



# The wiiw Balkan Observatory

Working Papers | 047 | June 2004

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Elements for Understanding Economic Reforms  
in Montenegro





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## *About*

Shortly after the end of the Kosovo war, the last of the Yugoslav dissolution wars, the Balkan Reconstruction Observatory was set up jointly by the Hellenic Observatory, the Centre for the Study of Global Governance, both institutes at the London School of Economics (LSE), and the Vienna Institute for International Economic Studies (wiiw). A brainstorming meeting on Reconstruction and Regional Co-operation in the Balkans was held in Vouliagmeni on 8-10 July 1999, covering the issues of security, democratisation, economic reconstruction and the role of civil society. It was attended by academics and policy makers from all the countries in the region, from a number of EU countries, from the European Commission, the USA and Russia. Based on ideas and discussions generated at this meeting, a policy paper on Balkan Reconstruction and European Integration was the product of a collaborative effort by the two LSE institutes and the wiiw. The paper was presented at a follow-up meeting on Reconstruction and Integration in Southeast Europe in Vienna on 12-13 November 1999, which focused on the economic aspects of the process of reconstruction in the Balkans. It is this policy paper that became the very first Working Paper of the wiiw Balkan Observatory Working Papers series. The Working Papers are published online at [www.balkan-observatory.net](http://www.balkan-observatory.net), the internet portal of the wiiw Balkan Observatory. It is a portal for research and communication in relation to economic developments in Southeast Europe maintained by the wiiw since 1999. Since 2000 it also serves as a forum for the Global Development Network Southeast Europe (GDN-SEE) project, which is based on an initiative by The World Bank with financial support from the Austrian Ministry of Finance and the Oesterreichische Nationalbank. The purpose of the GDN-SEE project is the creation of research networks throughout Southeast Europe in order to enhance the economic research capacity in Southeast Europe, to build new research capacities by mobilising young researchers, to promote knowledge transfer into the region, to facilitate networking between researchers within the region, and to assist in securing knowledge transfer from researchers to policy makers. The wiiw Balkan Observatory Working Papers series is one way to achieve these objectives.



# The wiiw Balkan Observatory

## Global Development Network Southeast Europe

*This study has been developed in the framework of research networks initiated and monitored by wiiw under the premises of the GDN–SEE partnership.*

The Global Development Network, initiated by The World Bank, is a global network of research and policy institutes working together to address the problems of national and regional development. It promotes the generation of local knowledge in developing and transition countries and aims at building research capacities in the different regions.

The Vienna Institute for International Economic Studies is a GDN Partner Institute and acts as a hub for Southeast Europe. The GDN–wiiw partnership aims to support the enhancement of economic research capacity in Southeast Europe, to promote knowledge transfer to SEE, to facilitate networking among researchers within SEE and to assist in securing knowledge transfer from researchers to policy makers.

The GDN–SEE programme is financed by the Global Development Network, the Austrian Ministry of Finance and the Jubiläumsfonds der Oesterreichischen Nationalbank.

For additional information see [www.balkan-observatory.net](http://www.balkan-observatory.net), [www.wiiw.ac.at](http://www.wiiw.ac.at) and [www.gdnet.org](http://www.gdnet.org)

# Elements for Understanding Economic Reforms in Montenegro

## Background and structure of the paper

How to understand background and context, which means essence of many data, graphs and facts about transition in Montenegro? That is the issue discussed in this study.

In order to catch that invisible as criterion for estimation I took, not ordinary, common growth and development indicators, but human development in this territory. Really, transition is by its definition (by expectations) process of: (a) human development increasing; (b) de-collectivization of society.

De-collectivization should result in strengthening of individual freedoms, while final goal is development of human benefits.

Do we, at this point of time, after ten years of transition have more individual freedoms; do we have more benefits from this transition decade?

This approach seems very convenient for explanation of the events which have happened in last ten years and the impact of that general living context on type, speed and results of transition in Montenegro.

This paper is basically divided into two parts. First part refers to the reforms conducted till 2002. The second part refers to current reform program, which is conceptual continuation of earlier reforms. There are some basic macroeconomic indicators for Montenegro too. First part of the paper, before explication of reform programs itself, explains general context of human development in Montenegro in last decade, which had very strong impact on reviving of reform thought and actions in Montenegro.

## 1. Human development context in last decade

The last decade of the twentieth century was extremely turbulent and traumatic for Montenegrin citizens. Collapse of FRY, wars within the territory of former Yugoslavia, international sanctions, NATO strikes, economic collapse and hyperinflation, beginning of the transition, political changes and struggle for power, arising of nationalism and recovery of many political conflicts at the political scene from the past... are only some of the

misfortune and trouble that hit Montenegrin citizens. That was mental shock, especially for the generations under 50 that were born in the Social Federal Republic of Yugoslavia (SFRY). They were born during the peace in the country that had the highest economic standards and human freedoms and were educated in the system based on the ideology that convinced majority that "the system in which they live is the system that represent the pick of human happiness and will provide eternal peace". But, suddenly those generations lost the ground under their feet. They found themselves in the vacuum! Overnight, peace was turned into war, war that involved neighbors and people that were born and lived together in the same country. Suddenly, friendships disappeared, families were broken and the vision vanished! One should saw the funerals of youngsters killed in the useless war, the places of sadness, lost hope and specter past!

All of that left scars and wounds on people's soul! Actually, every generation has its own scar. Those that experienced horrors of war and were born before the SFRY was established, retreated into themselves facing the fear for their descendants. They faced with the horrors of their own past and kept asking: "is it possible that the ghosts of past come back for their victims." Mid-generation, without experience and proper education for understanding the situation, become the victim of these events and transition process. Disappearance of middle class in Montenegro and loss of economic, political and social stability in the society that this stratum of citizens provides (or carry on its own back) represent sacrifice of those generations!

Young generation was also in shock! Foggy future that aroused even in SFRY at the end of seventies suddenly was covered with heavy clouds. Abyss and darkness! But, youth and strength didn't allow those generations to sit down! It was necessary to survive. One part of that generation was attracted with the national ideology, another part was involved in smuggling, and others went into gray economy or started their own business. The most prominent left Montenegro and large number gave up and devoted to inertia of the province and quickly grew old!

But, what happened with the generations that were younger than 15 when the collapse of SFRY began, or those that were born at that time? What happened with the generations that grew up and were educated in such traumas? How these young and innocent souls manage to put together in their mind pictures from theater of operations broadcasted on local TV with the pictures from the concerts or TV shows broadcasted on satellite TV stations? What is settled in their personalities? What is happening with their system of values or way of thinking? How to cure these mental wounds? Is oblivion medicine for the human souls?

Economic figures and indicators alone can not discover secret of human soul. They can not measure all pain or joy; they can not represent man's freedom. And, as Fyodor Dostoevsky said, there is no development without knowing the soul of the man, or without

knowing the structure of his needs (Abraham Maslow). Is man only a rational creature? Experience of the last decade in Montenegro and former Yugoslavia shows that man is not only a rational creature! Everything that was done, or better to say everything that was destroyed in the man from this region is work of the same man, and can be seen through the manifestation of his own action and practical moves. If we exclude NATO strikes (1999), all other wars, national-political clashes and pressures are results of same people, people that are in the same time victims and despots; people that are in the same time soft and cruel; filled with love and hate in the same time; people that are traditionally united and than suddenly they become selfish. Indeed, those issues do have general importance (they are not only related to Montenegro or former Yugoslavia), but still they do have their own specific weight at least for the fact that everything happened in Europe – the continent that at least in the last several centuries was spreading the culture throughout the world! The Europe itself was very much surprised that the wars are possible on its own territory.

When in our minds we go back to recent drama that happened in the former Yugoslavia, we might be under the impression that some hidden power defined behavior of all participants in those dramatic events dragging them towards the bloody clashes and obsessive hate.<sup>1</sup> Explanations that individuals (national leaders) are guilty for everything sounds naïve, especially from the point of further strategic vision of demographic transformation. All political leaders of Yugoslav republics were elected democratically! After they were elected, their moves were of such kind that they brought all the misery and pain to those that actually elected them! It is obvious that socialism didn't resolve national question, but pushed it aside. When masses accepted the idea that their identity is reduced to national spirit, we end up in the situation of so-called ***narrow consciousness followed with the disappearance of tolerance and growth of authoritativeness and xenophobia***. It become obvious that national interest doesn't recognize the limits of what is allowed and what is not or what is human and what is not! "Big national ideas" aroused on the small territory of Yugoslavia! Same as in England when "ships took over people" (at the beginning of the transition period textile industry took over the land from the farmers in order to farm ships), at the beginning of the transition period in Yugoslavia "big national ideas" took over people!

When we talk about Montenegro than we should point out to one paradox: the relation between orthodox citizens on one side and catholic and Muslim on the other one were more tolerant than among the orthodox citizens themselves. Multiethnic tolerance in Montenegro, especially among the domicile citizens, is on the very high level which is quite surprising for the Balkan! That was the reason why large number of non-orthodox citizens come to Montenegro, still with the additional flow to their mother country: Croats went to Croatia, Muslims went to Sarajevo...Multiethnic tolerance is very important for better

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<sup>1</sup> Dr Dragan Lakicevic: Arhipelag Balkan, Beogra, 2002 (str.6)

understanding the human development in Montenegro. But, idea of creating "Great Serbia" divided orthodox citizens in Montenegro into two parts: those that support unity of Montenegro and Serbia and those that support independent Montenegro! This division has also deep historic roots, and with the large part coincide with tragic division of the citizens in Montenegro during the Second World War into those that did fight against the Nazism (partisans) and those that more-less supported enemy (chetniks). After the end of the Second World War, when partisans took over the power, Montenegro became an independent Republic - one of the six that established Yugoslavia.

