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ECONOMIC REFORM PROGRAMME

OF

MONTENEGRO
(2022-2024)

COMMISSION ASSESSMENT

The economic reform programme (ERP) was submitted on 31 January 2022.

The economic consequences of Russia's war against Ukraine may render the macro-fiscal scenarios presented in the ERP partially obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the war against Ukraine and related sanctions, in its spring economic forecast in mid-May 2022.

The short-term macro-fiscal outlook may change considerably. However, the major medium-term fiscal and structural reform challenges and priorities identified in this assessment remain valid irrespective of the short-term outlook. Appropriate policy responses are essential to ensure a sustained economic recovery, greater resilience and fiscal sustainability.

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1. EXECUTIVE SUMMARY

The baseline scenario set out in Montenegro's economic reform programme (ERP) foresees real GDP to fully recover to its pre-COVID-19 crisis level in 2022 and to maintain robust growth afterwards, but uncertainty is exceptionally high. The reopening of borders contributed to a strong rebound of the economy in 2021, thanks to a revival of tourism and related services. Over the programme period, the economy is set to benefit from a strong fiscal stimulus in 2022, supporting households' income and lowering the tax wedge, as well as from an ambitious multiannual capital investment programme. However, there are downside risks. A new wave of the virus and the fallout from Russia's aggression against Ukraine could hold back tourism, slowing down the economic recovery. War-related risks could also lead to further rises in energy and food prices. Import may increase by more than expected if investment plans are realised.

The ERP's fiscal strategy relies on a strong stimulus in 2022 and back-loaded consolidation based on expenditure retrenchment. The strong rebound of the economy in 2021 boosted revenue and, together with capital budget under-execution and lower spending on goods and services, enabled a very sizeable improvement of the budget balance which came in lower than planned. However, the 2022 budget targets a sharp increase in the deficit driven by revenue measures to abolish health contributions designed to lower the tax wedge, as well as new social spending initiatives. Over the medium term, the fall in the revenue ratio is expected to be outweighed by planned expenditure restraint relying on some reduction in current spending, which did not yet receive support in parliament. The public debt ratio fell by some 20 percentage points to 85.5% in 2021 thanks to the economic rebound and the use of accumulated deposits to pay back maturing debt. Under the ERP, Montenegro plans to bring debt below 70% in 2024.

The main challenges facing Montenegro include the following:

- **While lingering downside risks to the economic recovery call for a cautious phasing out of fiscal support, the public debt burden, albeit declining, remains a challenge**. Non-discretionary spending remains high, exacerbated by electoral competition and a marked pro-cyclical fiscal stance in 2022. At the same time, given the high uncertainty about the pandemic and the impact of Russia's war against Ukraine, standing ready to provide crisis mitigation if needed seems appropriate. Overall, fiscal sustainability needs to be enhanced by a medium-term plan to reduce debt contingent on the economic outlook and based on specific measures. Broadening the tax base, streamlining tax exemptions and incorporating new budget revenue initiatives to offset recent revenue-decreasing measures would contribute to rebuild fiscal space and reduce public debt.

- **Strengthening the long-term sustainability of public finances requires improvements in fiscal governance and public investment management.** New expenditure initiatives are often adopted without properly taking into account their fiscal implications. Large infrastructure projects should be better managed and prioritised in light of the fiscal space available. Following up on plans to set up an independent fiscal institution would contribute to improving fiscal policymaking.

- **Making the regulatory environment business-friendly**. Public authorities have committed to digitalisation, with several reforms under way, and in 2021 the country fully implemented the electronic procurement system. New reform initiatives on access to finance, support for innovation and on the management of state-owned enterprises are both relevant and needed. Steadfast implementation of business-centric reforms should remain the authorities' focus over the coming years.

- **Reducing the size and scope of informal economy.** The 'Europe Now' reforms of 2021 reduced the tax wedge on labour and could have a significant impact on the informal economy. If successful, these reforms and changes in the regulatory environment, in particular on digitalisation, may well shrink the informal economy over the coming years. Nonetheless, it is necessary to keep a clear vision of desired changes, to follow with further reforms, to ensure full cooperation between businesses, state and local authorities, and to make a plan for monitoring and follow-up actions to achieve a pronounced impact on the informal economy.

- **Persistently unfavourable labour market outcomes undermine potential growth and improvements in living standards.** The COVID-19 pandemic continued to exacerbate the structural deficiencies in the labour market, including persistently low rates of labour market activity and high unemployment, especially among women, young people and the low-skilled. Montenegro has taken some initial steps to tackle these problems. Further efforts are needed to tackle high youth unemployment and to reform the social protection system. The provision of active labour market policies is not effective in activating people on the labour market. While some studies over the past year on active labour market measures were conducted, the country lacks a continuous monitoring mechanism of active labour market measures.

Montenegro partially implemented the policy guidance, jointly adopted at the Economic and Financial Dialogue meeting of 12 July 2021. The government provided well-targeted support to vulnerable sectors during the pandemic, preserving jobs, and provided liquidity to companies and citizens, supporting the strong rebound of the economy in 2021. It adopted a new fiscal strategy at the end of 2021 to boost economic recovery over the medium-term. However, some of the budget consolidation measures failed to be adopted, and the budget deficit for 2022 risks exceeding the level originally planned. Some initial progress was made with the public investment management assessment (PIMA) and establishment of a fiscal council. However, progress stalled after some initial work. Montenegro advanced on the preparation of the draft Youth Guarantee implementation plan, on the roadmap for reforming the social protection system, and made some progress on reforming the vocational education and training system.

The ERP 2022 provides an ambitious and comprehensive programme integrating economic, fiscal and structural reform plans that are partly in line with the key challenges and priorities that the Commission identified. The core of the programme is structured around the 'Europe Now' programme. Some measures accompanying this initiative were rejected and some unplanned measures incorporated, requiring adjustment later on to rebalance the programme. On structural reforms, the ERP incorporated many new, well-designed and relevant reforms, focused primarily on the identified key challenges to Montenegro's economy. Digitalisation, reforms of the labour market and of state owned enterprises are particularly relevant. A new measure related to the green transition is another welcome addition. The shared European growth model linked to the twin green and digital transition will have to be consolidated in the ERP process for

Montenegro, even more so in the current geopolitical context. There was moderate progress on implementing the reform measures in 2021.

2. ECONOMIC OUTLOOK AND RISKS

Montenegro's economy recorded very strong growth in 2021, though it did not fully recover its pre-pandemic level. The double-digit rebound in GDP was driven by a robust revival of tourism, helped by the reopening of borders and its positive spillover effects on related services. The increase in the number of visitors boosted private consumption, but it also resulted in a surge in imports due to the strong dependency of the economy on foreign goods. However, thanks to increased surpluses in the services and income balances, the current account deficit narrowed. Labour market conditions suffered particularly from the negative effects of the pandemic despite several state-support packages to preserve jobs. Employment kept contracting year-on-year, from the outbreak of the pandemic in March 2020 until June 2021.

The ERP projects GDP growth to average above 5% over 2022-2024, supported by an ambitious infrastructure investment and fiscal stimulus programme. According to the ERP, traditional sectors of the economy like tourism, energy and agriculture are expected to recover or exceed their pre-pandemic levels in 2022. The programme sets out an ambitious new multiannual investment cycle. After completion of the first section of the Bar-Boljare highway in 2022, work is planned to start in other sections by the end of 2022, together with the construction of new power plants, development of airports and other public infrastructures.

Another intention is to develop digitalisation and the IT sector in an effort to diversify the economy. Economic development would be further supported by fiscal stimulus provided by the government's 'Europe Now' programme[1]. This programme, accompanying the 2022 budget, aims to boost employment, investment and domestic demand by increasing net wages significantly as a result of lowering the tax wedge, hiking up the minimum wage and increasing public sector wages. Overall, these measures are expected to boost households' disposable income while reducing labour costs for businesses. As a result, the ERP expects real private consumption to rise by more than 4% on average over 2022-2024. Investment would return to growth in 2022 and it is expected to surge by some 9% in both 2023 and 2024. Meanwhile, public consumption growth would moderate from 2% in 2022 to 1.5% in 2024. After the recovery of the economy to its pre-crisis level in 2022, both imports and exports are expected to decelerate markedly afterwards. The ERP projects the output gap to close in 2022 and turn strongly positive by 2024, which raises questions about the sustainability of the forecast buoyant GDP growth.

The baseline GDP growth scenario is on the optimistic side and subject to significant risks. The macroeconomic outlook continues to be subject to a relatively high degree of uncertainty in the recovery phase from the COVID-19 pandemic as well as new risks stemming from Russia's war against Ukraine in particular given the exposure of Montenegro's tourism sector to the region (over 20 percent of Montenegro's

[1] See more details in Chapter 3, Public finance.

foreign tourists come from these two countries). However, the ERP's projection that it will recover the pre-pandemic GDP level in 2022 seems attainable considering the strong rebound registered in 2021, and further fiscal support from the 'Europe Now' measures, even as the government widthdraws most pandemic-related support measures.

Overall, the baseline scenario appears broadly in line with the Commission's forecast for 2022, but diverges noticeably for 2023 and 2024. In particular, the programme's ambitious public investment plan raises some doubts, considering the technical, financial and administrative hurdles experienced with major infrastructure projects in the past. The 'Europe Now' programme aims to quickly improve the living standards of the population by reducing the tax wedge and raising wages. However, it could result in higher domestically driven inflation, which is only factored into an alternative scenario (see below). Another risk only considered under the alternative scenario is the unstable political situation as some ERP reforms could be discarded or reversed in the event of a change of administration. The strong deceleration of imports foreseen in the baseline scenario is not consistent with past investment dynamics, as these usually require significant imports of construction machinery and equipment.

Table 1:

Montenegro - Comparison of macroeconomic developments and forecasts

	2020		2021		2022		2023		2024	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	-15.3	**-15.3**	10.7	**13.4**	6.4	**6.4**	3.2	**5.1**	n.a.	**4.5**
Contributions:										
- Final domestic demand	-6.4	**-6.4**	4.3	**3.5**	2.6	**3.8**	3.5	**5.5**	n.a.	**5.3**
- Change in inventories	-1.0	**-1.0**	0.0	**0.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-7.2	**-7.8**	6.3	**9.9**	3.8	**2.6**	-0.6	**-0.5**	n.a.	**-0.8**
Employment (% change)	-10.1	**-10.0**	3.5	**4.8**	2.3	**3.5**	2.5	**3.4**	n.a.	**3.0**
Unemployment rate (%)	18.3	**17.9**	19.3	**16.7**	18.5	**15.8**	17.2	**14.6**	n.a.	**13.6**
GDP deflator (% change)	-0.2	**-0.2**	2.3	**2.8**	2.3	**2.2**	1.4	**1.7**	n.a.	**1.4**
CPI inflation (%)	-0.8	**-0.3**	3.3	**2.1**	2.5	**2.3**	1.5	**1.8**	n.a.	**1.5**
Current account balance (% of GDP)	-26.0	**-26.1**	-17.8	**-13.1**	-15.8	**-10.5**	-16.8	**-10.2**	n.a.	**-10.0**
General government balance (% of GDP)	-11.1	**-11.1**	-3.4	**-1.8**	-0.5	**-5.0**	0.2	**-1.8**	n.a.	**-0.6**
Government gross debt (% of GDP)	103.5	**105.2**	87.3	**85.5**	77.8	**76.6**	71.7	**73.2**	n.a.	**69.9**

Sources: Economic Reform Programme (ERP) 2022, Commission Autumn 2021 forecast (COM).

