak and does not discuss main obstacles to growth and competitiveness in the energy sector, such as low energy efficiency. Links to national strategic priorities in the energy sector are not clear and not properly explained. Impacts of the measure and its effects on growth and competitiveness are also not demonstrated. Financial allocations for 2021 and 2022 have not been made, while for 2020 the funding source is unclear. The measure could possibly lead to improved competitiveness in the medium term (but not in the ERP framework). The need to analyse the organisational structure of the selected power companies is understandable for readers with background knowledge on the Montengrin energy sector. However, the strategic picture and links to wider objectives are not explained and the description of the measure does not demonstrate how it is relevant to the removal of barriers to sustainable growth and competitiveness.

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. 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, while ensuring sufficient funding for the current maintenance of rail and

road network remains an issue. Following the completion of the first section of the Bar-Boljare highway by September 2020, the government intends to perform a cost-benefit analysis and study financing for the next sections, but no decisions are expected in the next 2 years. Further steps are also needed to open the rail market up to competition. Ongoing tender for a concession to maintain and upgrade the country's two main airports in Podgorica and Tivat could address the issue of limited accessibility by air transport in the next few years. The efficiency of border-crossing procedures (and customs) is a related area where improvements are needed.

Measure 2: Enhancement of intercity scheduled passenger transport in road traffic

The measure's objective is to reform intercity road transport, which is currently performed by independent carriers. A study on improving scheduled intercity passenger transport by road will be conducted in 2020, while preparation, adoption and implementation of the relevant primary and secondary legislation is planned for 2021-2022. The measure is clearly in the early stage of development and the planned activities under this measure should largely depend on the results of the study. The measure is currently lacking clear targets and proper result indicators. Lack of a proper diagnostic of the entire transport sector in the ERP may lead to an incomplete or flawed assessment. The question of how to increase the number of passengers in scheduled passenger transport while reducing congestion, accidents and pollution should be answered before attempting further analysis. Links, synergies and trade-offs with other modes of transport, in particular rail, must also be explored. The possibility of introducing public service obligations must be duly considered to guarantee the provision of services of general interest, which are safer, of a higher quality or provided at lower cost than those that market forces alone would have allowed. The future role of the Ministry of Transport and Maritime Affairs as a contracting authority should be rethought. The expected positive impact on the environment does not seem ambitious enough. Therefore, a complementary policy measure could be established at national level to support the supply of clean vehicles through regulatory initiatives and incentives for the market introduction of environmentally-friendly vehicles.

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 €75 million to facilitate progressive modernisation in the next 3 years, mainly from EU funds. Agricultural land in use accounts for 18% of the country's territory, although 94% of such areas are pastures and meadows. Agriculture contributed 8.2% to the country's GVA in 2018 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 €500 million annually in imports and only €50 million in exports. Wine tops the exports list. Neighbouring Western Balkan countries, Serbia in particular, 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.

Measure 4: Support to investments in food production sector with the aim of boosting competitiveness

This is roll-over measure from the 2017-2019 ERP. However, the measure previously entailed only one component (support to food production sector to achieve EU standards through investments in the physical capital and manufacturing capacities of farms). Now a second component has been added, on the diversification of farms' economic activities (support to rural tourism and manufacturing of agricultural products directly on farms). The measure is relevant, appropriate, well embedded in the EU financing programmes (IPARD, IPA) and linked to national strategies. Nonetheless, a stronger link between this measure and the smart specialisation strategy priority on agriculture (innovative products, organic farming) would be needed: IPARD funds can be strategically directed towards support that is in line with development priorities (e.g. innovative products, opportunities for women and young people) and economic benefits (tourism market, 'craft' products, innovative products, export opportunities for e.g. ham, herbs). Result indicators should go beyond administrative output ('entities supported, funds paid') and report on the level of success of supported entities ('increase in profit, exports, increase in number of employees', etc).