With such act Montenegro recovered its independence that, after several centuries of being independent, was lost in 1919 with unifications with Serbia.

With the brake of former Yugoslavia, the relations between Montenegro and Serbia again become debatable. At the beginning of nineties in the era of national romantics in Yugoslavia, supporters of unification with Serbia had an advantage over those that supported independent Montenegro. That led to establishment of FRY (Montenegro and Serbia). But establishment of FRY didn't resolve the problem of political relations between Montenegro and Serbia. Not only that economic, political and social life was under the constant pressure of such a conflict and divisions, but the same was happening in everyday life of the citizens and families. This fact should not be forgotten when we talk about the process of transition and reforms in Montenegro and its consequences and results. "Belgrade Agreement" recently signed with the assistance provided by European Union, regulates relations between Montenegro and Serbia. The pressure of political division is weakening, but still exists! In the same time, the speed and the character of the reforms in Serbia positively influence on shifting the focus from political to economic issues. Also, large presence of international organizations and institutions in Montenegro, as well as progress in economic reforms, contribute that existing division loose the intensity and the influence on transformation of the society!

The parameters and processes that happened should be viewed within the historic-anthropological context of Balkan! In the mind of Europeans Balkan represent the door of Orient and the mixture of different small nations that was controlled throughout the centuries by Turkish Empery. The Balkan itself, at least the part that was under Turkish Empery, was not involved in the reform and education process. The consequence was strong influence of archaic notion and system of values, immature individualism, lack of education and non-articulated relation towards authority of state. An overall consequence was slowing down civil development and political democratization. This led to understanding that national emancipation is the ultimate goal! In the same time, national emancipation could be brutal as much as Turkish governance was. Authority and submissiveness remain in the system of communism. Other words, deficit of democracy which is typical for socialism did not allowed human development, or transformation of the

people into individuals! Despite the fact that socialism provided calm tranquility to the people and growth of standard (better education, health system, employment and housing), there was no change at the level of individualism, personal freedom, development of the civil society and citizen courage. It is very hard to say that only the historic-anthropological concept provides an answer why Yugoslavia disappeared in blood while Czech Slovakia or Great Soviet Empire disappeared quietly and peacefully?

Everything mentioned so far has the aim to point out on context in which ***some parameters and processes arisen, and we will talk about them in the rest of the Report***. It is hard to believe that Human Development concept can be understood without rough description of the context in which the events are taking place. We can understand modern mega-processes of globalization and information development only if we accept those *invisible forces*. It appears that there is much more of tradition, habits, culture and old ethnic deposit in the man, than what appears nowadays in the time of quick technological changes! Therefore, that social and historic sediment has to be taken much more into consideration, but in the same time (as experience in former Yugoslavia shows) one should not allow this sediment to pull out from the civilized framework!



## 2. Economic reforms and institutional changes as the dimensions of life quality and human development

### 2.1. From short-term to middle-term factors of development

Quality of the human development is mostly influenced by the level of economical activity and by the level of macroeconomic balance which is achieved. From the point of view of middle and short term, quality of human development, and economical dimension of human development depends on ***sustainable financial balance and institutional development*** (development of the economical and political system) among all. This paper has the aim to put light not only on the short term but middle term component of human development in Montenegro as well. We are going to point out the problems of ***establishing the macroeconomic balance***; with special retrospective view on the disequilibria of the budget, from where we are trying to pull the conclusion of the impact on future trends of budget consumption – especially the part regarding the social expenses (education, health, pensions, social security, investment in environment, etc.) and than to calculate the impact on ***institutional development and balance of the institutional development in Montenegro***.

### 2.2. Macroeconomic (dis) equilibrium

#### 2.2.1. Structural deficit

Montenegro, as well as other countries which are going through the stages of the transition have problems of establishing macroeconomic equilibrium. Or, difficulties of transition from the old economical system to new, capitalistic system, are related with the problems of the debt and deficit which socialist countries had and which are based on ***structural problems along with behavioral problems and problems of the way of thinking and attitude of people!*** It was not the mistake of Washington's consensus that stressed the significance of macroeconomic stabilization, like it was imposed by its late critics, but the mistake was that macroeconomic stabilization was observed separately from crucial components, which influenced the fact that macroeconomic stabilization became the ***goal*** at the beginning of economical reforms and ***not*** simultaneously and it was the asset or economical recovery. Without simultaneous discussion on current disequilibria and on institutional and structural changes, it is hard to understand the context of this component on human development.

***Macroeconomics*** of Montenegro has three vital imbalances:

***External imbalance*** which has several components:

External debt of Montenegro (after writing-off the part of debt to Paris club), including old savings amounts to around US \$ 332 millions. That is large burden for future development.

Negative trade balance amounted to € 393 (37,8% of GDP) in 2001, and €320 millions (26% of GDP) in 2002.

Negative current account balance amounted to € 139 millions in 2001 and was decreased to €166 millions in 2002.

Table 1: Balance of current transactions with foreign countries in Montenegro in 2000-2001 (in million €)

	Jan-Dec 2001	% GDP	Jan-Dec 2002	% GDP
<b>BALANCE OF GOODS</b>	<b>-491.012</b>	<b>-47.14%</b>	<b>-421.950</b>	<b>-34.55%</b>
Total export of goods	225.014	22.50%	220.022	20.07%
Total import of goods	716.026	69.74%	641.972	60.00%
<b>BALANCE OF SERVICES</b>	<b>97.354</b>	<b>9.35%</b>	<b>101.796</b>	<b>8.34%</b>
Revenues on services	150.707	14.47%	170.004	14.40%
Expenses on services	53.353	5.18%	68.208	6.06%
<b>TOTAL BALANCE OF GOODS AND SERVICES</b>	<b>-393.658</b>	<b>-37.80</b>	<b>-320.154</b>	<b>-26.21%</b>
<b>INCOME BALANCE</b>	<b>46.525</b>	<b>4.47%</b>	<b>67.126</b>	<b>5.50%</b>
Revenues from income	87.038	8.36%	110.331	9.03%
Expenses on income	40.513	3.89%	43.205	3.54%
<b>CURRENT TRANSFERS BALANCE</b>	<b>148.097</b>	<b>14.22%</b>	<b>86.871</b>	<b>7.11%</b>
Revenues	158.542	15.22%	97.106	7.95%
Expenses	10.445	1.00%	10.235	0.84%
<b>TOTAL REVENUES</b>	<b>631.628</b>	<b>60.65%</b>	<b>704.354</b>	<b>57.67%</b>
<b>TOTAL EXPENSES</b>	<b>830.664</b>	<b>79.76%</b>	<b>870.511</b>	<b>71.28%</b>
<b>TOTAL BALANCE OF CURRENT TRANSACTIONS</b>	<b>-199.036</b>	<b>-19.11%</b>	<b>-166.157</b>	<b>-13.60%</b>

Source: Central Bank of Montenegro

As one can conclude Montenegro has huge current account deficit. Current transfers which came in form of foreign aid were not sufficient to cover the deficit. Capital and financial transactions did not provide sufficient revenues which would cover current account transactions deficit as well. Foreign reserves too. Solution should be found in the informal sector and money which is in pallets<sup>2</sup>

**Internal imbalance**, which comes from very high unemployment rate. High unemployment rate is not only the problem and misfortune of the individuals but it is the problem of entire

<sup>2</sup> Question how much money are there in pallets is very current! Actually during transition and war people keep their money »under their pillows«, as the consequence of mistrust in banking system and state guaranties (along with bitter experience with system of pyramids which disserve over ten thousands of people in Montenegro). There are different estimations. One of them was based on EURO conversion, which was undertaken from January to March of 2002 in Montenegro. Total amount of cash exchanged was 980 millions DEM and the rest remained in banking system and pay system and the amount was 180 millions DEM. Population kept 800 millions. If one presumes that 25% of total cash exchanged came from Serbia, that means that population in Montenegro had 600 millions DEM around 300 millions € (ISSP, internal material).

economy. Macroeconomic disequilibria – as measure of the simultaneous disequilibria of all markets – can not be achieved if the disequilibria on the labor market is significant as it is currently. »How to productively employ people?«, became the key issue of all macroeconomic policies in Montenegro.

**Pension system deficit** which is 1/3 of all expenses for the pensions. Pension deficit is the social bomb which makes each stabilization program more risky.

**Budget or fiscal disequilibria**, which has short term consequences (given in the following section) as well as the long term effects because it endangers macroeconomic environment and it indirectly influence the long term trends in economy.

According to this, previous indicators refer to very large problems in total financial situation of Montenegro. They will be more extensive when all the expenses that occurred once mutual bodies of federation were created became the part of the budget, according to the Agreement signed in Belgrade on relationship between Serbia and Montenegro. Very extensive expenses are going be those for army financing. In the last several years Montenegro does not pay anything to federal budget, and do not gets anything from it (until the middle of 2003). Problem is that the share of Montenegro in total financing for the federal budget would be 10% of the current amount of budget in the Republic. That will enormously increase budget deficit of the Montenegro.

Solving the problem of the deficit encompasses some major structural changes in the economy and economical system, while current deficit claims cutting of the expenses side of the budget and increase of the revenues side of the budget (larger coverage of the budget revenues). In each case **macroeconomic situation will in short term and long term run create extensive challenges to human development of Montenegro**. Key presumptions which should be fulfilled is that they **should not be the instrument of the political competition** and they should not be observed from the prospective of petty political interests, but they should be solved in the context of **total human development** in Montenegro.