The programme presents an alternative low-growth scenario focused on a series of events, some of which would merit being considered as part of the baseline. The alternative scenario assumes higher inflation and a worsening of the epidemiological situation reducing tourism flows. This would result in a significant fall in private consumption until 2024, accompanied by a contraction of exports, falling by half in 2022 compared to the baseline. In addition, it assumes a slower increase in public investment which would also cause a sharp fall in GDP growth, notably in 2023 and 2024. Net foreign direct investment (FDI) inflows are forecast to remain much more resilient, declining only moderately (by an average of 1.3 percentage points of GDP) in the same two years. But this might not fully reflect the potential fallout of increased political uncertainty on investor confidence.

Inflationary pressure – driven in 2021 by import prices – is likely to mount following strong wage increases in 2022. So far, inflation has been led by the rebound in global oil and food prices through imports. The ERP baseline scenario foresees stable

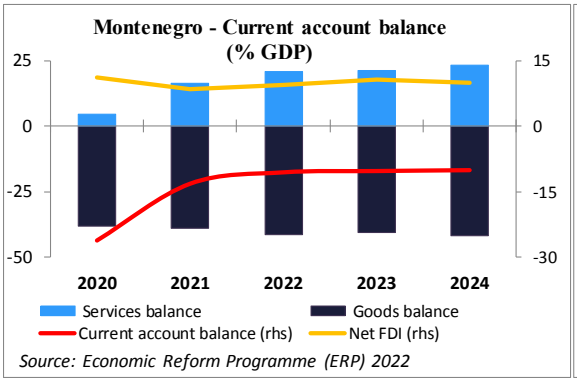
and moderate consumer prices over the medium term, with inflation averaging 2.3% in 2022 and easing gradually afterwards to 1.4% in 2024. This scenario appears benign in view of recent geopolitical tensions, which would lead to further rises in energy prices and to environmental charges on CO2 emissions, making electricity prices structurally higher. The ERP also assumes a strong and generalised increase of wages in 2022 (by some 17% in nominal terms), which is at odds with the scenario of low inflation. Second-round effects and the indexation of pensions and public sector wages to the minimum wage (which surged by 80% in net terms at the beginning of 2022) are likely to further increase inflationary pressures while worsening the sustainability of the pension system.

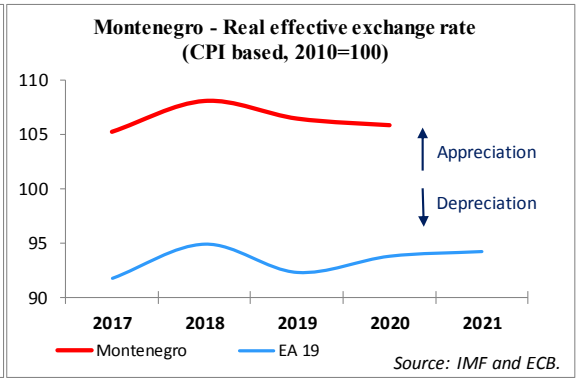
The ERP's projection of a decreasing current account deficit appears inconsistent with the ambitious investment programme. Montenegro's large external imbalances reflect the weak competitiveness of its economy (mainly due to non-cost factors) and high investment needs. Montenegro's current account is characterised by surpluses in the services and income balances driven by tourism and remittances, which only partially offset the chronic and large merchandise trade deficit. Following a large improvement in 2021 when the current account deficit halved thanks to the revival of tourism and remittances, the ERP baseline assumes a further sizeable reduction in 2022, and then small decreases (to around 10% of GDP) over the next two years. However, this scenario seems unlikely given the likely underperformance of tourism in 2022, and the robust investment growth projected for 2023 and 2024, which – taking into account historical evidence – is likely to result in high import needs for construction material and equipment. Furthermore, large wage increases exceeding productivity gains might impair cost competitiveness, although the reduction of the tax wedge through the abolition of health contributions provides some cushion.

Investments are set to remain stable, after recording double-digit levels during the pandemic. Net FDI inflows totalled 11.6% of GDP in 2020 and 11.7% in 2021. The ERP projects FDI to remain broadly stable, averaging some 10% of GDP in 2022-2024, and fully covering the projected current account deficit. Downside risks to this outlook stem from political risks coupled with a tightening of global financing conditions, which could hinder access to, or increase the cost of finance. Furthermore, the intention announced in the ERP to engage into construction of several sections of the Bar-Boljare and Adriatic highways simultaneously, could lead to higher than expected current account and budget deficits. The external debt surged to 224% of GDP in 2020[2] (driven by the denominator effect, as GDP contracted by 15.5% in nominal terms in 2020), after having remained stable at around 160% of GDP over the previous 10 years. The main reason for this massive increase was the emission of government debt to finance COVID-19 socio-economic support measures and to build up fiscal reserves.

[2] Data provided by the Central Bank of Montenegro. Figures not available yet for 2021.

Graphs: external competitiveness and current account





The banking system remained stable with some key metrics improving, but the quality of loan portfolios needs close monitoring. From March 2020 to September 2021, the Central Bank of Montenegro carried out an asset quality review (AQR) of all domestic banks according to ECB methodology based on pre-pandemic assumptions. Results confirmed the stability of the domestic banking system, and rated as satisfactory the level of asset quality and capital adequacy. The aggregated solvency ratio[3] was 16.2% (2019 reference data), above the statutory minimum of 10%. Only one bank was required to strengthen its position, after which its solvency ratio increased to 12%.

During the COVID-19 pandemic, the central bank adopted ten packages of temporary measures aimed at preserving the liquidity and solvency of domestic banks. As a result, the balance sheets of domestic banks recorded significant growth. Thus, at the end of 2021, banks' lending and deposits were 9.8% and 20.9% higher respectively compared to December 2019, while profitability (return on equity) returned to its pre-pandemic level.

Banks continued to fund themselves mainly through domestic deposits. However, there are risks due to a potential increase in non-performing loans (NPLs) as the loan moratorium expired in December 2021. So far, the NPL ratio has increased only moderately, to 6.2% of total loans at the end of 2021, compared to 5.5% in 2020 and 4.7% in 2019. To tackle this risk, the Central Bank of Montenegro will reinforce the supervision of credit institutions, insurance companies and financial investment conglomerates in 2022.

[3] i.e. regulatory capital to risk-weighted assets ratio.

Table 2:

Montenegro - Financial sector indicators

	2017	2018	2019	2020	2021
Total assets of the banking system (EUR million)	4,182	4,407	4,604	4,586	5,328
Foreign ownership of banking system (%)	73.0	74.3	67.9	80.3	85.0
Credit growth (aop)	11.8	8.5	4.5	3.2	6.4
Deposit growth (aop)	13.8	5.9	0.5	-3.0	24.6
Loan-to-deposit ratio (eop)	0.8	0.8	0.9	0.9	0.8
Financial soundness indicators (eop)					
- non-performing loans	7.3	6.7	4.7	5.5	6.2
- net capital to risk-weighted assets	16.4	15.6	17.7	18.5	18.5
- liquid assets to total assets	25.3	22.6	20.8	22.2	26.4
- return on equity	7.6	8.5	10.0	3.6	5.9
- forex loans to total loans (%)	0.7	0.5	0.4	0.2	0.2

Sources: National Central Bank, Macrobond.

3. PUBLIC FINANCE

The 2021 budget was much delayed but recorded a lower-than-planned deficit. The preparation of the budget was marked by tensions within the ruling coalition, delaying its adoption until June. Public institutions relied on temporary financing in the meantime. The adopted budget targeted a deficit of 2.8% of GDP, but the final outcome was lower, at 1.8% of GDP according to the ERP[4], thanks to both higher revenue and lower expenditure. This represents a very sizeable improvement compared to the deficit of 11.1% of GDP recorded in 2020. Budget revenue was boosted by the strong economic recovery as well as the introduction of higher excise rates, electronic fiscalisation of businesses' cash registers, increased tax discipline and the transfer of public companies' profits to the central budget. However, plans to tax illegally acquired property or undeclared revenue, and to introduce labelling of fuel products to reduce fraud, failed to be adopted. Overall, total central government revenue surged by 16.6% y-o-y and exceeded initial plans by 1.6%. Public expenditure declined by 2.6% y-o-y, coming 2.1% lower than planned, notwithstanding the high expenditure base set in 2020 to finance COVID-19 support measures and lower social security transfers in 2021. Significant savings were achieved in discretionary spending too. Moreover, further expenditure reduction came as a result of delayed public works worth some 1.4% of GDP.

The fiscal strategy combines tax reductions with spending retrenchment to achieve fiscal consolidation. The medium-term key objectives of Montenegro's fiscal policy consist in reinforcing macroeconomic stability and the long-term sustainability of public finances while supporting the recovery from the pandemic and economic growth. To this end, the government adopted in 2021 three plans: a medium-term fiscal strategy, an economic strategy (or 'Economic Recovery Platform for 2022-2026'), and an ambitious socio-economic programme called 'Europe Now'.

Although the medium-term objectives remain similar to the past, the new plans constitute a major policy change by introducing a progressive personal and corporate income tax

[4] 2.1% of GDP according to central government preliminary budget execution data.

system in Montenegro and abolish health contributions. As a result, tax revenue is projected to fall from an already moderate level by 2 pps. of GDP as of 2022. Non-tax revenue is also set to decrease as a percent of GDP as a result of abolishing health contributions. The decrease in the revenue ratio is forecast to be outweighed by a 4.8 pps decline in the spending ratio between 2021 and 2024, by making savings in government consumption and interest payments. The primary balance, which turned positive in 2021 as the budget outcome was better than expected, is set to deteriorate sharply in 2022 as revenue measures kick in, and is forecast to turn positive again only in 2024 thanks to the back-loaded retrenchment of expenditure.

The sharp increase in the 2022 budget deficit implies a strong pro-cyclical fiscal stance in a context of robust economic growth. The initial government proposal targeted a noticeable increase in the 2022 budget deficit to 3.8% of GDP, based on robust real growth of 6.4% and moderate inflation of 2.3%. Capital expenditure was planned to rise significantly to 5.6% of GDP, up from 4.3% a year before, in order to finance an ambitious plan of infrastructure investments. However, the budget adopted by Parliament on 29 December 2021 further increased the deficit target to 5.1% of GDP, after adding a number of unplanned social benefits amounting to more than 1.3% of GDP, while rejecting some of the government's proposed compensatory initiatives to balance the impact of revenue-decreasing measures[5]. The adopted budget thus assumes a sharp reduction in budget revenue in 2022 (by some 3 pps. of GDP compared to 2021) due to the abolition of health contributions and the introduction of a EUR 700 threshold as the non-taxable part of wages. Budget expenditure is set to increase by 0.5 pps. of GDP compared to 2021.

The 2022 budget is articulated around the 'Europe Now' programme, a major fiscal reform initiative to support the post-pandemic recovery. As of January 2022, the programme introduced a progressive income taxation system. This constitutes a major change in fiscal policy, putting an end to the 9% flat tax rate for corporate (CIT) as well as the personal income tax (PIT) of the past. The new regime brings in three CIT rates (9%, 12% or 15%), depending on the company's profit, and two rates (9% and 15%) for gross personal income between 700 and 1000 euros, or above, respectively. It also applies a new 0% tax rate for personal income up to 700 euros.

In addition, mandatory health insurance fees are also abolished, cutting the tax wedge on labour to 20.4% of the gross wage and up to 31.1% for net wages of 2 000 euros and higher, compared to the previous 39% flat rate for all. The aim of this reduction of labour costs is to support the formalisation of employment and promote job creation and investment. The budget also brought in a sharp (80%) increase in the minimum wage to EUR 450. The abolition of health contributions together with the minimum wage hike are expected to considerably boost the net average wage in Montenegro to EUR 700, up from EUR 537 at the end of 2021.

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[5] Additional expenditure compared to the government proposal related to reintroducing benefits for mothers of three or more children, make a third additional annual pension indexation (besides the two regular ones in January and July), a further increase in the minimum pension, and a new benefit for all children under the age of 18. Conversely, the Parliament rejected the proposed increases in excise rates and in the VAT rate for restaurants and catering services, and the amendments to the law on public-sector wages to lower wage coefficients to contain public wage growth resulting from the much higher minimum wage.