Industry

Montenegro's industrial base remains modest and hampered by low product diversification and low labour productivity. Industry (with construction) made up only around 12.5% of GVA in 2018 and 17.1% of the workforce. New investments in energy and aluminium production (the country's top exports) aim to improve 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 micro and small enterprises.

Measure 3: Support to technological modernisation of the manufacturing industry

This measure, which has been part of the ERP since 2016, consists of two components. Component one provides financial support to investments in manufacturing equipment. Component two has been refocused in 2020 on energy efficiency measures in manufacturing industry. The description of the measure, despite its long presence in the ERP, still lacks important elements, which make assessing impact difficult or even impossible. While the first component is intended to contribute to the competitiveness of the industrial sector, the financing conditions are not specifically linked to delivering results in innovation, creation of new industrial capacities or export potential. The result indicators are focused on administrative output (number of supported enterprises, value of purchased equipment). The measure's expected impact on competitiveness and employment appears to be pure speculation under the current financing conditions and result indicators. The second component, which is being phased in from 2020, will add energy efficiency, which is welcomed. However, the measure does not make any reference to the smart specialisation strategy, even though the need for such a link would appear obvious. Energy efficiency indicators should be developed and results measured in terms of energy savings over total energy consumption.

Measure 10: Enhancement of support to micro, small and medium-sized enterprises

This measure has been part of the ERP since 2016. The measure appears relevant and can have a significant contribution to making Montenegrin SMEs and the entire economy more competitive and to stimulating economic growth. The analysis part should, however, establish a clear link to Montenegro's current 2019-2023 industrial policy and will need to be complemented by description of: (i) how to ensure that businesses spend grants for the purposes they were awarded; and (ii) how to gather and analyse feedback from SMEs on the programme results (financial/non-financial components). These changes will improve the scope of the measure and influence conditions for participation. The analysis should also clearly demonstrate what progress has been achieved in recent years. Another concern is that comments from last year remain valid and do not appear to be reflected in the measure's current iteration. The description of activities should provide better details per year, and the minimum completion rates for continuous activities should be added. Indicators mostly focus on output (number of grants, value of support) rather than on expected results and improvements for SMEs. New relevant indicators would be highly recommended (e.g. increase in exporting SMEs, increase in those that adopted international standards, new cooperation links created between SMEs, entry into new markets, increase in export activities, etc.) The issue of the measure's sustainability once financial support is discontinued in the future is not addressed.

Services

The services sector remains the most important sector of the Montenegrin economy, providing 72% 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 around 80% of total exports in 2018. Over 90% of the tourist capacity is focused in the coastal region. Spa and congress tourism are possible niches that could be exploited, which 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.

Measure 5: Diversification of tourism product

The measure on diversifying the tourist sector has been present in the ERP for the last 3 years, but this is the first time when it has been adequately formulated, with clear and targeted activities. The measure is now well elaborated, with a clear description of implementation and expected impacts, and should have a positive impact on the competitiveness of the key sector of Montenegrin economy. The measure has been also clearly linked with policy guidance 6 of May 2019 (related to increasing labour market participation, in particular of women, young people and the low skilled), and strategic documents such as the smart specialisation strategy (related to creativity and innovation of SMEs). Budgeting is focused on co-financing (subsidies) and mobilising local-level initiatives to make tourism in the north of the country more attractive. Performance indicators (e.g. number of tourists and overnight stays) establish a correlation with the expected impact on competitiveness, although the newly introduced result indicator on the number of projects is unclear. There is also a risk that activities planned within the ERP timeframe may be delayed due to slow tender procedures.

Education and skills

Despite some improvements and efforts to increase its quality and relevance, Montenegro's education system continues to show low performance. Investment in education continued to increase and amounted to around 4% of GDP in 2018 [and the number of enrolled students has been increasing at all levels]. The tertiary attainment rate of those aged 30-34 is steadily increasing, but at 20% it is below the EU average (40.7% in 2018), but among better performers in the Western Balkans. As for the rate of early school leavers, Montenegro continues to outperform both the Western Balkan region and the EU average (4.6% in 2018 and decreasing). See also key structural challenge 1.