### 2.2.2. Budget consumption

Budget of Montenegro was always in problems during the last ten years. Key problems occurred because of the fall of total economical activities and because of the reduction of state capacity to compile all budget revenues from one side, and on the other side to retain earlier structure of budget expenses, which were increased by the larger number new users in the meantime (unemployment increased, problems in enterprises, problems with public consumption). Habit that state should solve not only each problem in enterprises and public institutions, but individual problems as well, is traditionally very strong in

Montenegro. This habit was enforced during the years of wars due to very difficult material situation of the inhabitants, and due to decrease of activities of many enterprises. Leading political party from year to year caught itself into the net of raising problems, which were mostly the result of its political choice after the break up of ex Yugoslavia into peaces – they abandoned project of reforms they started and accepted project of nationalism. Different types of »managing through somehow« and equilibriums along with the inflation could not be the ultimate solution. Problems of the budget (budget figured as the source of money for everything) grew both in Serbia and Montenegro, producing social and political problems. Considering that the situation in budget of both Serbia and Montenegro is very sensitive, Montenegro made the crucial political change earlier (1997) than Serbia (2000).<sup>3</sup>

Political changes in Montenegro (1997) created the basis for aid that was coming separately, which was donated to Montenegro by international donators. Using this aid Montenegro managed to balance its' budget, and to keep situation of tolerance in Montenegro. That inflow of international aid in Serbia occurred just after happenings from October (2000).

It is understandable that budget problems were not the only cause of political problems in Montenegro and Serbia, nor was speed of growth of budget problems the one which influenced the fact that some changes happened earlier in Montenegro than in Serbia. This components are nevertheless very present and they should not be underestimated! This refers to a **great importance the budget for the quality of human development** has in this area, especially in a short term run. Somehow, we keep forgetting that fact and budget deficit is dominantly observed as the component which influence the economical development. The experience we mentioned confirms the key thesis of the concept of the human development which says that if the human development is endangered than the consequences of this can hardly be put up not only by economy, but by the regime.

Analysis of budget consumption, from methodological aspect has justification only for the period after introducing EURO, or previously DEM, and that means for the 2000 and 2001 and is planned for 2002. The goal of this analysis is just to refer to basic budget (financial) framework which determinates some of social functions of the state which are important for the quality of the human development.

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<sup>3</sup> »Very extensive changes in political system of Montenegro occured when the leading party DPS broke into two parties (1997). Several leaders together with the president of the party and President of Montenegro left along with the members who were dissatisfied with the fact that the party abandoned the policy of the regime of Slobodan Milosevic from Serbia and those who were dissatisfied with the contribution which was made by other stream for the market and democratic reforms« (dr Vlado Goati, Political parties and ellections in democratic system, CESID, pg.40).

Table 2. Budget revenues and expenditures and sources for financing deficit

Central Government Budget, in euro millions									
	2000		2001		2002		2003		
	Execution	% of GDP	Execution	% of GDP	Execution	% of GDP	Plan	% of GDP	
Total revenues	172,1	20,9 %	221,2	21,1 %	229,8	18,8 %	361,0	27,2 %	
Total expenditures	233,8	28,4 %	259,3	24,7 %	255,0	20,9 %	451,2	34,0 %	
Overall cash budget balance, excluding grants	-61,7	-7,5 %	-38,1	-3,6 %	-25,2	-2,1 %	-90,2	-6,8 %	
Grants	56,1	6,8 %	12,0	1,1 %	26,9	2,2 %	23,2	1,7 %	
Net borrowing	5,5	0,7 %	17,0	1,6 %	-11,2	-0,9 %	23,7	1,8 %	
Privatization receipts	0,0	0,0 %	9,1	0,9 %	37,7	3,1 %	23,3	1,8 %	

Source: Ministry of Finance, calculation by ISSP

Note: At the end of 2002, 28 mil. Euro from privatization transferred like deposits in banks. From this amount 20 million euro are included in budget for 2003, like deposits from previous year, in July budget revision.

Note: The Budget Law for 2003 represents numerous structural changes in comparison with budget laws in previous years. These changes are a consequence of the implementation of new tax laws. The new tax laws changed the system of tax collection on the revenue side and added new obligations for the Union budget and a new method of transfers to the extra-government units on the expenditure side. As a result the central budget structure as given in the Budget Law for 2003 is not comparable with central budget structures from previous years.

High deficit of the budget varies from year to year. Budget deficit is basically covered with the aid of international community.

That means that the greatest part of international aid goes for budget deficit coverage. There is a question whether direct aid from the point of view of short term gives better results from the point of view of long term run? Would it be more efficient if aid was given to enterprises, or directly invested into education and institutions?

Nevertheless, according to estimation of EU experts, Montenegro can manage to balance budget in years that are coming. In each case, if this kind of prognosis really takes place it will have very positive effect on quality of human development in Montenegro.

### 2.3. Macroeconomic strategies needed for economical and human development

Total amount that was given for different areas of human development – education, health, social care, will depend on character of macro-economic strategies which are being created and will be created in Montenegro.

Financial situation in Republic points out **significant need to increase production of goods and services** as the real basis of life standards increase in Montenegro, and total quality of human development.

For increase of growth rates, one needs following macro-economical strategies:

**Monetary stability**, in the context of creating healthy bank system and deficit reduction in current account

**Wage policy in state sector**. This is extremely important because Montenegro has very high inflation rate (over 20%) although EURO is introduced as stable currency and the prices are completely liberalized. The key principle in this area should be to relate changes of salaries with the changes in productivity.

**Health budget policy** - Organic Budget Law contribute to this, as well as treasury system, which is implemented. Main goal is establishing of sustainable budget in following four years.

**Tax reform**, which is already taking place while the law in this area is the same as law in EU.

**Reduction of informal economy**

**Privatization and economical liberalization.**

If the country lead their strategies based on these principles, it would create basis for increase of expenses for health, education and social expenses. Therefore expenses for health will grow from €57,7 millions (2000) to €81,6 millions (2002), while expenses for pensions grow from €121,4 millions (2000) to €163,2 millions (2002).

It is to be expected that the trend of increase of the share of expenses from the budget and public expenses will raise, and that the number of users will decrease! Raise of the share in budget will result on the account of decrease of donations of the state for the state enterprises as well as from the decrease of interviewing in the economy. From the point of view of the human development it is important to point out that the percent of money which is given for agriculture, fishing and hunting is (3,4% in 2001., for the 2002 2,5% was planned) – that is the aid for people from villages!<sup>4</sup>

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<sup>4</sup> Ministry of agriculture, wood processing industry and water supply in period between 18. 03 – 31. 05. 2002. realized the project called «Supplement for the old people». Project had one goal: to provide some form of social security for elder households at villages and to keep people in the villages so the natural resorses could be used better.

Right on supplement for old people, is for those people who life from agriculture are older than 65 (women 60 ), who have spent their lives at villages doing nothing but agriculture for living.

Repayment of the first rate is realised and 3220 of agricultural producers got their supplement which was 30 €(EURO) for the month of April.

Quality of further development in many areas will depend on the speed needed for reduction of deficit of the budget and increase of GDP growth rate. Prerequisites needed are in stage of creation for both, especially through the package of measures regarding the economical and institutional changes. It will be spoken on this subject in the next section of this report.

## 2.4. Public expenses and quality of the human development

Public expenditures should be taken as »productive« activities of the state which produces public goods and services for all the inhabitants. Nevertheless, policy of public expenditures is being observed from the short term macro-economical point of view (provision of short term balance). With all this policy often has the purpose to buy current social peace (for example: give aid to the enterprises or institutions from case to case in order to avoid strikes and mutinies) to politically motivated activities known from theory on political cycles (M. Prokopijevic, 2000). This approach do not aloud to take all dimensions in public expenses policy. Basically the problem regarding the public expenses can be observed in three dimensions:

***Problem of the level of public expenses***, which depend on revenues available (taxes, fees, custom fees, tariffs, transfers, credits) where public revenues can be observed as external component when policy of public expenses is questioned. Ultimately revenues from the budget are determined by the level of GDP!

***Problem of the consumption efficiency***, or how to satisfy the greatest number of needs with the available public expenses.

***Problem of the optimal structure of the state and state sector***, because the structure of the state bodies and their efficiency influence »production« results of public expenses.

If we analyze the policy of public expenses in Montenegro, than the first dimension was dominant until the 2001 and 2002 (Organic Law on budget was ratified, system of vault was introduced). Entire policy of public expenses was based on the question how the budget should look like, so that it has the tendency of grow, regardless the low economical activity. That produced basic logic which is totally wrong ***with the public*** which encompasses the fact ***that the level of the budget depends primarily on political will***, from the fact whether the state wants or not to give more to some categories of the population, ***without establishing the relation between the level of taxes and level of economical activity***. One can still think that state can create money endlessly, without any activity from enterprises and people. This approach (»state always has money «) in other words ***soft budget restriction*** neglected the component of efficient usage of public

expenses. Nevertheless transfer to *hard budget restriction (2001)* points out importance of two dimensions: ***efficiency of the usage of public revenues and the size of the state.***

Economic and human development starts with the size and efficiency of use of public expenses. In that sense it is important that we define key goals of public consumption in the next period (promotion pro-poor growth; reduction of poverty, help deal with vulnerability) and estimation of the effects on wealth which is more clear, especially those groups whose choice is growing through the public consumption mostly.

Stressing the efficiency of public consumption is the key principle of the new approach in this area in Montenegro, which is simultaneously contributes to the quality of human development and makes basis for economic growth.