The budget incorporated additional wage increases for public health and education workers. Overall, full implementation of the 'Europe Now' programme, as adopted in December 2021, would require the adoption of corrective measures (as initially foreseen) to ensure its sound financing and avoid the projected sharp increase in the budget deficit.

Box: The budget for 2022

* On 29 December, the Parliament of Montenegro adopted the 2022 budget law. It projects a deficit of 5.1% of projected GDP.
* The 2022 budget put into effect the 'Europe Now' programme. However, Parliament rejected some of the measures to strengthen the revenue side of the budget , and incorporated a series of unplanned social benefits into the budget, without offsetting measures.
* Structurally, the introduction of progressive taxation in January 2022 represents a major change to the fiscal framework, putting an end to years of low flat tax rates.

Table: Main measures in the budget for 2022

Revenue measures*	Expenditure measures**
• Increasing the minimum wage and reducing the tax wedge on labour *(Estimated impact: -2.4% of GDP)* • Rescheduling tax receivables *(Estimated impact: 0.3% of GDP)* • Introduction of CIT and PIT progressive taxation *(Estimated impact: 0% of GDP in 2022 and EUR 0.5% of GDP afterwards).* • *Reducing informal economy (Estimated impact: 0.2% of GDP)*	• Increasing the minimum wage and reducing the tax wedge on labour *(Estimated impact: -0.01% of GDP)* • Aligning other expenditure categories *(Estimated impact: 0.2% of GDP)* • Benefit for mothers of 3 or more children *(Estimated impact: 0.5% of GDP)* • Benefit for all children under 18 *(Estimated impact: 0.5% of GDP)* • Increasing the minimum pension *(Estimated impact: 0.3% of GDP)* • Introducing a third annual pension indexation (instead of two) *(Estimated impact: n/a)*

Measures rejected in Parliament or withdrawn by the government:

- Change of excise tax policy *(Estimated impact: 0.4% of GDP)*
- Fiscal labelling of fuels *(Estimated impact: 0.3% of GDP)*
- Taxation of undeclared revenue *(Estimated impact: 0.4% of GDP)*
- New legislation on games of chance *(Estimated impact: 0.3% of GDP)*
- Increase in the VAT rate (from 6% to 21%) for restaurants and catering services *(Estimated impact: n/a)*
- Tax on cash withdrawal for businesses *(Estimated impact: 0.09% of GDP)*
- Amendments to the law on public sector wages in order to readjust wage coefficients to the new minimum wage *(Estimated impact:0.06% of GDP)*

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.

Source: ERP

In the medium term, the ERP projects an expenditure-based consolidation path. Tax revenue is projected to recover somewhat in 2023, as the ERP expects some of the measures rejected by Parliament to be presented again and finally adopted, such as the taxation of undeclared assets and further increases in excise rates. Budget revenue is also set to increase further as a result of reducing informality and the impulse from robust economic growth expected in 2023 and 2024. The ERP expects the introduction of progressive taxation to remain neutral for personal income tax revenue. Corporate income tax revenue projections (assuming a 0.5% of GDP increase from 2023) seem optimistic as more than 90% of domestic companies are micro or small firms benefitting from the lower 9% tax rate.

On the expenditure side, capital spending and social security transfers are planned to remain broadly stable over the medium term at around 5% and 12% of GDP respectively. However, current expenditure is set to decline significantly from 40.4% of GDP in 2022 to 35.8% in 2024 as the level of current spending remains stable in nominal terms over this period in a context of rapid GDP growth. As a result, the budget deficit will gradually decline, to reach 0.6% of GDP in 2024 with a primary surplus of 0.8% of GDP.

Overall, the ERP expects the 2022 tax reform to have a positive multiplying effect on the economy over the medium term, broadening the tax base thanks to the creation of new jobs, higher consumption and investment and the reduction of informality. The long-term sustainability of public finances would be reinforced as a result. However, this back-loaded fiscal consolidation scenario appears vulnerable to expenditure slippage risks. As witnessed with occasion of the adoption of the last budget, the unstable political situation generates a pre-electoral context prone to increasing social spending.

Table 3:

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

	2020	2021	2022	2023	2024	Change: 2021-24
Revenues	44.6	44.0	41.0	40.9	40.4	-3.6
- Taxes and social security contributions	36.2	36.5	33.8	34.6	34.5	-2.0
- Other (residual)	8.4	7.6	7.2	6.2	5.9	-1.7
Expenditure	55.7	45.8	46.0	42.7	41.0	-4.8
- Primary expenditure	53.0	43.4	44.2	41.1	39.6	-3.8
of which:						
Gross fixed capital formation	6.3	4.3	5.6	4.9	5.3	0.9
Consumption	13.1	12.0	11.3	10.6	10.1	-1.9
Transfers & subsidies	14.3	12.7	13.5	13.5	12.8	0.2
Other (residual)	19.4	14.4	13.8	12.2	11.4	-3.0
- Interest payments	2.7	2.4	1.8	1.6	1.4	-1.0
Budget balance	-11.1	-1.8	-5.0	-1.8	-0.6	1.1
- Cyclically adjusted	-5.8	-0.9	-5.5	-2.2	-1.5	-0.6
Primary balance	-8.4	0.6	-3.2	-0.3	0.8	0.2
- Cyclically adjusted	-2.6	1.7	-3.3	-0.6	0.0	-1.7
Gross debt level	105.2	85.5	76.6	73.2	69.9	-15.6

Sources: Economic Reform Programme (ERP) 2022, Commission calculations.

The ERP projects public debt to decline rapidly to around 70% of GDP by 2024. The debt stock reached a record high of 105% of GDP at the end of 2020, driven by high budget deficits and a large Eurobond issued that year to pre-finance debt maturing later under favourable conditions. This boosted government reserves to 19% of GDP at the end of 2020. In 2021, part of these reserves were used to pay back maturing debt worth some 5.7% of GDP, which, combined with the strong economic rebound and the primary surplus, resulted in an almost 20 pps. fall in the debt ratio.

Despite the planned significant increase in the budget deficit, the ERP expects the public debt ratio to continue falling markedly in 2022, due to growth effects and further debt repayments from cash reserves, which still amounted to 10.9% of GDP in September 2021. In 2023-2024, growth and inflation effects will become the main factors driving down the public debt ratio.

Overall, the decrease in the debt ratio and debt management efforts have lowered vulnerabilities linked to the high debt burden and its composition. In 2021, the government concluded a hedging arrangement with a consortium of private banks to shelter public finances from currency risk on an USD 944 million loan from China to build a major highway section. The swap deal also reduced the interest rate on this debt from 2% in US dollars to 0.88% in euro. Currently, around 97% of the public debt is held in euro and only 2.3% in USD. In addition, 74.3% of all debt carries fixed interest rates.

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

	2020	2021	2022	2023	2024
Gross debt ratio [1]	**105.3**	**85.5**	**76.6**	**73.2**	**69.9**
Change in the ratio	28.8	-19.8	-8.9	-3.4	-3.4
Contributions [2]*:*					
1. Primary balance	**8.4**	**-0.6**	**3.2**	**0.3**	**-0.8**
2. "Snowball" effect	**16.7**	**-12.3**	**-4.9**	**-3.3**	**-2.7**
Of which:					
Interest expenditure	2.7	2.4	1.8	1.6	1.4
Growth effect	13.9	-12.1	-5.0	-3.7	-3.1
Inflation effect	0.2	-2.6	-1.7	-1.2	-1.0
3. Stock-flow adjustment	**3.7**	**-6.9**	**-7.1**	**-0.4**	**0.1**

[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) 2022, ECFIN calculations.

Box: Debt dynamics

Active debt management operations in 2021 and 2022, using government cash deposits to repay public debt instead of borrowing to roll it over, are set to generate large stock-flow adjustments, which combined with a gradual improvement in the primary balance in the outer years, are expected to drive a fast reduction in the public debt ratio by some 35 pps. of GDP in 2020-2024. A favourable scenario of strong GDP growth, moderate inflation and falling interest costs would continue supporting the reduction in the debt ratio, thanks to the snowball effect.

The ERP identifies numerous risks to the achievement of planned fiscal targets. Apart from the risks related to the 'Europe Now' programme mentioned above, the weak financial situation of some public companies as well as some state guarantees represent additional hazards for the stability of public finances. Overall, these risks could be managed by using the government's cash deposits or a well calibrated budget rebalance. There is also a specific (and unavoidable) issue concerning future statistical data revision. Concretely, the future introduction of the European System of Accounts (ESA 2010)

methodology would require reclassifying some operations of public companies into the general government sector, increasing deficit and debt levels.

More optimistically, the ERP expects that some reforms, such as improving the corporate governance of state-owned enterprises (SOEs), streamlining the public administration, or the concession of Montenegro airports, could result in a better fiscal performance than planned. However, many of these reforms are not new and have either failed in the past or have been postponed several times, which raises doubts about their implementation. Another major risk – not reflected in the ERP –, concerns the political situation following the no-confidence vote and the fall of the government in February. This may result in structural reform delays, policy reversals or budgetary slippages but also in underperformance of planned capital investments as construction plans may be further delayed.

Box: Sensitivity analysis

The programme makes a detailed analysis of the deficit, with a comparison between scenarios as well as with the previous ERP. The comparison of scenarios includes a detailed risk matrix identifying potential positive and negative events (see above). However, a detailed impact of each single risk is not quantified; only their total effect on the budget balance, as reflected in the alternative scenario.

Last year's programme projected an almost balanced budget for 2022 and a surplus for 2023. By contrast, this year's ERP baseline scenario projects no surpluses and a particularly high deficit for 2022. This sudden change, in a context of strong recovery of the economy and budget revenue above pre-pandemic levels (in nominal terms), is the consequence of the government's intention to frontload the 'Europe Now' programme and thereby provide a rapid boost to the economy.

Introduction of a progressive taxation system represents a major systemic change. As of 2022, the system should help reduce inequalities. Higher revenues and profits would contribute more to sustaining public finances, while the introduction of a non-taxable part of the wage (with a threshold above the average salary) would benefit workers on a lower income. Overall, the new structure of spending devised in the Europe Now programme is conducive to growth and social inclusion by supporting capital spending, lowering labour costs and increasing significantly households' disposal income.

Gaps in the budgetary framework remain to be addressed. Amendments are still pending to the Law on Budget and Fiscal Responsibility with a view to establishing an independent fiscal council to strengthen the oversight of fiscal policy, although some preparatory work has already been done. Activities are being carried out to implement projects to enhance the budgetary system, establish a proper medium-term budgetary framework and improve internal financial control. Programme budgeting was introduced with the 2021 budget. However, it will take a few years to achieve full implementation, with the introduction of performance indicators to monitor progress.

The Revenue and Customs Administration is implementing a project to set up an integrated revenue management system (IRMS) and an online fiscalisation system in real time, to increase transparency of the tax payment process and reduce informality. This would contribute not only to improving the efficiency of the system, but also to implementing the 'Europe Now' programme. The government has been working on the development of a public asset management company (called 'Montenegro Works'),

inspired by the model of the Hellenic Corporation of Assets and Participations (HCAP), to achieve a more efficient and integrated operation of public companies. There is a considerable delay in rolling out accrual accounting and production of government finance statistics based on ESA2010 standards.

4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Montenegro's comparative advantage is built on its geographical location, climate and landscape. Its small and open economy is service-oriented and largely focused on tourism as the principle source of income. Services account for nearly 80% of all exports, while foreign tourists directly generate over 20% of the country's GDP. Given the country's reliance on one sector and its small size, the economy remains vulnerable to external shocks and the challenges of climate change. This calls for action to diversify the economy and increase the value added in economic activities. Skill development programmes, in response to the country's smart specialisation strategy priorities, as well as action in the policy areas related to the digital and green transitions should become the priorities for the Montenegrin authorities.