Measure 15: Establishment of a system of continuous monitoring of the quality of practical education at employers

The measure is relevant for improving education outcomes and contributing to the school-to-work transition. It follows up on the previous measure "Implementation of apprenticeships with employers" which was fully in place in the previous year. The current measure focuses on dual VET education only, but it would be important to also focus on implementation of practical learning in higher education and to work towards tracing and data collection for all students. The 2020 activities are mostly preparatory activities that will serve later on when conducting the survey on the results of practical education.

Employment and the labour market

See analysis above in section 4 under key challenge #1.

Measure 16: Increased participation in the labour market, particularly of sensitive groups of unemployed persons

The measure targets relevant groups, namely youth, women and the low skilled, people with disabilities, and other hard-to-employ people. The measure should bring about comprehensive use of active employment policy measures tailored for the targeted groups. Such measures will include education and training programmes for adults, employment incentives, the direct opening of new jobs and incentives to entrepreneurship. However, the number of people targeted will be lower due to lower funding. So far, there is no system in place for comprehensive monitoring and review of the quality and adequacy of ALMPs.

Measure 17: Adoption of the National Employment Strategy for the period 2021-2024

The measure is relevant for setting stronger and comprehensive framework for tackling structural labour market challenges by integrating the principles of the European Pillar of Social Rights as the first country outside the EU and the sustainable development goals. The National Employment Strategy should take into consideration the performance assessment of measures and activities implemented under the previous strategy. In addition, the strategy's focus on the implementation of the new labour law is also very relevant considering the adoption of this important reform and needs to be prioritised and implemented rigorously. The preparation and adoption process will need to be accompanied by comprehensive consultation process and strong social dialogue. The strategy's timely and effective execution and its monitoring will be crucial for tangible results.

Social protection and inclusion

See analysis above in section 4 under key challenge #1.

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

The measure is a continuation from previous year and is a welcome effort towards improving the social situation of the elderly. However, as already assessed in the 2019-2021 Commission assessment, the scope of the measure is not sufficient for it to represent a structural reform measure to address the key social challenges and is too limited to have an impact on employment and competitiveness. The given measures provides for a decrease in the number of day care facilities to be opened during 2020 (only one) as compared to the two centres that were opened in 2019.

ANNEX A: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2018	2017	2016	EU-28 Average
Energy				
Energy imports dependency (net imports/consumption, %)	N/A	40.2%	34.7%	55.1% (2017)
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro GDP	300.26	329.78	326.84	117.69
Share of renewable energy sources (RES) in final energy consumption (%)	38.81%	39.71%	N/A	17.98%
Transport				
Railway Network Density (meters of line per km^2 of land area)	N/A	18.4	N/A	49.9 (2016)
Motorization rate (Passenger cars per 1000 inhabitants)	N/A	310	N/A	507 (2017)
Agriculture				
Share of gross value added (Agriculture, Forestry and Fishing)	8.2%	8.4%	9.0%	1.6%
Share of employment (Agriculture, Forestry and Fishing)	N/A	7.9%	N/A	4.0%
Utilised agricultural area (% of total land area)	N/A	18.6%	N/A	40.0% (2017)
Industry				
Share of gross value added	12.5%	11.3%	12.2%	19.1%
Contribution to employment (% of total employment)	9.9%	9.5%	9.8%	17.3%
Services				
Share of gross value added	72.3%	73.4%	72.1%	73.8%
Contribution to employment (% of total employment)	73.1%	75.0%	74.8%	71.9%
Business Environment				
Rank in WB Doing Business (Source: World Bank)	42	51	48	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	71	77	70	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	N/A	25% to 33%	Up to 37.2%	
Research, Development and Innovation				
R&D intensity of GDP (R&D expenditure as % of GDP)	0.36%	0.35%	0.32%	2,12%
R&D expenditure – EUR per inhabitant	27.3€	24.10€	20.60€	656.5€
Digital Economy				
Percentage of broadband penetration (Mobile and fixed)	69%	65%	N/A	86%