Reforms strategy, essence of reforms package and human development

### **2.5.1. Why do we need reforms?**

First and the fundamental question here is: ***why do we need reforms?***

First of all, reforms should be in function of better, easier, and more completed life of population, and any individual of a society. Reforms are being carried out for the people that should benefit from them! Even though, this emphasizing might look strange to some readers, inheritance of transition countries and Montenegro, as one of them, still warns! Really, if we say that main goal of reforms is benefit of an individual, that basically differs from *philosophy of collectivism* according to which people have lived for centuries, philosophy in which valid goals were general (normal, political, class). Reforms – that is transition to *philosophy of individualism*! To *philosophy of freedom, in other words freedom of choice of any individual*! Freedom of choice in every particular field, like economy, politics, education, health care etc.

It is transition from society that forced people on their choices to society of freedom of choice. It is the essence of transition! It is the change of invisible constitutional substance of a society! Limiting transition on economic dimension only, on simple multiparty system, on liberalization, on simple wider openness is not enough. Transition is all of that! *But all of this should be born (not imposed) in the head of every individual or, at least majority of people!* That's why transition is hard and painful, and first of all *long-term process* at the same time! Transition is, in fact, creating of transition conditions that effects evolutionary development of people attitudes and way of thinking typical for well-built democratic societies on the West. It is hard, not only because of the circumstances in which it is



carried out, but because of the fact that people in transition countries are not ready to be free! («Escape from freedom» wrote by Erik From). Freedom means responsibility! Freedom implies ability of a man to make decisions and to bear consequences of those decisions!

In context of all previously said, concept of human development should not be conceived in *mechanical sense* – reduce the poverty, increase employment, and so on, but like *the change of system philosophy and change of basic principles of society and individual attitudes*.

Previous parts of this paper have just pointed out *state* of human development in Montenegro, in other words its *crisis*. Way out that crisis is possible only if *institutional environment is reformed as same as public policies in every field*. Human development concept explains on the brightest way why reforms were needed and what is their goal! *If the center of human development is man, reform is way that leads to that center – man!*

Reforms package and institutional framework founded through adoption of new law acts; in other words, balance of institutional development in Montenegro is presented in extension.

### **2.5.2. Preliminary observation: time and circumstances in which reforms are conceived and implemented**

Excluding introduction of multiparty system (1990) and Law on return agricultural soil to previous owners (1994), economic and social reforms in Montenegro have started during 1998, after the changes in ruling political coalition. Certainly, there were many attempts in order to change economic system. However, rigid policy toward reforms, as well as different conflicts existing in former Yugoslav territories, disturbed entering in the transition process.

Until the political changes have happened in Serbia, (October 2000) reforms were carried out in the shade of the latent conflict with Milosevic, several months bombing during the 1999 and huge political changes in Montenegro caused by the attitude toward state status (independence - yes or not). Positive influence on reforms, besides the political determination, had the international support and aid, given directly to Montenegro, despite the fact that it was formally part of Yugoslavia.

Montenegro started to build new economic system, and gradually, during 1998, took over all economic functions, involving those that belongs to the Federation such a customs, foreign currency, foreign-trade regime, bank system, etc. All fiscal flows and transfers

between the Montenegrin and Federal government were cut. Montenegro is functioning according to the principle of ***institutionally completed economic independence***, while at the same time only representatives of the pro-Yugoslav parties participate in the work of - federal bodies.

However, if we consider the fact that the ***army*** was under the federation control (there was a real danger of intervention) and regarding all *political splits* in Montenegro, as well as *the situation in the surroundings*, conditions for conducting reforms processes were unfavorable and difficult. That has had an influence on the rhythm, character, and priorities within the reforms.

### 2.5.3 a) Approach to reform processes

Key starting point of the reforms is fundamental change of the ***economic system***. However, transition from the planned economy to the market guided economy has an implication on the changes in the ***politic system and the role of state***. Late transition at the beginning of the way that leads Montenegro to restructuring made all problems visible. Problem of *selection of reforms strategy* was born. Mere copying of reforms experiences from the other transition countries was not possible. Conditions in Montenegro were different and specific.

Montenegro was the ***only transition country, which has taken the responsibility to conduct changes of whole system*** (political and economic), and ***during that period it had not completed state independence*** (internal and external), or ***all authority levers necessary to conduct reforms***. So, it wasn't simple to carry out monetary reform (replacement of dinar with DM), because the army, not commanded by Montenegrin authorities, didn't want to accept that, because money it had received from the federal budget were dinars.

In the selection of strategy for reforms, despite the fact that every undertaken measure, ***could be endangered from the constitutional, political, and military side*** (because of un-solved relations between Montenegro and Federation) and ***create conflicts*** (which are, unfortunately, in Balkan countries almost always was solved by war), it was vital to consider several more facts:

The size of Montenegro and its economy

Geographic position of Montenegro (Mediterranean position and the border with seven states or entities)

Mixed national structure of population (62% have enunciated as Montenegrins)

The large number of refugees (displaced persons) from the all ex-SFRY Republics and all nationalities (their participation in total population was up to 17%)

Late transition (in contrast to countries, Montenegro entered transition processes with GDP which amounted 58% of GDP from 1899, the year taken as the start year of transition the East Europe

Departure of large number of young educated people from Montenegro, that decreased, already critical strength of human reforms potentials.

Start of reforms process was proceeded state devastation with war conditions, hyperinflation, dividing of society into classes, increased smuggling, etc.

Establishing ***new institutions and investing in the human capital*** is the strongpoint and key priority, in other words base of the reforms. All the more so, due to the fact that Montenegro did not have many institutions and legislative necessary for conducting reforms. Truly, several federal institutions were taken over (e.g. customs), but it didn't solve the problem of the institutional framework. At the very beginning Montenegro found itself in the position the ***institutions vacuum*** (which was loaded by implementation of some federal laws, what made characteristic hybrid system, which was unclear, first of all for the investors and entrepreneurs) and that situation had to be solved as soon as possible. In addition, the situation within economy is worse every day. Macroeconomic disequilibrium (above all budget deficit, balance of payment deficit and high foreign debt) imposed necessity of establishing macroeconomic stability. Change of property relation, that is privatization, becomes necessary in order to: create conditions to increase economic efficiency as well as to change mental structure (population's way of thinking). All these processes require prices liberalization, deregulation, and economy openness.

Late transition and wish to solve all economic problems as soon as possible publicly emphasized fast and most desired solutions, rather than actually possible ones. And actually possible reforms solutions require time!<sup>5</sup>

However, logic, which dominantly proclaims that reforms, should be approached as a process (gradually), and as a search for the quick final solutions (shock therapy). Conditions for the shock therapy did not really exist, so choosing the accelerated gradual approach was unavoidable and objectively caused!

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<sup>5</sup> The fact that reforms require time in the society such as Montenegrin, in which influence of ideological and political factor is strong, according to which verbalism is conceived as a reality (it is important to say what should be done, and not how things should be done) and rhetoric, especially criticism is more important than the results! Opinion according to which pre-condition for successful reforms is simple change of political elite, instead of essential changing of institutional system have been, and still are large obstacle for deducting reforms in Montenegro.

In other words, instead of the political fight by the different strategies, verbal war and accusing among political parties is present, and it doesn't consist clear differences related to the reforms development in Montenegro. Discussions after political agreement, which regulate relationship between Serbia and Montenegro and according to whom problem of Montenegrin State status lost its importance (it has been solved) point to this opinion and all political parties seem to lose a part of their political programs (for or against independence)! Obviously, continuation of reforms in Montenegro requires another political-parties configuration!

In the same time, instead of the rapidity and desired results of transition, instead of the statistic approach, reforms processes and their dynamic dimension were supported and encouraged, along with understanding the reality that Montenegrin economy had disequilibria in every time spot and that, both, macroeconomic disequilibria and reforms processes should be managed. Accepting accelerated gradual reforms approach was based on the certain principles, established by actors of reforms in Montenegro at the very beginning.<sup>6</sup>

### **2.5.3 b) Basic principles of economic reforms**

Proceeding from the reality in Montenegro as the start point and the other lessons from experience of other transitions countries new economic system is based on the next principles:

Private property domination in Montenegrin economy, protection of property rights, freedom of contracts and protection of investors

Economic freedoms, development of entrepreneurship, private initiatives and innovations

Rule of law

Internationalization of Montenegrin economy (opening economy)

National treatment of foreigners (the same rights to both foreigners and domestic persons, involving property of land and real estates)

Deregulation of economy on all levels (reduce state influence) and economic liberalization.

Development of the regional cooperation structure; joining the Euro-Atlantic economical and political structures

New understanding of sovereignty—acceptance and respect of international standards and protection of human right as in EU ad USA

Macroeconomic stability.

Proceeding from these principles Montenegro started to appreciate self-sufficiency (closed system) as little as possible, and to respect market economy more every day (openness) and to develop the tendency toward integration processes in the region and EU!

### **2.5.4. Reforms package (1998-2002)**

#### **2.5.4.1 Genesis and essence of reforms**

As it has already been said, the fact that we are late with reforms processes compared to other ex socialistic countries and circumstances in which we conducted reforms, required

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<sup>6</sup> See more: dr Veselin Vukotic: Conceptual bases of the new economic system in Montenegro, Institute for Strategic Studies and Prognoses (ISSP), Podgorica, 1998.

on one side fast decision making, and on the other, possibilities of choice were narrowed. At the very beginning, as if trade-off existed between economic reforms and measures aimed to stop further drop in economic growth and population protection (subventions to enterprises, public works, increasing number of social security users etc.).