The Commission has conducted an independent analysis of Montenegro's economy to identify the key structural challenges to competitiveness and inclusive growth, drawing on Montenegro's ERP and other sources. This concise analysis shows that, despite progress made, the country suffers from several structural and crosscutting weaknesses across many sectors of the economy. The key challenges in terms of boosting competitiveness and securing long-term inclusive growth remain the same as identified in the last years. They are:

(i) increasing employment, particularly of women and young people, and tackling long-term unemployment;

(ii) strengthening the regulatory environment and

(iii) reducing informality in the economy.

This assessment therefore focuses on those three key 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 closely follows progress in Montenegro's annual report on issues of strengthening the rule of law and fighting corruption.

Key challenge 1: Increasing employment, in particular of women and young people, and tackling long-term unemployment

Despite the economic growth in 2021, labour market indicators only improved marginally. The unemployment rate in the third quarter of 2021 fell by 4.2 pps. to 14.8%, compared to the same period in 2020. The employment rate increased from 43.0% to 46.5% and the activity rate from 53.1% to 54.6%, though it has still not reached the pre-crisis level of 60% in the third quarter of 2019, according to Monstat. By way of comparison, in the EU, the unemployment rate (15-74) was 6.9%, the activity rate (20-64) was 78.9% and the employment rate (20-64) was 73.6% in the third quarter of 2021.

There are significant disparities between the country's three regions. The unemployment rate in the Northern region (33%) was more than eight times that in the Coastal region (4%) in the third quarter of 2021. A number of vulnerable groups, including Roma and persons with disabilities face additional challenges in accessing the labour market, despite the support available for these groups under employment and education programmes. Montenegro adopted two further economic support packages in 2021 aimed at job retention by providing support to businesses, workers affected and vulnerable groups.

As a direct response to the 2020 policy guidance to 'take measures to preserve employment including by ensuring short-time work schemes and flexible working arrangements', Montenegro proposed to roll over Measure 16 from the 2021 ERP, and proposed Reform Measure 2 – 'Introducing new work schemes and work-life balance'. The aims of the measure remain appropriate and in line with EU-Montenegro priorities.

The most vulnerable groups on the labour market are still women, young people and the low skilled, and long-term unemployment remains a structural challenge. The pandemic had a significant negative impact on youth employment (15-24), with employment rate for the age group falling to 18.4% in the fourth quarter of 2020 from 26.9% in the fourth quarter of 2019. The rate of unemployment (15-24) also rose to 42.0% in the fourth quarter of 2020 from 27.8% in the fourth quarter of 2019. In 2019, the rate of young people (15-29) not in employment nor in education or training (NEET) stood at 21.3%. This reflects significant difficulties in transitioning from education to employment, and a mismatch between the skills acquired through formal education and the skills in demand on the labour market. It could also indicate few job opportunities available for young people. The NEET rate increased significantly in 2020 to 26.6%. The NEET profile analysis conducted by the International Labour Organization (ILO) points to a high and increasing number of unemployed graduates from secondary and higher education who are out of employment. The highest share of unemployed people continue to be those with a lower level of education. High long-term unemployment persists; 75.5% of the unemployed people were unemployed for more than a year in the fourth quarter of 2020. Montenegro adopted the National Employment Strategy for 2021-2025 together with the Action Plan for 2022 on 29 December 2021 after a significant delay. The ambitious Strategy contains measures to support a sustainable rise in employment, including through strengthening skills development. Montenegro's local employment strategies are important in guiding efforts to address regional differences by taking tailored measures.

The country has active labour market measures to help young people join the work force, though the effectiveness of these measures remains to be seen. The government took steps to put in place a Youth Guarantee in Montenegro. In 2019, it put in place a specific measure designed to encourage young people to join the labour market through employment or self-employment, however its effectiveness is yet unknown. The professional training programme for graduates in place for over a decade has been recently evaluated by the ILO, finding that the programme has been ineffective and recommending that (ILO, 2022). In line with the Western Balkans Declaration adopted in July 2021 on ensuring sustainable labour market integration of young people and with the 2021 policy guidance, Montenegro acted quickly to create a multi-stakeholder group in charge of drafting the Youth Guarantee implementation plan. Reform Measure 3 on 'Introducing the Youth Guarantee Programme in Montenegro' is expected to support this work and provide a cross-sectoral policy overview combining multiple measures to

activate young people. In 2021, Montenegro launched an employment programme for young people in preparation for the Youth Guarantee.

The pandemic widened the already wide gender gap in the labour market. The employment gap (20-64) between women and men continued to widen, standing at a 15.6 pps. difference in the fourth quarter of 2020 (compared to 11.2 pps. difference in the fourth quarter of 2019). In 2020, the rate of women inactive on the labour market (20-64) remained far above the rate for men at 40.1% compared to 25.4%. Employment gains continue to be larger for men than for women. Gender-sensitive career counselling, programmes aimed at encouraging young women's enrolment in non-traditional vocational programmes and studies, or programmes aimed at helping women come back to the labour market after a prolonged absence, for example as a result of childcare, are lacking (OECD, 2021). In July 2021, the government adopted a new National Strategy for Gender Equality for 2021-2025 and an Action Plan for 2021-2022, identifying clear operational objectives and measures to improve gender equality. The pandemic also had a negative impact on the previously improving enrolment rate in early childhood education and care, which should help improve the employment and training prospects for women. Previous improvements made in the enrolment rate of children in pre-primary education worsened by 7.6 pps. in the 2020/2021 academic year compared to 2019/2020, which is an expected effect of the pandemic. Regional disparities remain with low take-up in the north. The government adopted the Strategy and Action Plan for Early and Preschool Education for 2021-2025 in 2021. Implementing these measures should help restore the previous gains made.

Active labour market policies (ALMPs) are not sufficient to help jobseekers find sustainable, long-term employment and they still focus insufficiently on re- and up-skilling. The country lacks a comprehensive monitoring and impact assessment of the effectiveness of ALMPs, including following up on the number of beneficiaries who remain employed in the long term following their participation in activation programmes. This means that continuous policy adjustments are not made to render the policies fit for purpose. Efforts are ongoing to improve the currently ineffective institutional set-up and functioning of Montenegro's public employment service, the Employment Agency of Montenegro (EAM). This is reflected in *Reform Measure 1 – 'Strengthening operational capacities of the Employment Office for the performance of services and measures via digitalisation'* which follows through on Reform Measure 17 in the 2021-2023 ERP. The process to digitalise EAM based on the results of the procedures identified and revised is expected to facilitate its work. It is also expected to improve the provision of tailor-made and targeted services for young people and adults, and to contribute to the effective monitoring and evaluation of ALMPs.

Informality remains an obstacle to improving labour market outcomes. Although it is assumed that the wage-subsidy measures in response to the pandemic have prompted employers to formalise some of their employees, disincentives to declare work remain, and this requires a comprehensive set of measures. The Labour Law adopted in December 2019 and the tax reform measures in the Europe Now programme adopted at the end of 2021 aim at increasing labour market flexibility and remove the incentives for undeclared work. The capacity of the Administration for Inspection Affairs, under which the Labour Inspectorate operates, remains limited.

A mismatch of skills remains a significant challenge, particularly for young people. According to the 2020 Human Capital Index issued by the World Bank, 'a child born in Montenegro today will be 63% as productive when they grow up as they could be if they

enjoyed complete education and full health'. The quality and relevance of the entire education system and the lack of practical experience of graduates from vocational and higher education have been long-term challenges. This has been aggravated by the COVID-19 pandemic and continues to be a reform priority under the Osnabrück and Bologna Declarations (ETF, 2022). There is a high rate of people transitioning from vocational education and training programmes to higher education and other programmes that are less suited to market needs. Occupational mismatch (i.e. over-qualification) is highest for people with a tertiary education (around 14%). Although tertiary educational attainment is still lower than the EU average, the labour market cannot absorb the numbers of tertiary graduates in certain areas, such as business and humanities, and yet there is still a shortage of medical and STEM graduates (ETF, 2019). This is detrimental notably in view of their significance for the occupational domains targeted by the smart specialisation strategy. Montenegro's Entrepreneurial Lifelong Learning Strategy for 2020-2024, the National Partnership and the Innovation Fund are expected to help address these skills shortages. Furthermore, the Strategy for the Development of Vocational Education in Montenegro (2020-2024), along with its action plans, outlines measures for overcoming workforce skills shortages and to improve the efficiency and the effectiveness of the VET system and lifelong learning. Montenegro has committed to the Western Balkans agenda on innovation, research, education, culture, youth and sport, which is expected to guide its reform efforts.

Lifelong learning and adult education with up- and re-skilling has not yet played a sufficiently prominent role, including in facilitating the green and digital transitions. Given the very high share of long-term unemployment, developing and implementing these measures remains essential. In 2022, drawing up a digital education action plan and the Digital Skills Strategy should identify further measures to address these shortcomings.

These shortcomings were clearly identified in the 2022-2024 ERP. It proposes two new reform measures to target the persistent skills mismatches in the labour market and improve the relevance of the education system, *Reform Measure 4 – 'Increasing employability of adults by improving their skills and competences needed at the labour market'* and *Reform Measure 5 – 'Digitalisation of the education and development of digital skills'*. These are in line with the European Commission's policy recommendations.

Montenegro adopted several reform measures in 2021 and 2020 that aim to improve the protection of the most vulnerable segments of the population, improve general living conditions and bring more people onto the job market. In line with the Social and Child Protection Strategy, the government with the help of UNICEF has commissioned a study to review the social protection system. Following up on the 2021 policy guidance, it has drafted a comprehensive roadmap of reforms. Following amendments to the Law on Pensions and Disability Insurance and the Law on the Labour Fund in July 2020, in May 2021 it brought in other changes. It adopted amendments to the Labour Law raising the minimum wage from EUR 222 to EUR 250 as of 1 October 2021, and to the Law on Social and Child Protection granting universal benefits to all households with children under the age of six. The measures adopted under the Europe Now programme in December 2021 also include increasing the net minimum wage from EUR 250 to EUR 450 and raising the non-taxable personal income to EUR 700, thereby decreasing the tax wedge on low-wage earners.

Reform Measure 6 on 'Reform of the national system for disability assessment' and *7 on 'Define financial preconditions for reforms proposed under the Roadmap'* respond to the need to complete the social care system and to reform the social protection system in line with needs.

Key challenge #2: Strengthening the regulatory environment

The institutional and regulatory environment in Montenegro calls for further reforms in the coming years. The regulatory environment is not sufficiently business-oriented and hinders the dynamic development of local companies and foreign investors' activities, as underlined in detail in the Commission's ERP assessments in 2020 and 2021. Substantial improvements are needed to remedy the inefficiencies and delays when dealing with the administration, excessive complexity and the administrative burden from local taxation and para-fiscal charges, and the effectiveness of consultation mechanisms between authorities and the business community, which should be continuous and structural. Also on the list of issues for improvement are transparency in decision-making, inconsistencies and arbitrary interpretation and law enforcement by public authorities, and access to finance for SMEs, both in general and in specific contexts (COVID-19, innovation policies).

Companies stress that these deficiencies weaken the regulatory environment at central and local levels and hold back Montenegro's economy. This translates into lost opportunities in terms of jobs (with an impact on Key Challenge 1) and provides incentives, specifically to micro and small enterprises, to carry out undeclared work and transactions (thus fuelling the issues described under Key Challenge 3).