[NB: households]				
Share of total population using internet [NB: population 16-74]	72%	71%	N/A	85%
Trade				
Export of goods and services (as % of GDP)	42.9%	41.1%	40.6%	46.2%
Import of goods and services (as % of GDP)	66.7%	64.5%	63.1%	43.0%
Trade balance (as % of GDP)	-43.9%	-43.3%	-41.9%	
Education and skills				
Early leavers from education and training (% of population aged 18-24)	4.6%	5.4%	5.5%	10.5%
Youth NEET (% of population aged 15-24)	16.2%	16.7%	18.4%	10.5%
Formal child care - children aged less than 3 years (% of total)	34.13%	32.89%	28.9%	35.1%
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	N/A	50%	N/A	57% (2017)
Employment				
Employment Rate (% of population aged 20-64)	59.8%	58.2%	57.1%	73.2%
Unemployment rate (% of labour force aged 15-64)	15.5%	16.4%	18.0%	7.0%
Gender employment gap (Difference between the employment rates of men and women aged 20-64)	13.8%	13.8%	11.7%	11.6%
Social Protection System				
% of population at risk of poverty or social exclusion	31.4%	33.7%	34.6%	21.9%
Impact of social transfers (Other than pensions) on poverty reduction	23.8%	24.84%	17.24%	33.2%
Self-reported unmet need for medical care (of people over 16)	N/A	2.7%	2.7%	2.0%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	7.40	7.57	7.38	5.17

Source: EUROSTAT, unless otherwise indicated.

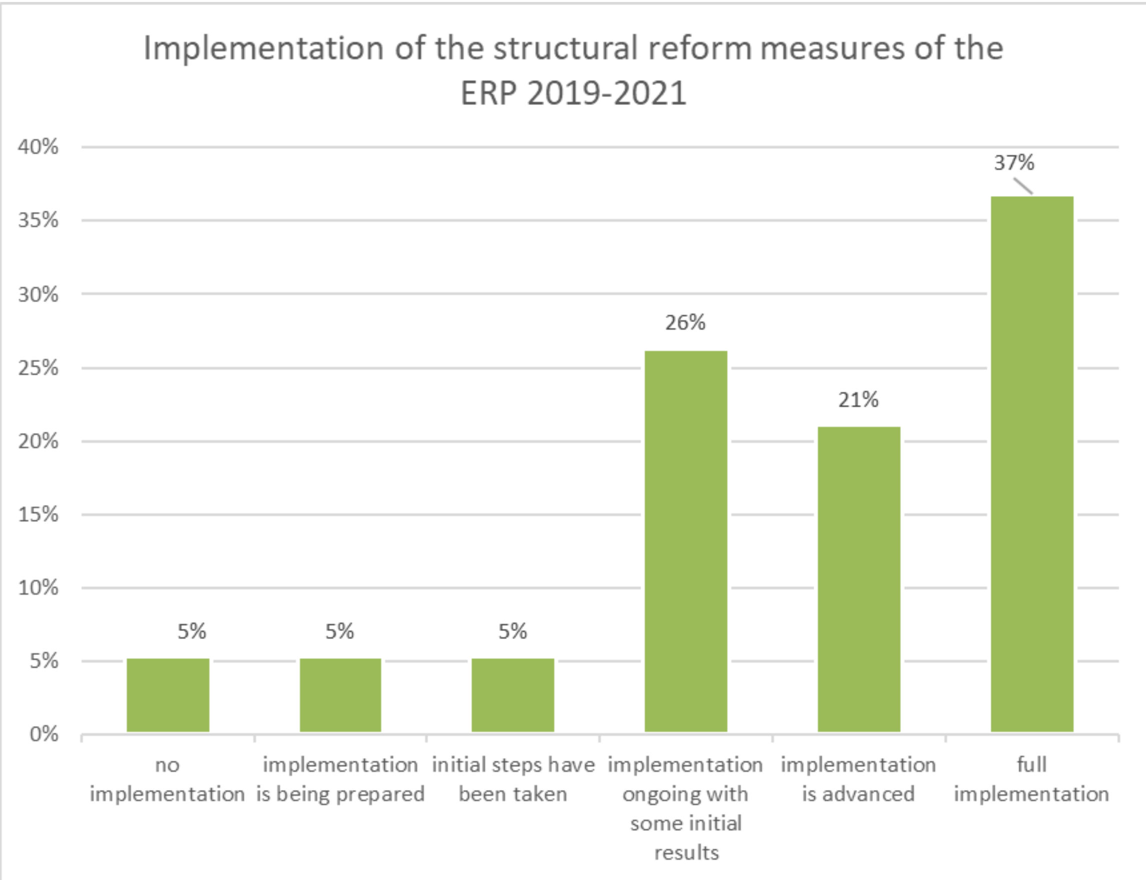
ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM 2019-2021 ERP