Considering aggravation of political relations with Serbia, economic relation between these two Republics of the same state had been limited at first (1998), and then 1999 almost completely interrupted (from 65% share of Serbian companies in market of Montenegrin companies dropped to around 12%).<sup>7</sup>

According to previously said, fast and comprehensive liberalization and deregulation in Montenegro have resulted more from **pressure of the circumstances** than it could have been decision from previously prepared reforms package.

Even though economic relations with Serbia became weaker every day, Montenegro used dinar as means of payments. Weak dinar was very powerful means not only for hindering reforms, but to cause huge difficulties for population. In order to protect citizens, and to accelerate reforms, **package of monetary reforms during 1999** took important place. **Package of privatization law acts**, preceded this, and that was essence of reform at the end of 1998 and beginning of 1999. Thus in November 1999 DM have been introduced as legal means of payments in Montenegro.

Conceptual basis of reform have been fully expressed in **two platforms for negotiations with Serbia on redefining relations within federation** (1999 and 2000). Economic part of these two platforms **emphasized openness, liberalization, privatization, rescinding barriers, reducing customs, decrease in state role in economy** (but increase in area of transition management, social security, education, health), and **it was more favorable for Montenegro**, as small economy, which has tourism as the strategic sector, where all agricultural surpluses have to be exported, key product - aluminum is market traded. Besides, problem of unemployment is more expressed in Montenegro (because few big

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<sup>7</sup> That leads to the paradox that the most closed border in Europe was between Serbia and Montenegro, that were, by Constitution, within one state, FR Yugoslavia! Ramps were set on all cross borders and internal customs regime was introduced. System of payments was interrupted too, and banks in Germany and Italy did all international payments. This resulted with need of Montenegrin enterprises to look for the new markets in the region.

It pressured opening of all borders, and reducing all limitations in foreign trade area, extremely high decrease in customs rates (from about 20% to averagely 3%). All of those required price liberalization in Montenegro, which was conducted up to level of 97% of all prices (prices of electricity and communal services are still being controlled). Due to hindered turnover with Serbia, importance of Serbian market was extremely reduced for all Montenegrin enterprises. Before bombing (1999) about 65% of selling and purchasing market for companies from Montenegro was Serbian market. That is understandable, due to international sanctions, which have had »closed« economies of Serbia and Montenegro so for enterprises from smaller Republic, market of larger Republic become exceptionally important. Already 2000 Serbian market make only about 14% (official data) and about 25% (ISSP data) of selling and purchasing market for Montenegrin enterprises.

state enterprises bankrupted) and development of SME sector is extremely important. Important stimulus to reform development was technical help of USA Government through USAID, that is providing that help from 1998.

In 2000 attention was focused on **business environment** (Law on corporations, Law on foreign investments, Securities Law...), **package of the budget reform laws, and package of tax laws, as same as intensifying privatization and development of capital market.**

Gradually during 2001 preparations for reforms were built within areas of labor **market, education and health care.** In any case this reforms package is prepared after package of key economic reforms and is on its very beginning.

Further text gives basic ideas on particular parts of reforms.

#### **2.5.4.2. Institutional reforms in certain areas**

Description of the institutional reforms in Montenegro is given through the next groups: 1) Monetary reform and reform of the banking sector; 2) Fiscal reform; 2) Reform of business surrounding; 3) Privatization and capital market; 4) Other reforms; 6) Role of state in transition.

The complexity of this approach is showed by the graph (honeycomb).

Above all, it is necessary to point out that **institutions** exist wherever people realize the need to organize their actions in accordance with the rules set in advance. Institutions involve a **set of rules and regulations that define the space in which actors who attempt to achieve particular objectives operate.** Thus, institutions can't be understood as an instrument for ordering to actors what to do and how to do, than as versus, they are complex of rules set in advance for actors within which they have freedom for decisions making, initiative and creation.

Institutional reform in Montenegro means introduction of new institutions, changing in people behaving and way of thinking, as well as the »new rules of game« reconstitution. **Institutions, legislative, and transparency** are the key pre-conditions of the transition's success.

#### **Monetary reform and reform of banking sector**

Economic system that is being established in Montenegro originated from introduction of the convertible currency, from idea of eliminating political influences in this area and is aimed to provide conditions for to involve in European Monetary Union. That was the reason why Deutsche mark was used as a parallel currency from November 1999 (together with Yugoslav dinar). Since November 2000, Deutsche mark is the only paying instrument in Montenegro, and it has been changed by EURO since the January 2002. EURO is the only legal paying instrument in Montenegro.<sup>8</sup>

Within the monetary reform, it has been changed the Central Bank role. Actually, before the new Central bank Law has been implemented (2000), the Central bank has been a part of the Central bank of Yugoslavia. After this Law was adopted, the Central bank have become independent institution (independent from the Central bank of Yugoslavia) and from the Government of Montenegro as well. The Central bank's Council manages the bank, and it is chosen by the Parliament and responses to the Parliament. The Central bank of Montenegro doesn't have issuing function. It's key functions are:

Bank and financial system regulation (including licensing of the banks and financial organizations, along with companies from the insurance area)

Conducting activities of system of payment

Relations with international monetary institutions

Moreover, the Central bank is obligated to convey its opinions on implementing economic policies every year as well as projections of key economic indicators for current year.

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<sup>8</sup> High inflation, constant dinar devaluation, as well as the fact that more than 60% transactions has been realized in DM (what formally was not permitted), were reasons why we entered in this area's reform on the reforms process beginning in Montenegro. Different solutions were considered when we are talking about payment instrument. Three solutions were possible options: 1) Currency Board; 2) National currency introduction; 3) DM introduction as a payment instrument. The third solution was chosen. DM was introduced on the beginning of November 1999. Initial DM amount, which the State put in the legal turnover, was DM 20 millions (wages paying out to administration, pensions and other state expenditures), what was around 15% of the money supply in Montenegro (the rest money presented were dinars)? During the first part of 2000, DM supplanted dinar from the turnover system, and there were 90% of the money quantum in DM in July 2000. This is one more example, which confirms, that stronger currency represses the weaker one.

DM was exchanged to EURO from January till the end of March 2002. Around DM 900 millions has been exchanged in Montenegro. The majority of exchanged money is outside the bank sector in people hands.

According to the Montenegrin economy structure – aluminum as the most important product, services (The Port, Shipyard, maritime companies, transport) and tourism- which requires economic openness, EURO is appearing as a payment instrument which facilitates and stimulates the opening and integrating flows of Montenegrin economy. Moreover, trough the real transactions settlement and financial discipline EURO should transfer focus of economic and business policies on the policy of structural adaptation and productivity increasing, i.e. cutting inertia according to which all problems in economy and company are solved through seeking cheap loans, which usually are not repaid or are devaluated trough inflation.

Central bank leads the bank sector restructuring procedure in Montenegro. In year 2002, Montenegro has five state-owned and two private-owned banks. The largest state-owned bank, »Montenegrobank« has entered privatization process in 2002, and has been privatized in 2003. At this moment around 76% of capital in Montenegrin banking sector has been privatized. Privatization process of only one state bank "Podgoricka bank" still lasts..

Like in all areas, the possibility for foreign investment in this year is completely open, as well. One private-owned bank (Euromarket bank) has only foreign capital, which is also a part of other two private-owned banks.

The bank system recovery is considered as a part for the whole economy's recovery and development, as well as the investors (domestic and foreign) confidence creating. That was the reason why this was and is still the area of the priority reforms.

The next graph (honeycomb) presents the fields in which the institutional reform process has begun. Two association are very important: 1) large number of fields in which radical changes should be made; 2) that requires much work and reforms management (swarms of bees in order to fill the comb with honey).

Despite the fact that the reforms result can be »sweet«, it needs enormous human work as a pre-condition.

Graph 1. Economic Reforms in Montenegro





## Public finances and reform of tax system

The main objectives of reform in this area can be shortly shown through:

Public and transparent budget

Responsibilities of fiscal policy

Low but usual and stable taxes

Decrease in non-productive expenditures and improvement in public expenditures structure.

In order to reach these goals set of tax laws was introduced:

Corporate Income Tax Law

Personal Income Tax Law,

Value Added Tax Law,

Tax on Real Estate Law,

Excise Law,

Tax Administration Law.

Besides that, the Budget Law and the Public Procurement Law were adopted by Parliament in order to provide transparency and budget preserving. The Treasury has been formed and management and control of budget expenditures is improved. The budget for 2002 is prepared according to the new budget classification.

## Business surrounding reform

Montenegro is creating very stimulant business surrounding. The aim of reform in this area is to facilitate entry into business (company foundation) and similarly, the exit (bankruptcy of the firm). As difference from previous law, the new Company Law reduce, for example, rate for founding new firm to 1 EURO. On the one side, the previous law contained administrative prohibitions (it took more than 40 different documents and lot of time for firm foundation), on the other hand new law is applying only few documents and announcement of licenses has to be done no longer than 4 days.<sup>9</sup> Bankruptcy Law has, inducted international standards in this area, instead of long and complicated procedure (bankruptcy process could last for years).

*Foreign Investment Law* explains national treatment of strangers, as a principle of new economic system. Foreign citizens and legal entities can invest in companies, securities and real estates (land, also), following the same procedure, and have the same rights and obligations that matter domestic physical and legal entities. Investment is free in all areas, except for weapons and army equipment. Foreign investor is allowed to reinvest his profit or

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<sup>9</sup> See: Analyses of process of firm registration in Montenegro, Center for entrepreneurship, April 2000, Podgorica

to bring it from Montenegro. The Law does not give any advantages to foreign investors; system is the same for foreign and domestic investors.

One of the biggest weaknesses from the previous economic system is unreliable accounting. New Accounting Law was announced, and it includes European procedures and standards. This law recruits revisers rule.