Montenegro made tangible progress in 2021 to improve the business and regulatory environment, despite the COVID-19 impact. It met a major milestone on public procurement, migrating from a paper-based system to the fully electronic system by the end of 2021. Electronic procurement is expected to bring significant improvements to public procurement over the coming years. A centralised e-procurement system via a single, dedicated portal, enabled by making comprehensive changes to procurement legislation (aligned with EU law) paves the way for significantly easier access to information on tenders from all contracting authorities, speeding up procedures and improving their transparency. Implementing e-procurement has the potential to significantly reduce the scope for corruption, breaches of competition rules and the potential for lengthy and costly appeals.

Involving businesses and social partners in dialogue with the government and regulatory processes saw some promising developments. Businesses found it easier to have their voice heard in the design of structural reforms planned under the current ERP and in the adopting COVID-19 mitigation measures. The development and expansion of the role of the Competitiveness Council in 2021 could spur a more systematic involvement of business partners in designing, drafting and implementing measures that affect businesses. Supported by a permanent secretariat and ad hoc technical working groups and bodies, the Council has the potential to become an important forum of consultation with the government.

The first result of this closer cooperation is the Register of (fiscal and para-fiscal) Charges, reporting information on levies and charges affecting businesses at national and local levels. The Register provides a basis for further simplification and harmonisation in

the domain of local taxation. It remains to be seen whether the authorities will use the Competitiveness Council in the future to strengthen major government reforms and programmes. This would be in line with the policy guidance (PG 4) of the 2021 Joint Conclusions of the Economic and Financial Dialogue between the EU and Montenegro.

The government has embraced digitalisation as a way to strengthen Montenegro's regulatory environment. The process to digitalise the public sector and develop transactional e-government services features prominently in the policy guidance of the Joint Conclusions (PG 5). In its latest ERP 2022-2024, Montenegro committed to developing transactional electronic government services that, when implemented, may greatly improve the institutional and regulatory environment and bring clear gains in terms of efficiency and transparency of relations between businesses and public authorities. Though most of these reforms were planned or initiated earlier, the outbreak of the COVID-19 pandemic provided an additional stimulus to these e-government projects. Implementing the discussed e-government services could achieve a significant reduction in the scope for corruption and unequal treatment between businesses. Accelerating the digitalisation of the economy and public administration may also facilitate progress in addressing key challenges 1 and 3, as it reduces the time and cost of administrative procedures for employers and businesses.

The proposed *Reform Measure 9 – 'Establishing a full electronic registration of enterprises'* is credible and well developed. It should streamline the procedure of setting up and registering a company.

Another of the proposed reforms – *Measure 11 – 'Strengthening competitive position of MSMEs by establishing a single access point'* aims to create a web portal containing all information relevant to micro, small and medium enterprises that should also enable digital application for MSMEs support. It is relevant and could contribute to creating a business-friendly regulatory environment.

Reform Measure 13 – 'Improving digitalisation of the e-government by developing a platform for complex e-services' focuses on developing transactional level e-services of key interest to the Montenegrin society. While its scope and significance go beyond the institutional and regulatory environment, business (in particular micro and small businesses) would be among the beneficiaries of the reform. The measure is relevant for increasing the competitiveness of and innovation in the Montenegrin economy. The government could focus on simplifying administrative procedures, both paper-based and digital, to achieve better results. It is not clear how the local authorities are involved in providing the envisaged e-government services.

Reform Measure 14 – 'Improving legislative and regulatory framework for further development of broadband internet connection infrastructure' could be considered a flanking measure for the development of digital services at the national and local level. It concentrates on the adoption and implementation of the Law on Electronic Communications (in line with Directive (EU) 2018/1972), the national plan for broadband development and the strategy of development of 5G networks. The reform is relevant and will undoubtedly contribute to developing a competitive and modern economy. A more detailed description of expected impacts on competitiveness, society and labour is advised.

Access to finance, support for innovation and reform of state-owned enterprises complement the list of regulatory environment reforms over the coming years. Montenegro's current ERP adds new areas of focus for the structural reforms under the regulatory environment challenge. Better access to finance for micro, small and medium enterprises is, in a way, a classic area of business, institutional and regulatory environment reforms in many EU and Western Balkan countries. In Montenegro, it regained prominence due to the pandemic, with SMEs in the tourism and related sectors hit very hard in 2020 and only partially recovering in 2021.

Reform Measure 10 – 'Improving access to financing for MSMEs by creating a Credit-Guarantee Fund' is relevant and credible, but it depends on swift adoption of the legislative framework by the Montenegrin Parliament.

Access to funding also features prominently in developing innovation and providing support for research and development. *Reform Measure 12 – 'Strengthening the national innovation and research ecosystem'* focuses on effectively implementing the Innovation Fund to support innovative enterprises and on building the institutional capacity of the Council for Innovation and Smart Specialisation, in line with the country's smart specialisation strategy. It is relevant and aligned with the EU strategies. Successful monitoring and implementation of the measure depends on the Ministry of Economic Development and the Innovation Fund having sufficient administrative capacity.

A prospective public financial management reform, *Measure 15 – 'Improving management of business undertakings in majority state ownership'* fits in well with other reforms of the regulatory environment. As reported by the latest OECD Competitiveness Outlook 2021, Montenegrin state-owned enterprises are managed and perform worse than other state-owned enterprises in the region. The ultimate aim of the reform, according to the Ministry of Finance and Social Welfare, is to define an optimal portfolio of state ownership, transform the management structures and practices of selected enterprises and ultimately improve their financial performance by setting up a holding company for these enterprises. If successfully implemented, this would have a major impact on the performance of Montenegro's economy, given that state-owned enterprises are some of the largest companies and the largest employers. Nonetheless, the scope of the reform presented in 2022-2024 ERP is much narrower and focuses only on the setup and initial operations of Montenegro Works company, the body that should spearhead these reforms. A comprehensive approach in the next edition of the ERP is desirable.

In summary, Montenegro's efforts to improve its regulatory and institutional environment started showing some results in 2021. This also prompted the government to table new priority reforms in this field. Public authorities committed to action to digitalise the economy and roll out new e-government services. If fully implemented, these reforms have the potential to improve the efficiency and transparency of the regulatory environment, reduce costs and limit the scope for corruption. New reform initiatives on access to finance, support for innovation and management of state-owned enterprises appear very relevant. Working towards an inclusive, business-oriented regulatory environment and implementation of a business-centric culture by the central and local public administrations should remain the authorities' focus in the coming years.

Key challenge #3: Formalisation of the economy

The informal economy constitutes a major obstacle to the inclusive, sustainable growth and the competitiveness of Montenegro. According to different studies and

estimates, the informal economy represents between 25 and 33% of the country's GDP and employs around 30% of the workforce (UNDP). The informal sector is fuelled by deficiencies in the institutional and regulatory environment, weaknesses on the labour market, insufficient enforcement capacity of the public authorities, corruption and tax non-compliance. The most common practices of the informal economy in Montenegroare reportedly informal employment and other forms of informal contracts (particularly for works in the services sector), unregistered sales of goods and services; tax avoidance on sales of excisable goods; pursuing economic activity without registration or the required license.

The impact of the informal economy is particularly harmful for the SMEs operating legally and microenterprises in the services sector, which dominate the economy. These smallest companies perceive informal competition as the most costly obstacle to doing business. The costs of the informal economy and corruption are also higher for innovative companies, which particularly hinders the development of sectors of the economy that are based on knowledge and skills. On the side of the public authorities, the lack of proper monitoring tools is an obstacle to preparing, implementing and assessing the results of targeted reform measures that attempt to address the informal economy.

Policies that aim to reduce the size of informal economy 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 informal economy, apply strong disincentives and penalties to businesses and individuals that continue operating in the informal sector and unfairly compete with legitimate businesses. Public authorities also need to take decisive actions to close any gaps in the legal and institutional system that are subject to abuse. The authorities need to draw on a wide spectrum of measures to combat the problem of informal economy effectively.

Previous attempts to reduce the informal economy were undermined by the lack of continuity and political support and by delays caused by the COVID-19 crisis. Reducing the scale of the informal economy became a formal priority for the government in 2017. An action plan adopted at that time had a rather limited scope, focusing on a narrow range of activities (such as checks and suppressive action on businesses via different inspection services, with the focus on the tourism sector) that could provide a quick increase in revenue to the state budget. A more comprehensive approach to informal economy and a more ambitious, if undefined programme of reforms was outlined in the 2019-2021 ERP. The authorities acknowledged, at the time, the need for a multi-faceted, multisector approach to the challenge and the importance of involving legitimate businesses and social partners in action to reduce the informal economy.

However, since the time, the activities reported under successive ERPs focused mostly on internal reorganisations, reshuffling responsibilities between different administrative bodies and working groups and repackaging previous plans. They did not result in a convincing new approach to the informal economy and failed to overcome most of the previously identified deficiencies. Progress was delayed again by the outbreak of the pandemic, which put on hold virtually all informal economy – related activities scheduled under the structural reforms part of the ERP, and personnel changes. As a result, despite the EU recommendations and Policy Guidance provided through the Joint

Conclusions in recent years, Montenegro did not produce a new action plan that would go beyond suppressive and control measures or provide incentives to bring companies and work into the formal economy.

The 2022-2024 ERP relies heavily on measures in the 'Europe Now' programme to tackle the challenge of the informal economy. Reducing the size of the informal economy, with an emphasis on the labour market, is one of the stated goals of the 'Europe Now' programme, a fiscal and tax reform adopted by the parliament at the end of 2021. The key reform under this programme combines the reduction of the tax wedge on labour, thanks to the abolition of health insurance contribution paid by employers, and the introduction of non-taxable income for gross salaries up to EUR 700. This is accompanied by a higher (than before) personal income tax on salaries above EUR 1000. These measures are expected to lower the labour costs for employers and lead to the creation of new (legal) jobs, thus directly reducing the level of undeclared work in the economy.

Reform Measure 17 – 'Improving the business environment by reducing the labour tax wedge' – is a direct reflection of this key reform in the 2022-2024 ERP. The measures are relevant, ambitious and comprehensive. They seek to address all three key challenges for Montenegro's economy – the first reform of such cross-cutting nature in the ERP. The reform certainly has the potential to make a significant impact on the size of informal economy in Montenegro, but potential risks (which are not described well in the text) are high. Careful monitoring of the impact and getting an up-to-date picture of the informal economy sector in Montenegro (see below) are needed to assess the short and mid-term results of the reform and to make any adjustments, if necessary.

The key labour tax reform is accompanied by two, relatively low-key measures. *Reform Measure 16 – 'Suppressing informal economy through the tax administration reform'* is a continuation of the measure from previous years. It aims to improve the efficiency of the Revenues Administration and reduce costs for taxpayers, providing the capacity to uncover and act on the informal economy. As such, the measure is relevant and clearly developed. However, and as indicated in the past, the risks of further delays in implementation due to restructuring, limited capacities and turnover of staff remain high.

A new reform, *Measure 18 – 'Information system and mobile application for monitoring the tourism parameters'* aims to link some of the IT systems of the public administration and roll out a new mobile application to register guests to curb unregistered (and thus non-taxed) stays in holiday accommodation. The reform is embedded in the economic priorities of the government, but appears narrow in scope for a strategic-level priority reform addressing a key challenge. It would become more effective if linked with other measures designed to curb the informal economy and boost the competitiveness of legally operating companies in the tourism or services sector.

The ERP lacks a cross-sectoral, overarching measure that underpins action to reduce the informal economy. According to government officials, the long-delayed work to draft Montenegro's new action plan on the informal economy, mentioned in the last three ERPs, is expected to continue in 2022, but no longer in the scope of this strategic document. As a first step, a survey on the informal economy is to be carried out among companies and households. A consultancy was reportedly chosen to carry out this task and assist the working group, comprised of officials from different ministries, in

selecting and designing the activities to be included in the action plan. The survey should also be instrumental in the context of the tax wedge reform (Measure 17).