There was moderate progress on implementing the measures in 2019, with an average score of 3.7 out of 5. Reporting on the activities is mostly of good quality. Adjustment to the scoring was made for one of the reforms, based on the description of the implementation and explanations covered by the table, and on the Commission's own research.

Implementation has been stronger for some measures, such as measure 7 on the legislative framework for prudential supervision of banks, measure 14 on trade facilitation, and measures 15-16 on education.

Implementation has been weaker for other measures, such as measures 1 and 2 on management of electric power companies and improving the framework for integration into the regional electricity market, measure 8 on the regulatory framework for public procurement and measure 12 on electronic communication networks.

Implementation was particularly weak for measures 3 and 19 – creating independent rail transport regulatory and safety authorities and incentives for including children in sports activities.



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Government of Montenegro submitted the 2020-2022 Economic Reform Programme to the Commission on 31 January 2020.

Inter-ministerial coordination

The preparation of the 2020 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

The national ERP coordinator organised an initial roundtable on preparation of the 2020 ERP in September 2019. The draft 2020-2022 ERP was available from 3 to 23 December 2019 for public consultation. The authorities organised a roundtable discussion on 20 December. Comments provided by stakeholders and replies of the drafters are annexed to the ERP. The draft ERP was discussed in the Parliamentary Committee for Economy, Finance and Budget on 24 December 2019, but the ERP does not provide any substantial information on the impact of this discussion on the final document.

Macro framework

The programme presents a clear and concise picture of past developments. It covers most of the relevant data, with a few exceptions on external debt and labour market developments. The macroeconomic framework is sufficiently comprehensive and coherent. The baseline macroeconomic scenario is broadly plausible, and major uncertainties and risks are clearly outlined and recognised. The programme also presents an alternative scenario resulting in lower economic growth in case of external shocks on tourism and investment. While the underlying assumptions are well elaborated and quantified, projections for 2020 seem relatively benign in view of historical experience.

Fiscal framework

The fiscal framework is well aligned with the baseline medium-term macroeconomic scenario. It appears sufficiently comprehensive and integrated with the overall policy objectives. In general, most revenue and expenditures measures are sufficiently explained, in particular for 2020, while the medium-term impact is elaborated more succinctly. The programme does not present long-term projections of population trends or of the implications of an ageing population on the labour market and public finances (Table 7). It also fails to present contributions to changes in gross debt (Table 4). Further efforts are required to ensure the fiscal data are compatible with ESA 2010.

Structural reforms

The structural reform sections (Sections 4, 5 and 6) follow the guidance note. A dedicated section of the ERP provides information on the implementation of the policy guidance for 2019. Reporting on the structural reform measures from the 2019-2021 period is generally both sufficient and up-to-date, albeit with some minor errors and details missing. The number of reform measures in the 2020-2022 ERP is limited to 18 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.

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