Large number of other laws, which are in a spirit of free entrepreneurship and business, is announced. Over-seas Insolvency Law, Secure of Requirement Law, Electronic Business, and Electronic signature Law are some of them.

#### Privatization and capital market

Creation of a new structure in property relations is one of the keystones of reform. Experiences from first phase of privatization (1996-1999) in which dominating model was inside privatization (selling shares to employees with discount) and management buy out and buy in procedures, which showed that privatization requires clear legal and institutional foundation. Publicity and transparency could be provided on that way. In the second phase of privatization, with experts help from USAID and DFID legal and institutional structure in this area has been established. In this phase privatization models have been broaden by International Tenders, Batch-sale tenders, and Voucher privatization program. The biggest companies re privatized through selling of stocks or seeking for strategic partner from abroad. Some of the middle size companies are being privatized through Batch-sale tender (sale and capitalization). Small businesses are privatized by auction and mass voucher privatization.<sup>10</sup>

More than 51% of capital has been privatized in Montenegro (2001). Thus, more than 80% of previously state –owned companies have been privatized completely or have private capital as the highest item in capital structure. In 19 biggest companies, those are being privatized state still hold controlling shares package (between 51-66%). It means that there is no company without private capital in Montenegro.<sup>11</sup>

From the human development's point of view, fact, which should be emphasized, is that about 90% of legal aged citizens of Montenegro became shareholders (through internal or mass voucher privatization). It resulted in *high level of property democracy*.

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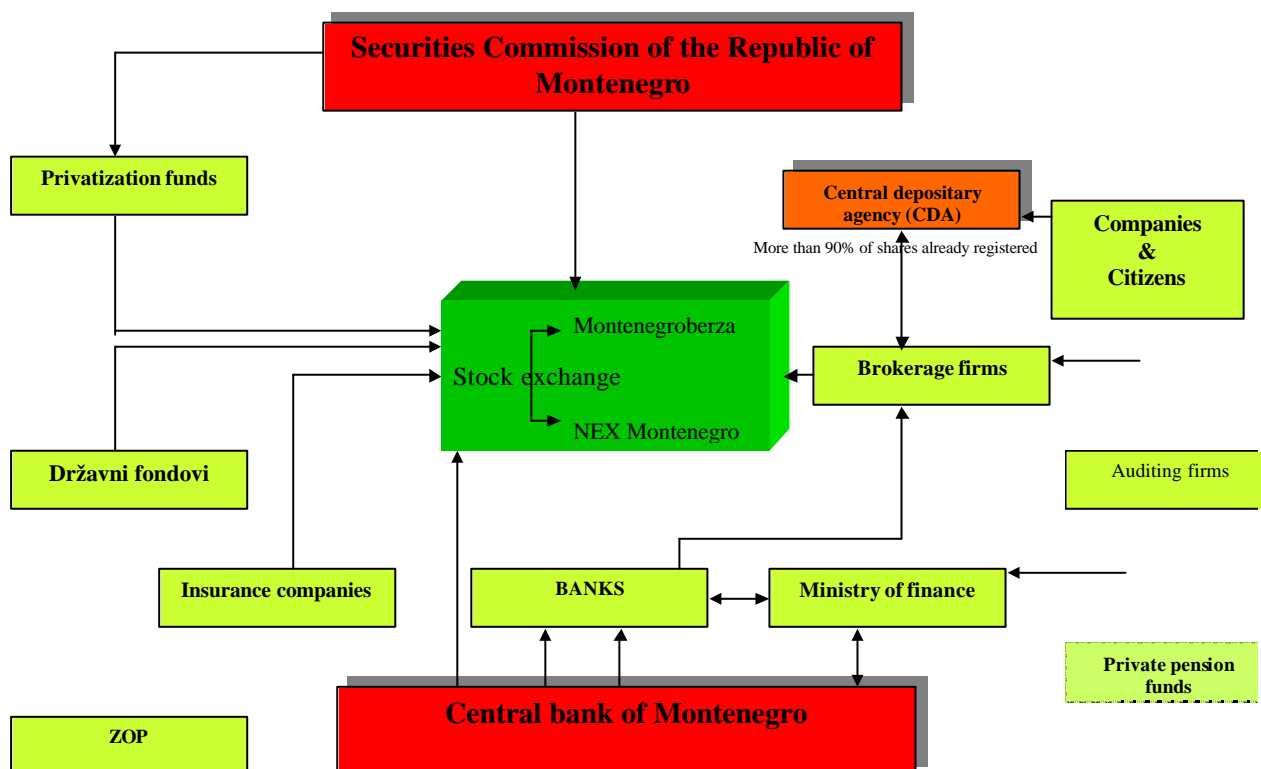
<sup>10</sup> Slogan of privatization is: "We do not sell our companies, we are buying good owners"... As a result of this approach there are companies in Montenegro (Pro Monte from Norway, Inter Brew from Belgium, ISN from USA, Hit from Slovenia, investment funds from Slovenia, Daido metal from Japan, many banks, and insurance companies...

<sup>11</sup> Second phase of privatization provided much higher level of transparency and publicity, which resulted with higher confidence in this process of all publics, especially international. World prize won by P.R.A. agency for the best public campaign and results of the MVP campaign confirms that. Besides, it is very important international recognition, for, according opinion of many, the most transparent privatization process in the region

Six privatization funds have been formed in Montenegro and 66% of Montenegrin citizens invested their vouchers into these funds. Six management companies, owned by, both domestic and foreign financial institutions (banks and insurance companies), particularly investment funds from Slovenia, run these funds. Simultaneously, in cooperation with USAID about 160 investment managers, brokers, and dealers have been educated and licensed. Privatization is viewed in connection with *capital market*. Its effects on development of capital market measure the success of privatization. *Capitalism without capital market cannot be established*. All basic institution of capital market has been created, and large number of young people is drilled for work in these institutions. Key law, which regulates this area, is Securities Law, and it has passed the procedure in Montenegrin Parliament in 2000. Next scheme shows all institutions of capital market and their connection.

Scheme 1. Capital Market in Montenegro (institutional approach)

Veselin Vukotic: Capital market in Montenegro



Shema: Capital market in Montenegro (institutional approach)

## Reforms in other areas

Economic system reform is closely related with reforms in other areas:

Statistical system reform, whose objective is methodological assimilation with European and international standards and introduction of system of national accounts (SNA). Team of international experts supported by experts from EUROSTAT is working on this reform.

Pension system reform, aimed to forefather from PAY GO system to capitalized pension system, leaned on three stilts: 1) Pay go, 2) Capitalized and 3) Voluntary.

Insurance reform, which includes establishment of operation standards and regulation according to the international standards.

Establishing new system of economic regulation. Privatization of big infrastructure systems creates conditions for private monopoly to replace state monopoly, and to endanger consumers` interests (power, water, telephone) can be ruined. New system of regulation that is being implemented in Montenegro is based on complete independence from the Government and its direct responsibility to the Parliament. Operative business will be done by Agency for regulation, as it is, for example Agency for regulation of telecommunications. Agency for power regulation is establishing.

### *a) Reform of health care system*

Reforms in health care have just begun. This reform is treated as part of overall reforms of social security system in Montenegro. Ministry of health have adopted reform document named "Health policy in Montenegro until 2020" (Ministry of health of the Government of Montenegro, 2001).

Goals of health policy are:

Extension of life expectancy

Improvement of life quality related to health

Reduce health differences and provide access to health care institutions

Insurance from financial risk

Measures of health care policy refer to improvement of life and working conditions, especially food, place of residence, water supplying and improvement of life and working environment. One among measures is adequate distribution of resources available according to the health priorities. Citizens should be active participants in implementing measures and reaching goals of health care policy. Priority within health promotion will have measures that improve health, prevent illness, and treat ill people and effective organization of health protection.

### *b) Reforms of educational system*

Government adopted set of six laws, which started the process of reforms within the educational system of Montenegro.

Educational system reforms have a clear goal and it is the modernization of the entire system and its decentralization in order to improve availability and quality of education. The new education system must be harmonized with the strategic development objectives in Montenegro.

Following objectives are to be achieved by the educational reform:

Education along with the science and technique should become engine of development;

Education should support all the working fields through its' participation;

To satisfy the needs, interests, wishes and ambitions of the individuals willing to educate themselves;

Education should be organized in the way which provided conditions for the development of freedom of thinking and conscious activities.

The reforms priorities, which are planned, for the short term run:

Introduction of the way of teaching and learning which has higher quality;

Physical conditions improving in classrooms and schools;

Development of certain methods of reforms and being aware of their significance.

The priorities of the reforms in Montenegro in the long term run are:

Financing of the education and more efficient use of the current funds;

Additional training for teachers, considering that the most of the teachers did not have any opportunity for professional improvement and personal development;

To improve the quality of lectures and quality of learning;

To find the way for decentralization of centralized administrative structure in educational system

### *c) Labor market reform*

Labor market reform is being conducted in order to eliminate existing inflexibility of labor market, and to adjust legal framework to new-established economical and property structure. Main reasons for inflexibility of labor market lie in existing socialistic legislative which affirms socialistic concept of employees recruitment. Complicated procedures regarding the laying of the employees enhance inflexibility. Liabilities of employer regarding the severance payment, obligation of the employer to provide training and qualifying for

higher position, along with the long terms needed laying off employees are limiting factor for releasing redundancies.

Liberalization of labor market and adoption of international standards should be reached through implementation of new reformed regulations. First of all, there is new Employment law, which has been introduced at the beginning of this year, and Labor Law, which is under Parliament procedure.