Montenegro implemented two related initiatives not included in the ERP structural reforms during the pandemic. The first resulted in new excise duty stamps, backed up by a smartphone application that enables users to check the authenticity and legality of excise goods. The second, the e-fiscalisation initiative, aimed at registering and supporting proper taxation on all cash transactions at the point of sale. It was partially implemented in 2021 and work will continue in 2022. These are rare examples of actions aimed at reducing the informal economy that were achieved in the last years.

Follow-up action, better coordination and steadfast implementation are required to achieve tangible results. The yet-to-be drafted government plan to reduce the size of the informal economy would benefit from an approach combining targeted, suppressive and control measures with further incentives to legalise informal businesses and informal employment, beyond the measures taken under the 'Europe Now' programme. Another, so far disregarded aspect of the informal economy that requires government attention is the need to address the most obvious gaps and inconsistencies in legislation that facilitate the operation of informal businesses (for example, concerning the powers of labour inspectorate that operates under the Administration of Inspections Affairs). A deep reform of inspection bodies and their digitalisation is necessary, together with action to develop capacities of inspections and tax authorities. Continuous coordination of action by different public institutions, businesses and other social actors and a structured dialogue involving both central and local authorities is key for the successful and timely implementation of any measures. The process of the digitalisation of the public administration and services provides ample opportunity to reduce the scope and size of the informal economy. The determination of the public authorities to enforce rules through administrative and judicial means will play an equally important role in the process.

In summary, the government has recognised the magnitude of the challenge posed by the informal economy for the long-term, sustainable development of Montenegro and it took some decisive actions at the end of 2021. It remains to be seen whether the reforms and legal changes initiated under the 'Europe Now' programme will result in a significant reduction of the informal economy. Successful implementation of key tax reforms in the labour market and changes ongoing in the regulatory environment, in particular digitalisation, may indeed address some of causes of the informal economy over the comingyears. Nonetheless, a clear vision, further reforms and a plan for follow-up actions is needed to produce a cumulative and pronounced impact on the informal economy.

Box: Monitoring performance in light of the European Pillar of Social Rights[6]

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. The European Pillar of Social Rights Action Plan, adopted on 4 March 2021, aims at rallying all relevant forces to turn the principles into actions. Since the 20 principles provide direction on how to achieve upward convergence and better working and living conditions in the EU, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes a sharper focus on employment and social reforms through greater monitoring of 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 of Social Rights to guide the alignment of their labour markets and welfare systems with those of the EU.

Relative to the EU-27 average, Montenegro faces challenges with regard to a number of indicators of the Social Scoreboard supporting the European Pillar of Social Rights.

The COVID-19 pandemic reversed years of positive labour market trends. Although employment and unemployment rates, as well as the share of young people (15-29) not in employment, education or training (NEETs) had begun to improve, the pandemic undermined this progress. Structural challenges in the labour market persist, including high and increasing long-term unemployment and continued regional disparities. The gender employment gap continued to narrow steadily, although figures remain below the EU-27 average.

MONTENEGRO		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU avg, improving
	Individuals' level of digital skills (basic or above basic)	Worse than EU avg., trend N/A
	Youth NEET (% of total population aged 15-29)	Worse than EU avg., deteriorating
	Gender employment gap	Worse than EU avg., improving
	Income quintile ratio (S80/S20)	Worse than EU avg., improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU avg., deteriorating
	Unemployment rate (% of population aged 15-74)	Worse than EU avg., deteriorating
	Long term unemployment rate (% of population 15-74)	Worse than EU avg., deteriorating
	GDHI per capita growth	N/A
Social protection and inclusion	At risk of poverty or social exclusion (in %)	Worse than EU avg., improving
	At risk of poverty or social exclusion rate for children (in %)	Worse than EU avg., improving
	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU avg., deteriorating
	Disability employment gap	Worse than EU avg., deteriorating
	Housing cost overburden	Better than EU avg., improving
	Children aged less than 3 years in formal childcare	N/A
	Self-reported unmet need for medical care	Worse than EU avg., improving

Skills mismatches and the weak provision of adult learning affect school-to-work transitions and result in workers being insufficiently prepared to find suitable and sustainable employment. The quality and relevance of the entire education system and the lack of practical experience of graduates from VET and higher education are long-term challenges, which have been exacerbated by the pandemic. Montenegrins' level of digital skills was slightly below the EU-27 average in 2017, but there is insufficient data to identify a trend. Montenegro continues to outperform the EU-27 average on the rate of early leavers from education and training.

Employment remains the best route out of poverty. 37.8% of the population and 45.8% of children were at risk of poverty or social exclusion in 2020. After falling continuously, the rates increased again following the outbreak of the pandemic. Though the social protection system has not so far been well equipped to target and assist those in need or to bring people onto the labour market, the Roadmap of Reforms of the social and child protection system is expected to address the systemic shortcomings. In 2020, Montenegro outperformed the EU-27 average in terms of the housing cost overburden, and significantly improved its performance as regards self-reported unmet medical needs, remaining only slightly under the EU-27 average.

The collection of timely and reliable data needs to be sustained and strengthened. Efforts should continue to bring the employment and social statistics more into line with EU standards and to send statistics to Eurostat systematically and on time.

[6] The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2020 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). For data see Annex B. NEET: not in employment nor in education and training; GDHI: gross disposable household income.

5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2021

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has adopted targeted policy guidance (PG) for all partners in the region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the PG is similar to that of the country-specific recommendations usually adopted under the European Semester for the EU Member States. The Commission evaluates the work carried out to implement the policy guidance in the following year's ERP assessments. The table below presents the Commission's assessment of implementation of the 2021 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at Ministerial level on 12 July 2021.

Overall: Partial implementation (57.9%)[7]	
2021 policy guidance	**Summary assessment**
PG 1: Provide well-targeted and temporary pandemic-related fiscal support to vulnerable households and businesses; provided that the economic recovery takes hold by the time of adoption of the 2022 budget, supplement the budget with a medium-term fiscal consolidation plan foreseeing a gradual reduction of the budget deficit and public debt ratio, starting in 2022.	There was **partial implementation** of PG 1: 1) **Partial implementation**: During the COVID-19 pandemic, the government adopted five packages of socio-economic measures, including wage subsidies to preserve jobs and support vulnerable sectors, including pensioners and unemployed workers. It provided new credit lines under favourable conditions as well as loan moratoria and tax deferrals, for companies and citizens. Overall, support measures are being gradually phased out and no new socio-economic packages were set up since April 2021, as the economy started recovering strongly. Montenegro adopted a new fiscal strategy and budgetary medium-term framework in December 2021. However, the 2022 budget targets a higher deficit of 5% of GDP for this year (above the fiscal rules' ceiling of 3% of GDP), declining gradually afterwards to 0.6% of GDP in 2024. Public debt is planned to fall markedly from 84.5% of GDP in 2021 to 67.6% in 2024. However, consolidation targets seem difficult to attain without additional measures to strengthen budget revenue and contain or reduce spending.
Prepare a new public administration optimisation plan with a view to contain the share of the public sector wage bill in GDP.	2) **Limited implementation**: Montenegro adopted a new public administration reform strategy (2022-2026). The strategy sets out a plan to optimise human resources in line with the digitisation of the public administration. However, it does not set targets for this adjustment, pending on performing a series of functional sectoral analyses first.

[7] 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.

Establish an IT system for electronic management and security printing of excise stamps in order to broaden the tax base by reinforcing the fight against informality and tax avoidance. Advance the implementation of a public investment management assessment (PIMA) programme, to improve the quality of public investments.	3) **Full implementation**: Implementation of the new system for electronic management of excise stamps started in 2021. The system includes QR codes and new digital security elements to prevent the illegal trade of excise products. 4) **Limited implementation**: A PIMA assessment report was released in July 2021, followed in August by an IMF report with recommendations, and an action plan (to be adopted in Q1 2022).
PG 2: Adopt amendments to the Law on Budget and Fiscal Responsibility with the aim of setting up an independent body in charge of fiscal oversight. Develop a comprehensive overview of all tax exemptions, including an analysis of their economic and social impact. Support the economy and business liquidity by reducing public sector arrears and deadlines for VAT return.	There was **partial implementation** of PG 2: 1) **Limited implementation**: Amendments to the Law on Budget and Fiscal Responsibility are being prepared in order to create the formal preconditions for the establishment of a fiscal council. Adoption of the amendments is planned in the first half of 2022. 2) **Partial implementation**: The Ministry of Finance and Social Welfare drew up a list of tax exemptions with the technical support of the IMF. However, the analysis of the economic and social impact is still pending. 3) **Substantial implementation**: The time limit for VAT refund was reduced from 60 to 30 days. Measures were part of the socio-economic measures to support the economy during the pandemic. Further progress was made in reducing public sector arrears (i.e. liabilities for current expenditure), recording a 8.4% y-o-y contraction at the end of 2021.
PG 3: Maintain a strong financial sector regulatory framework in line with international and EU best practices, ensure sound credit risk management, a transparent display of asset quality and adequate provisioning. Further reduce institutional and legal obstacles to swift and effective NPL resolution mainly outside the responsibility of the central bank, including by facilitating out-of-court settlement and modernising the insolvency regime. Complete the ongoing Asset Quality Review, transparently publish its general findings and timely take remedial action where needed.	There was **substantial implementation** of PG 3: 1) **Substantial implementation**: Good progress was made in key pieces of legislation to further align Montenegro's regulation and supervision with the current EU framework. This included the Law on Credit Institutions and the Law on the Resolution of Credit Institutions that became effective in January 2022. Most support measures have been phased out, except some for households. Regarding provisioning, the coverage ratio has decreased slightly, but remains high in a regional comparison. 2) **Partial implementation**: The CBCG has completed a survey that identified slow collateral resolution procedures. It also created an inter-ministry working group to resolve the issues. Overall, however, progress in legislation and in implementing actions to strengthen the broad institutional framework for efficient insolvency has been slow. 3) **Substantial implementation**: The AQR was completed, and its main headline results published. Follow-ups are currently being implemented by banks.

PG 4: In cooperation with local authorities and representatives of business community, conduct an analysis of businesses-related procedures at the local administration level to identify sources of possible inefficiencies and propose improvements of the institutional and regulatory environment, including for infrastructure developments. Establish technical-level mechanisms and administrative best practices allowing for a continuous structural dialogue between authorities and the business community. Focus on further simplifying business taxation, reducing number and diversity of para-fiscal charges and facilitating payment of tax commitments.	There was **substantial implementation** of PG 4. 1) **Partial implementation:** The Competitiveness Council, which brings together representatives of the government, business associations and municipalities, developed an action plan to remove by mid-2022 some of the less complex barriers to business that were identified by the Council. 2) **Substantial implementation**: In February 2021, the government adopted a new decision on the membership and functions of the Competitiveness Council, with the aim of increasing its role and efficiency. There was improvement in communication, consultation and involvement of the private sector on draft legislative acts and on the directions of the country's economic policy development (ERP). 3) **Substantial implementation**: The registry of fiscal and para-fiscal charges was set up in March 2021 and is regularly updated. There are plans to create a similar registry for business licences. All municipalities implemented laws on administrative fees and on local communal fees, adopted in March 2019. Work is progressing on electronic registration for companies and it should lead to a further reduction or abolishment of the fees and charges applied when registering a business.
PG 5: Prioritise digitalisation of the public sector and development of transactional electronic government services to speed up and enhance the economic recovery. Finalise work on a new action plan to tackle informality and start implementing it, including targeted preventive measures and incentives to legalise informal businesses and employees. Ensure structural cooperation between central and local authorities in the development and implementation of measures aimed to reduce the informal economy.	There was **partial implementation** of PG 5. 1) **Substantial implementation:** Digitalisation of the public sector became a priority for the government and is supported by two strategies, the Digital Transformation Strategy 2022-2026 and the Public Administration Reform Strategy 2022-2026. The project to set up a national platform for the provision of complex e-services started in 2021. Further reforms focus on the digitalisation of crucial public services like education, healthcare and employment. 2) **No implementation:** Work on the comprehensive action plan on the informal economy is postponed to the second half of 2022. **Partial implementation:** Central and local authorities (represented by the Union of Municipalities) worked together with business associations on structural reform issues, including on the informal economy, in the framework of the Competitiveness Council. The action plan to remove some of the less-complex barriers to business, developed by the Competitiveness Council, includes actions to combat the informal economy.
PG 6: Establish an inter-ministerial task force involving	There was **substantial implementation** of PG 6: 1) **Full implementation**: The inter-ministerial task

relevant ministries, their agencies and stakeholders to develop a Youth Guarantee implementation plan.	force was set up, involving relevant ministries, their agencies and stakeholders with the task of drawing up a Youth Guarantee implementation plan.
Based on the review of the social protection system, finalise the roadmap and start implementing social protection reforms.	2) **Substantial implementation**: The review of the social protection system was finalised and the Roadmap of Reforms was drafted, although it has not yet been officially adopted nor does it contain a clear timeline and financial planning. Reform efforts have continued, notably by amending the Law on Social and Child Protection granting universal benefits to all households with children under the age of six.
Prepare, in cooperation with the business sector, a roadmap with concrete measures for reforming the practical and dual VET education system to improve their impact on labour market outcomes.	3) **Partial implementation**: The Action Plan for 2022-2023 for the Implementation of the Strategy for Vocational Education (2020-2024) sets out various measures and activities reforming the practical and dual VET education system to improve their impact on labour market outcomes.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2022-2024 ERP

Public financial management

The reforms of Public Financial Management (PFM) over the last two years led to the introduction of programme-based budgeting, including the first elements of performance budgeting. Additional legislative changes are needed to complete these reforms, such as the establishment of a fiscal council and the adoption of accrual accounting. A new PFM strategy for 2022-2026 has yet to be finalised. Capital budgeting, debt management, and asset management require further reforms. The interoperability of the different IT systems remains an obstacle to some reforms. Some progress was made in 2021 on budget transparency. However, the monitoring and reporting framework is still lacking, due to IT issues. The civil society is not systematically involved in monitoring the implementation of the PFM reforms. Implementation of the public sector accounting law in 2022 remains uncertain.

Reform Measure 15 'Improving management of business undertakings in majority state ownership' is analysed under the key challenge on strengthening the regulatory environment.

Green transition

Montenegro committed to the green agenda for the Western Balkans to achieving carbon neutrality by 2050. It is in the process of drawing up a national energy and climate plan. The country needs to address significant challenges in the areas of energy, transport and Trans-European Networks, and in particular on the future of the coal power plant in Plevlja, which produces approximately 50% of the country's electricity.

The environmental impact of the construction and exploitation of the next sections of Bar-Boljare highway needs to be neutralised. Waste management and wastewater treatment is another area where significant work is necessary. Air pollution remains a major concern in the regions of Plevlja, Podgorica and Niksic. There was moderate improvement on nature protection and biodiversity protection over the past years, but further progress is needed to align the country with EU standards.

Reform Measure 21 'Reducing release into circulation of lightweight carrier plastic bags and single-use plastic products' is a new reform, relevant given Montenegro's environmental concerns. It may also result in increased cooperation between the NGO sector, scientific community, businesses and local administration. The analysis lacks real data on recycling and on the volume of plastic waste. The impacts of the reform may be difficult to measure, as statistical data on plastic waste and recycling is not available.

Digital transformation

The digitalisation of the public sector and development of transactional e-government services for the population and businesses has featured prominently among the priority reforms of the Montenegrin government over the past years. The process gained additional momentum during the COVID-19 pandemic. Access to broadband networks is key to the digitalisation of the economy, public services and to implementing Montenegro's Smart Specialisation Strategy in the ICT industry. By the end of 2020,

some 93% of Montenegrin households were in the area with a high-speed broadband connection (defined as 30 Mbit/s). However, the actual take-up of high-speed broadband or better among households is much lower, only reaching some 29% in 2020. Meanwhile 20% of households still had no internet access in 2019, despite it being technically available, with the figure increasing to 37% in rural areas.

Four reform measures that address digital transformation are analysed in the section covering the key challenge to strengthen the regulatory environment.

Business environment and reduction of the informal economy

The analysis of these areas and of their relevant reform measures (10 in total) is provided in the section on the key challenge to strengthen the regulatory environment and the key challenge on formalisation of the economy.

Research, development and innovation

Public and private investments in research, development and innovation are low. Montenegro is nonetheless considered an emerging innovator in the European Innovation Scoreboard for 2021, with a summary innovation index of 47.8% relative to EU 100%. The links between academia, research institutes and business are still weak. Only 2.2% of Montenegrin micro, small and medium enterprises invest in R&D, compared to 22% at regional level. Research staff are employed almost exclusively by the government or in the higher education sector. With a rate of 0.50% of GDP invested in R&D (2018), Montenegro's spending is just over one fifth of the EU-28 average (2.18% of GDP in 2018). The adoption of a Smart Specialisation Strategy (S3) in June 2019 allows Montenegro to concentrate its scarce resources on thematic sectors for research and development as a basis to strengthen sectoral policies based on innovation. Its areas of specialisation are agriculture and food processing, energy and sustainable environment, sustainable health tourism and ICT.

Reform Measure 12, 'Strengthening the national innovation and research ecosystem', is analysed under the key challenge on strengthening the regulatory environment.

Economic integration reforms

The low level of processing local products and the small size of businesses hinder the country's competitiveness for exports. Montenegro's largest exports are low value-added bulk products - aluminium, bauxite and electricity. These three items alone made up 42% of all merchandise exports in 2020. Manufactured goods, construction materials, machinery, transport equipment and food are the main imports. There is significant potential to increase intra-regional trade within the Central European Free Trade Agreement (CEFTA) framework and with the EU, as trade preferences granting access to the EU market without customs duties apply to 98.6% of Montenegrin products.

In 2020, during the pandemic, Montenegro's foreign trade contracted by 18.1% compared to the previous year. Bilateral trade with the EU contracted similarly, by around 16% year-on-year. The EU remains Montenegro's main foreign trade partner, accounting for 44% of all trade (i.e. 38.5% of exports and 45.1% of imports of goods). This compares to 31.2% of trade with CEFTA countries. The total trade in goods and services plunged from 108.5% of GDP in 2019 to 86.3% in 2020. The EU also remains the main source of foreign direct investment inflows for Montenegro.

The 2022-2024 ERP does not include reforms that cover this area.

Energy market reforms

The energy market is in need of improvement to its infrastructure and efficiency. Energy transmission losses amounted to over 17% of electricity consumption in 2017, five times the EU average. The reliability of the electric power supply in rural areas also needs to improve. The use of renewable energy sources is high. In 2018, some 39% of the country's electricity production came from renewable sources, mostly hydropower and biomass. Energy production from renewable sources and cross-border trade in energy should increase significantly over the coming years thanks to new investments. The wholesale and retail electricity markets in Montenegro are open for competition, but new providers are yet to come.

Reform Measure 20, 'Financial support to households aimed at applying energy efficiency measures' is rolled over from the last ERP. The reform remains relevant and credible. Geopolitical developments are likely to accelerate implementation of this measure.

Transport market reforms

Montenegro would benefit greatly from developing and improving transport infrastructure and from ensuring a good connection with European transport corridors. The country's geographical situation makes it particularly important to improve transport links with the wider region and the rest of Europe. Montenegro scores very low on road, airport and shipping connectivity. There is continuous if slow progress on improving and modernising sections of the road and rail networks, mainly thanks to EU funding. Sufficient funding for the current maintenance of rail and road network remains an issue. Further action is needed to open up the rail market to competition. The suspended 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.

The 2022-2024 ERP does not include reforms that cover the transport market.

Agriculture, industry and services

Montenegro is a net importer of food, importing on average a value of EUR 500 million a year and exporting only a value of EUR 50 million. Agricultural exports to the EU remain mostly untapped due to the limited scale of agricultural production and the need to meet EU veterinary and plant health requirements. Agricultural production is largely made up of small, often family-run holdings with high production costs, limited organisation and a lack of suitable equipment. Developing ecological farming, local and regional brands and food processing are among the priorities of the Smart Specialisation Strategy.

The industrial base remains modest and hampered by the low degree of product diversification and low labour productivity. The production of higher value-added products remains limited and local industry has a low degree of exposure to European and global supply chains. The government's efforts focus on providing support to SMEs and SME policy, a natural choice in a small economy. Industrial policy receives continuous support from the state, but access to finance remains a significant obstacle for micro and small enterprises.

Services, particularly tourism services, are the country's main export. They accounted for around 80% of total exports in 2019 before the pandemic. The sector provided over 72% of gross value added in 2019 and employed close to three quarters of the workforce. The country's Smart Specialisation Strategy of 2019 identifies health tourism as a direction to develop, which would partially offset the high seasonality in tourism. Further diversifying the services sector away from tourism would reduce the economy's vulnerability to external factors, such as the pandemic, geopolitical risks, and climate change.

Reform Measure 22 'Support to investments in the food manufacturing sector aimed at strengthening the competitiveness' is a continuation of the reforms tabled in previous ERP editions. The reform is linked to IPARD implementation and dependent on IPARD funding. The measure is relevant and of a good quality, well developed and explained. It provides links to the Smart Specialisation Strategy and creating green jobs for young people.

Reform Measure 19 'Sustainable green tourism' is a revised version of a reform tabled in the previous ERPs to support tourism. It proposes to include green growth ('greening' of tourism establishments) and digitalisation as important components in tourism. The measure is relevant and justified. It appears well designed and realistic, though implementation will depend on further developments in the health and economic context. The funding appears rather limited given the ambitious scope of this reform.

Reform Measure 10 'Improving access to financing for MSMEs by creating a Credit-Guarantee Fund' is analysed under the key challenge on strengthening the regulatory environment.

Education and skills

This area and Reform Measures 4 and 5 are analysed above in Section 4, under Key Challenge 1.

Employment and the labour market

This area and Reform Measures 1, 2 and 3 are analysed above in Section 4, under Key Challenge 1.

Social dialogue

Montenegro made a marked improvement in the consultation of social partners in 2021. The tripartite Social Council resumed its meetings and was regularly consulted on relevant decisions, including on the Europe Now programme. The effectiveness of social dialogue and the mainstreaming of the consultation of social partners across all relevant ministries and departments however remains limited. The update of the general collective bargaining agreement following the adoption of the new Labour Law in 2019 has still not been finalised.

Social protection and inclusion

Reform Measures 6 and 7 and, partially, this area are analysed above in Section 4, under Key Challenge 1.

The social situation in Montenegro has stagnated after the improvements made in previous years. **Employment remains the best route out of poverty.** The at-risk-of-poverty-or-social-exclusion (AROPE) rate is lowest for employed persons (10.5% in 2019, below the 11.2% EU average) while the AROPE rate for people not employed is 39.9%. Activation measures coupled with targeted social assistance therefore remain key. Children of all ages are at the highest risk of poverty. Short working lives and an increasing dependency ratio put pressure on the sustainability of the pension system, with additional pressure expected due to the new pension reform.

Healthcare

Although the availability of healthcare services is adequate, primary healthcare provision is insufficient. Under the Law on Compulsory Health Insurance, all citizens are entitled to access to healthcare. However data on real coverage is scarce, with estimates ranging from 99.3% (age 65 or over) to 81.3% (18 to 24) (CeMI, 2017). Financing the healthcare system has improved, reaching 8.42% of GDP in 2018, but out-of-pocket payments remained staggeringly high at 39.6% in 2018, compared to the EU average of 15.6%.