New employment Law defines employing, insurance and rights of employees, as well as conditions for achieving those rights on very precise way. This Law deprived the monopoly which Employment fund had on Labor market and defines conditions of participation of other legal persons in mediation process when employing. It encourages competitive environment and efficiency on labor market.

This Law regulates all issues from the domain of rights of unemployed persons regarding the informing about possibilities of employing, mediation during employing process and work engagement, and regarding entering programs of active employment policies. Special treatment have issues regarding financing and sub-financing of new jobs, educating and giving scholarships to unemployed persons according to requirements of market.

Changed economic structure requires different qualification structure of labor force. New regulations prescribe the rules regarding the preparation for the job, including professional orientation, training of skills, retraining, qualifying for higher positions, and innovation of knowledge.

Labor Law which is in parliament procedure is and basic idea of the law is to liberalize the relations in this particular area, as well as harmonize of existing practice with international standards. It should eliminate all defects of existing regulative regarding the rights and obligations between employers and employees. This primarily refers to very complicated regulative, long procedures and high transaction costs during hiring and firing process.

#### *d) Reform of Judiciary system*

Quality of human development depends on the court system at one territory. Real level of democratization of a society is dependent on judicial system.

Judiciary system of Montenegro encompasses primary court (15), Supreme Court, Constitutional court, and Economical court. Total number of judges in these courts is around 240. Although the judge selection process is officially politically neutral, political

component substantial, because judges are being appointed by Montenegrin parliament. Judiciary system is inefficient with very unfavorable working conditions.

Adoption of Court Law (2001) that followed example of similar legislative in European countries initialized reform processes in this area.

This Law introduced Appellate and Administrative Court that will start to operate in 2004. The Court Council of the Republic is introduced through this piece of legislative, as well, and its competency will be to elect and dissolve the judges.

#### **2.5.4.3. Role of state in transition**

Establishing of market oriented economy require active role of the state. Experiences of transition countries confirm this thesis. However, problem is how to answer the questions what is the role of state in transition? Should state do same things as in central- planed economy? Does economical system based on market orientation demand different role of state?

During the transition state, should prepare legal framework for establishing domestic market. Especially important thing is how to protect property and contracts as well as how to enhance freedom of agreement.

Macroeconomic stability, liberalization and deregulation are also important field of state activities. Economic stability and economic freedom are public goods, which have to be "produced" by state.

Field of restructuring, privatization and restitution are also important tasks for the state.

Changes in the role of the state in economy have to be introduced if state wants to meet transition needs.

However, in Montenegro a lot of things have to be done regarding the reform of public administration. There is inertia of organizing public administration and its specific parts in conservative way. Problem for Montenegro became more actual considering that Montenegro took over responsibilities from federal level and that means that there is the need for more institutions.

Focus was moved away from the public administration problems due to the reforms which should occur in other fields and due to problems that need to be solved. During the transition some improvements are noticed. For example Institute for public administration was established. Since that Montenegro have had lack of resolutions as well as financial support for such important and complicated processes.

Montenegro has relatively huge public administration (15 ministries, 4 republic councils, 3 republic administrations, eleven republic administrative organizations). Government of Montenegro have 19 members and in this sense it is larger than governments of Slovenia, Macedonia, Estonia and Ireland. Having in mind low technical level, working conditions along with the sloth of public administration and its volume (approximately 40,000 on republic level and 2000 on local level) need for reforms became urgent. Nevertheless, the critical point of public administration reforms is the concept of understanding of the role of the state. Is Montenegro going to leave behind traditional approach, based on local way of thinking, that state is more important than individual and it is obliged to solve all problems and that wasting of resources of the state resources is fair (syndrome from the past). Philosophy of paternalistic understanding in Montenegro is very strong.

Having in mind size of Montenegro (13,500 km<sup>2</sup> and population of 650,000), goal which Montenegro has: to establish open economical system, along with acceptance of EU standards, Montenegro has to have small, efficient, well-equipped and well-paid public administration. Beside this, role of the state has to be minimal and focused on establishing and protection of market roles. These are foundation for the concept of microstate in Montenegro. According to that Montenegro has to do following:

Decrease number of Ministries and authorities

Improve efficiency of public administration;

To enhance transparency of public administration;

Administration should be transformed into public service. Efficient mechanism for protection of freedom and rights of citizens should be established.

De-politicization and professionalism of public administration;

Improvement of local administration role (make it closer to citizens).

Without new concept of public administration and fast implementation of it economic and social reforms will be endangered. Like Weber says: New Constitution can not be implemented by old administration.

### **3. Reforms package 2002-2006 (Economic Reform Agenda)**

After the elections held in October 2002, condition for further implementation of dynamic economic reforms in Montenegro. Before all new elected coalition Government won four year mandate; relations with Serbia are solved for next three years; economic reforms in Serbia had rising trend, and influenced positively on reform process in Montenegro. Results of previous reforms, especially new adopted laws, introduction of DEM, price liberalization and level of openness created conditions for implementation of



comprehensive economic reforms program. If adoption of concept and establishing of institutional sovereignty was first phase, this phase was further development of reforms on these conditions! After many discussions and with involvement of many experts and NGOs Government adopted Economic Reform Agenda. Agenda is comprehensive document of further institutional development of Montenegro. Basic assumption for this: institutions as important resource of further institutional development and life quality in Montenegro.

The Agenda relies on five key pillars, which are connected through network. Those are:

**Entrepreneurship**

- or how to encourage and help individuals to enter businesses. Entrepreneurship is the energy for the realization of the Agenda. In that sense, activities should be concentrated on (1) removing barriers for doing business; (2) adjusting tax rates, in order to optimize private sector growth; (3) strict control of government expenditures; (4) protection of property rights; (5) increasing economic freedom; (6) increasing the availability of loans and credits; (7) private sector participation in providing public and administrative services.

**Investment**

- or how to make Montenegro attractive for investments, especially in comparison with other countries in the region. Key starting point is: (1) protection of property rights (court system, bankruptcy procedures, restitution, prevention from corruption and conflict of interests); (2) efficient institutional framework (financial market, capital market); (3) privatization of public companies and banks

**Competitiveness**

- or how to decrease the cost of production, improve the quality of products and its marketing characteristics, as well as to expand the market. Items below are of particular importance: (1) reduction of administrative and transaction barriers; (2) World Trade Organization Accession; (3) European Union harmonization; (4) attract foreign companies in Montenegro; (5) reduction of infrastructure costs (energy, transportation, insurance, interests).

**Transparency**

- or how to increase the visibility of economic system functioning, preventing the existence of a "parallel" system (gray economy, corruption, rent-seeking, subsidies, subventions, contingents, permissions, etc.). The main task of transparency is, before all, to strengthen the functioning of the official system, basic system institutions, in other words the same game rules should apply for all.

Transparency provides functioning of market and democracy through rule of law. Law is "above" politics (democracy).

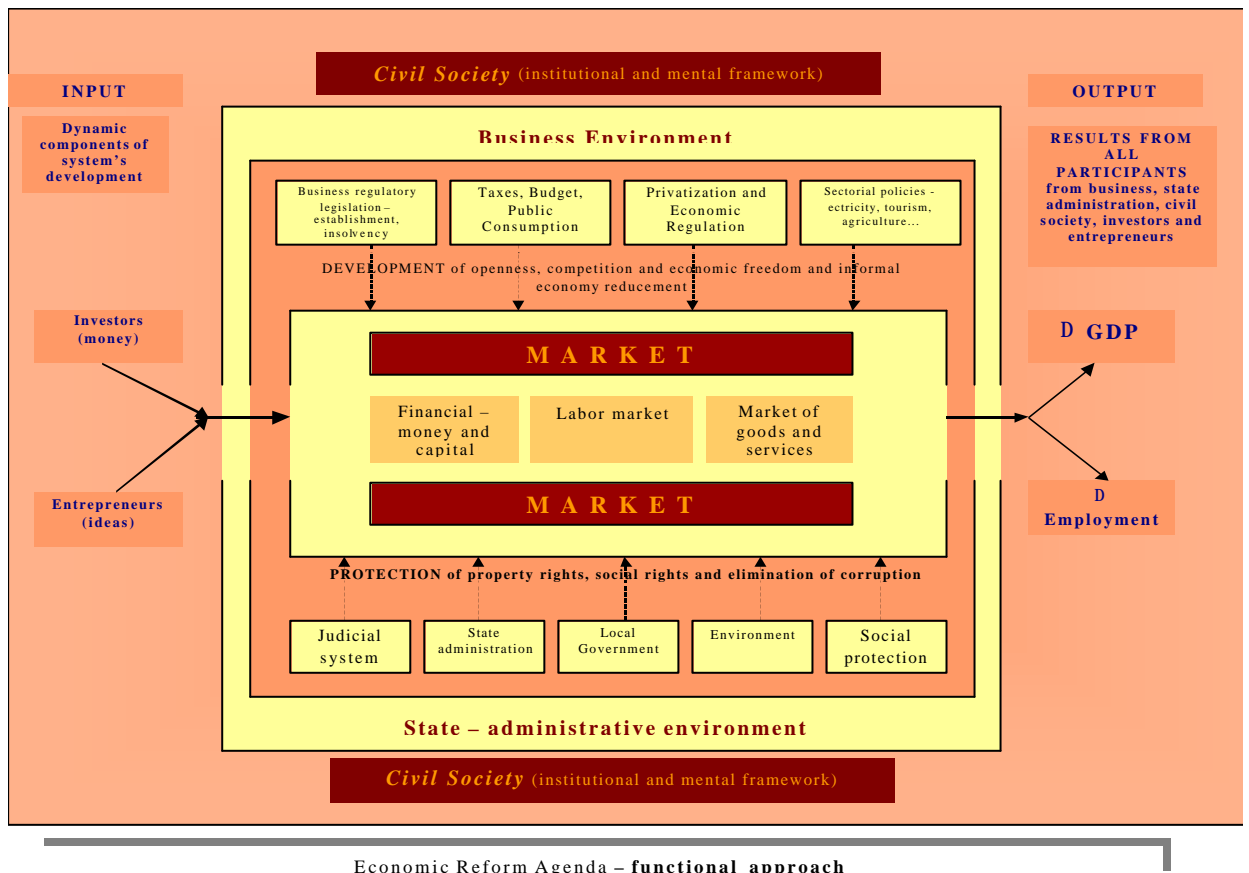
**Employment**

- or how to increase the number of employed people, capable to earn enough for a better quality of life through independent work. Result of all undertaken activities should be an increase of employment.