Although the availability of healthcare services (number of hospital beds and medical staff) is comparable to the EU averages, primary healthcare provision and prevention measures remain underdeveloped. The rate of self-reported unmet medical needs rose sharply to 3.1% in 2019, having previously fallen significantly to 2.1% in 2020, close to the EU average of 1.8% in 2020. The government adopted a Strategy for Improving the Quality of Health Care and Patient Safety (2019-2023) in 2019, focusing on improving and monitoring the quality of healthcare.

Reform Measure 8 on 'Improving access to and quality in delivery of healthcare services and the digitalisation of the healthcare system' rolls over Measure 20 from the previous year. Implementation of this measure did not progress due to the pandemic, and neither did the aim to bring in telemedicine services. Telemedicine has the potential to remedy certain shortcomings in the provision of primary healthcare services, such as accessibility, but it remains to be seen whether it will address the overall structural shortcomings of the healthcare system.

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

Area/Sector	2016	2017	2018	2019	2020	EU-27 Average (2020 or most recent year)
Energy						
Energy imports dependency (%)	34.6%	40.5%	31.1%	32.9%	27.4%	57.50%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	263.06	263.25	259.50	258.14	280.25	110.18
Share of renewable energy sources (RES) in final energy consumption (%)	41.53%	39.69%	38.80%	37.72%	43.77%	22.09%
Transport						
Railway Network Density (meters of line per km^2 of land area)	18.1 w	18.1 w	18.1 w	18.1 w	N/A	49.0 (2018)
Motorization rate (Passenger cars per 1000 inhabitants)	297 w	310.6 w	331.7 w	350.3 w	N/A	519 (2018)
Agriculture						
Share of gross value added (Agriculture, Forestry and Fishing)	9.0%	8.4%	8.2%	7.9%	9.1%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	7.8%	7.9%	8.0%	7.1%	7.5%	4.3%
Utilised agricultural area (% of total land area)	18.4% w	18.6% w	18.6% w	18.6% w	18.7% w	40.6%
Industry						
Share of gross value added (except construction)	12.2%	11.3%	12.5%	11.9%	13.5%	19.5%
Contribution to employment (% of total employment)	9.9%	9.5%	9.9%	9.5%	10.1%	18.2%
Services						
Share of gross value added	72.1%	73.4%	72.3%	72.3%	70.1%	73.1%
Contribution to employment (% of total employment)	74.7%	75.0%	73.1%	73.4%	74.1%	71.0%

Business Environment						
Rank in Global Competitiveness Index (Source: World Economic Forum)	70	77	71	73	N/A	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	Up to 37.2%	25% to 33%	N/A	N/A	N/A	N/A
Research, Development and Innovation						
R&D intensity of GDP (R&D expenditure as % of GDP)	0.32%	0.35%	0.50%	N/A	N/A	2.32%
R&D expenditure – EUR per inhabitant	20.60€	24.10€	37.7€	N/A	N/A	694.60€
Digital Economy						
Percentage of households who have internet access at home	69.8% w	71%	72%	74%	80% w	91%
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	69.9% w	71.3% w	71.5% w	73.5% w	78% w	88%
Trade						
Export of goods and services (as % of GDP)	40.6%	41.1%	42.9%	43.8%	26.0%	46.7%
Import of goods and services (as % of GDP)	63.1%	64.5%	66.7%	65.0%	61.0%	42.9%
Trade balance (as % of GDP)	-43.9%	-44.9%	-46.2%	-44.1%	-41.5%	N/A

Education and Skills						
Early leavers from education and training (% of population aged 18-24)	5.5%	5.4%	4.6%	5.0%	3.6%	9.9%
Young people neither in employment nor in education and training (NEET) (% of population aged 15-29)	22.3%	21.4%	21.0%	21.3%	26.6%	13.7%
Children aged less than 3 years in formal child care (% of under 3-years-olds)	28.9% [w]	32.89% [w]	34.13% [w]	37.21% [w]	N/A	35.3% (2019)
Individuals who have basic or above basic overall digital skills (% of population 16-74)	N/A	50%	N/A	N/A	U	56%(2019)
Employment and Labour Market						
Employment Rate (% of population aged 20-64)	57.1%	58.2%	59.8%	60.8%	55.2%	71.7%
Unemployment rate (% of labour force aged 15-74)	17.8%	16.1%	15.2%	15.2%	17.9%	7.1%
Long term unemployment rate (% of labour force aged 15-74)	13.4%	12.5%	11.4%	12.0%	13.4%	2.5%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	11.7 pps.	13.8 pps.	13.8 pps.	13.3 pps.	12.9 pps.	11.0 pps.
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	16.6 pps.	25.8 pps.	21.2 pps.	18.7 pps.	28.0 pps.	24.5 pps.
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	107.23

Social Protection System						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	43.1%	42.2%	41.2%	36.6%	37.8%	21.9%
At-risk-of-poverty or social exclusion rate of children (% of population 0-17)	48.9%	49.0%	48.5%	43.9%	45.8%	24.2%
Impact of social transfers (Other than pensions) on poverty reduction	17.24%	24.84%	23.72%	16.95%	18.71%	32.68%
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)	7.38	7.57	7.37	6.72	5.96	5.24
Housing cost overburden (% of population)	16.5%	15.1%	14.7%	11.7%	9.4%	9.9%
Healthcare						
Self-reported unmet need for medical care (of people over 16)	2.7%	2.7%	2.3%	3.1%	2.1%	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	38.23%	42.17%	39.61%	38.56%	N/A	15.57%(2018)

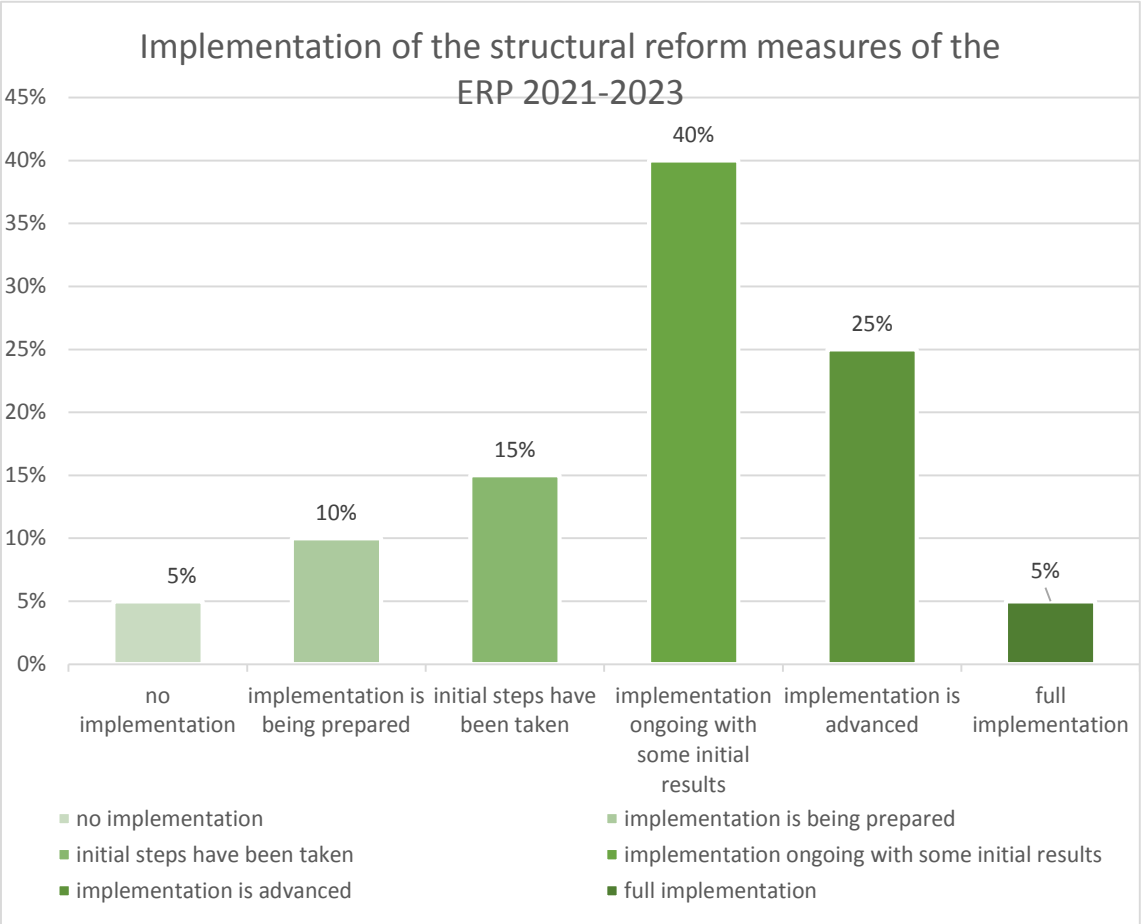
w: *data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as regards their quality and adherence to EU statistical methodology'*

Source of data in Annex B: EUROSTAT, unless otherwise indicated

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM 2021-2023 ERP

Montenegro made moderate progress in implementing the measures in 2021, with an average score of **3.16** out of 5. Reporting on the structural reform measures from 2021 is sometimes vague and often does not tally with the set indicators, with some few reforms missing the scoring completely. Information provided on some reforms was based on administrative outputs only.

Implementation was strong for some measures, such as Measure 5 on boosting the competitiveness of MSMEs and their access to the new markets and Measure 14 on setting up the system for continuous monitoring of the quality of apprenticeship at the employer's. Implementation was weaker for many other measures, such as Measure 2 on supporting investments in the food-manufacturing sector with the aim of boosting competitiveness and Measure 7 on suppressing the informal economy by reforming the Tax Administration. Implementation was particularly weak for Measures 6 and 20 – on improving and implementing the measures for suppression of informal economy and on the use of telemedicine services in Montenegro. Work on the latter measure and several other reforms that had weak levels of implementation was undermined by the COVID-19 pandemic.



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government of Montenegro submitted the 2022-2024 Economic Reform Programme to the Commission on 31 January 2022.

Inter-ministerial coordination

The Ministry of Finance and Social Welfare coordinated the work to prepare the 2022 ERP. An inter-ministerial working group involved all relevant ministries. State Secretaries from the Ministry of Finance and Social Welfare and the Ministry of Economic Development ensured support and visibility for the ERP process at the decision-making level.

Stakeholder consultation

The national ERP coordinator organised an initial consultation on the design of the ERP measures in September 2020. Another public consultation on the draft of the document took place in December 2021, including a round table public discussion.

Macro framework

The programme presents a clear and concise picture of past economic developments and covers all relevant data available at the time of submission. The information provided is coherent, concise and well structured. The quality of the translated text is good. Statistical tables are more complete than in the past with almost all the relevant data covered, but weaknesses remain, for instance on the balance of payment capital and financial account table. The macroeconomic framework is coherent, consistent and sufficiently comprehensive and provides a good basis for policy evaluation and discussions.

Fiscal framework

The fiscal framework is well detailed, in line with stated policy objectives and consistent with the ERP macroeconomic framework. However, the programme is less exhaustive on medium-term developments, in particular the fiscal consolidation path. Overall, the factors behind the ERP's projected revenues and expenditures mirror the 'Europe Now' initiative, and they are presented clearly. However, some revenue measures assumed in the ERP's macro and fiscal scenarios were rejected or pending (uncertain) adoption by the new government, whose plans are still unknown, weakening ERP's medium-term projections. Montenegro's fiscal reporting does not follow ESA2010 standards, and therefore does not meet the Commission's fiscal notification requirements.

Structural reforms

The structural reform parts follow the guidance note. A dedicated section in the ERP provides information on the implementation of the policy guidance for 2021. Reporting on the structural reform measures from 2021 is in some cases too vague and does not use the set of indicators adopted for the reform. There are 22 reform measures in the 2022-2024 ERP and this exceeds the page limit, partly due to the European Commission requests for improvements. The structure of the 2022-2024 reform measures is, in almost all cases, well prepared in terms of scope, timeline and the budget for activities planned.

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