The Economic Reform Agenda is an all-inclusive four-year plan, which is adopted by the Government of Montenegro in order to achieve the following goals:

- Economic growth driven by the private sector
- EU compatibility of legislation and processes
- Maximization of Montenegro's potential in areas where it has advantages
- Protection of the Environment

Main goal of Agenda is to motivate investment of financial resources and ideas in Montenegrin economic system, on market basis, which means with higher level of economic freedoms and with stronger state role in protection of rules and implementation of the laws. All of that can be measured with increase of GDP, as well as human development



Scheme 2: Agenda of economic reform functional approach

Economic Reform Agenda governance is special part of its implementation. Software for Economic Reform Agenda has been developed and in every moment that electronic network can show names of the people and institutions responsible for implementation of each part of the Agenda, as well as the tasks which are finished and those which are not finished yet. All reports about realization of Economic Reform Agenda can be found on that web-page. Prime Minister coordinates and governs realization of Economic Reform Agenda together with two teams: (a) team of domestic experts and Deputy Prime Ministers which counts 9 people, and (2) the other team consisting of the same 9 people from the first team broaden with representatives of USAID, EU and other international donors. Meetings of the first team are held each 15 days, while the other team meets once a month! Experience shows that reform governance is extremely important for its results.

In annex of this paper the list of the tasks achieved through Economic Reform Agenda is given, as well as the lists of tasks which need to be achieved in future periods..

#### 4. Macroeconomic results and key problems

Table and graphs given below shows the key results of previous reforms in the field of economy:

Graph 2: Key macroeconomic trends in Montenegro

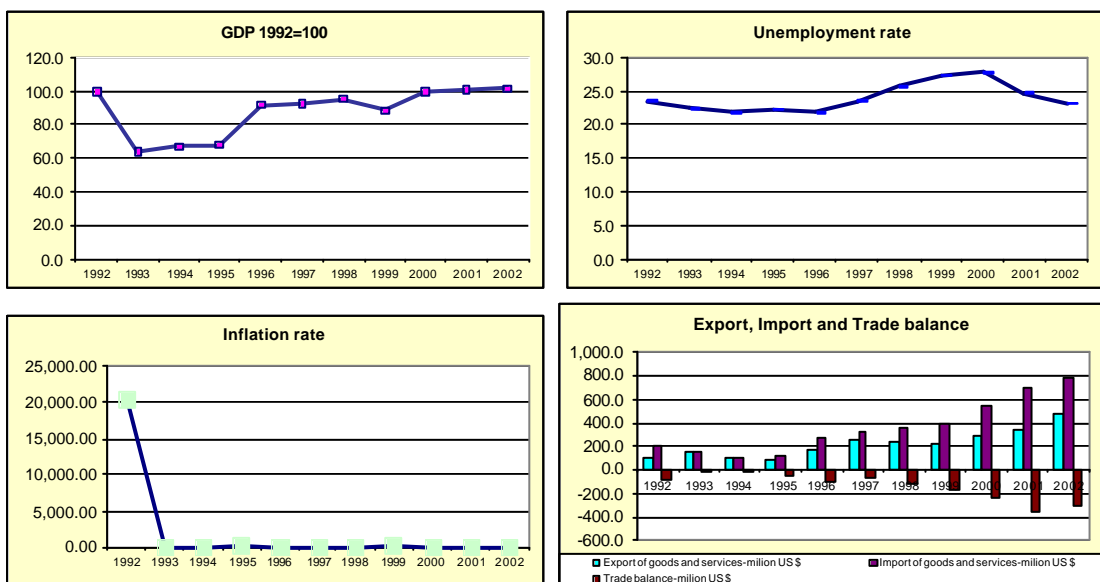


Table 3: Macroeconomic indicators in Montenegro 1989-2002

	Gross Domestic Product (GDP) - million US \$ - constant prices	GDP 1992=100	GDP per capita - US \$ - constant prices	Industrial production - 1992=100	Agriculture - 1992=100	Unemployment rate	Number of employed	Number of unemployed	Inflation rate	Export of goods and services - million US \$	Import of goods and services - million US \$	Foreign trade balance - million US \$
1992	1,027.4	100.0	1,646.5	100.0	100.0	23.6			20,293.2	112.6	195.1	-82.5
1993	655.3	63.8	1,037.0	66.0	91.8	22.4			n.a	146.8	159.4	-12.6
1994	686.6	66.8	1,080.7	60.6	97.4	21.8			n.a	94.3	101.1	-6.8
1995	701.8	68.3	1,099.0	59.0	102.4	22.2	178,868	55,436	111.80	79.1	126.0	-46.9
1996	939.6	91.5	1,461.3	89.6	105.8	21.9	183,483	56,477	47.20	177.2	272.9	-95.7
1997	953.8	92.8	1,473.3	90.8	116.0	23.5	178,562	57,342	16.20	249.5	322.0	-72.5
1998	982.5	95.6	1,508.5	90.5	116.8	25.7	180,365	50,693	42.00	239.9	360.2	-120.3
1999	908.9	88.5	1,387.2	83.3	122.0	27.3	184,832	53,340	128.40	211.5	383.8	-172.3
2000	1,022.1	99.5	1,552.6	86.2	115.9	27.8	181,762	54,949	24.80	293.6	545.4	-251.8
2001	1,032.0	100.4	1,559.9	85.0	124.0	24.8	175,242	57,536	28.00	345.3	695.2	-349.9
2002	1,041.2	101.3	1,570.4	86.1		23.3	177,617	57,688	9.40	471.4	777.7	-306.3

## 5. Instead of Conclusion

What is shown as problems in implementation of Economic Reform Agenda?

Government is under pressure of social problems, higher every day. The key principle of economic reforms: increase of efficiency is endangered, with emphasized need for social security.;

High share of public expenditures and still very high dependence of business in Montenegro from state companies.

Process of forced harmonization with Serbia under pressure of EU, recuperation of the social layers and companies, which are against economic freedoms and for protection: in other words expectation of many companies that state should redirect its protection role (protection of laws and legislation) on protection of certain companies and layers (with customs, tariffs, contingents, price control, subsidies).

Low level of economic freedom. Despite many good and liberal solutions implemented in certain areas the overall system is still rigid for investors and entrepreneurs: this estimate should be taken in consideration from the context of size of Montenegrin market and its integrations (free trade)

Problems in work of Parliament. Opposition parties do not participate in the Parliament work, which reduce the efficiency of this body;

High level of gray economy;

Inefficient implementation of Bankruptcy Law

Problems of restitution slow down the reforms in the area of property rights and protection of property rights.

Inefficient court system, as well as immense and partial effect of law and institutions in the field of corruption, conflict of interests and money laundry

Labor factor is too expensive. Taxes and contribution fees paid on the salary amount to 95 % of gross salary.

## 6. Annex:

Current status of the Economic Reform Agenda's projects implementation from

<b>REALIZATION OF ECONOMIC REFORM AGENDA</b>	
<b>COMPLETED</b>	
<b>Adopted laws:</b>	Pensions law; Law on Electronic Signature; Law on the Prevention of Money Laundering (unit is being established); Law on Assumption of Debt and Frozen Foreign Savings.
<b>Enacted laws:</b>	Energy Law; Law on Deposit Insurance; Law on Local Government; Law on Local Government Finance; Law on Direct Election of Mayors; Law on Inspection Oversight; Labor Law but new Labor Law does not meet the spirit of or criteria outlined in the Agenda.
<b>Privatization:</b>	Privatization of Jugopetrol and Montenegrobanka is completed.
<b>Other:</b>	Secured Transaction Registry: established, hardware and software installed, staff members trained, instruction on operation adopted by Ministry of Justice; A new Government spokesperson appointed who will oversee public education program for the Agenda; GOM Web Site was established.
<b>On track/progress</b>	
<b>Reorganization of the Ministry of Finance:</b>	Plan finalized and adopted by the Ministry of Finance.
<b>Reform of the Tax System:</b>	Formal appointment of key personnel in DPR in line with newly adopted internal organization has taken place, which will enable more effective implementation of reforms in the tax area.
<b>Laws:</b>	<p><u>Mortgage regime</u>: Working group established at the Ministry of Finance.</p> <p><u>Insurance Law</u>: A decision needs to be reached on Oversight Authority for the insurance industry.</p> <p><u>Restitution Law</u>: Development of draft on track. Expected to enter committees this month</p> <p><u>Law on Foreign Payments</u>: On -track, being finalized;</p> <p><u>Regulations for implementation of Law on Private Sector Participation in Public Services</u>: Draft is finished.</p> <p><u>New legal structure on environment protection</u>: Process initiated, tender published for the Finish Government project</p> <p><u>Gaming Law</u>: In progress. Draft of the Law being developed.</p>
<b>SAP</b>	Commission , Council and Parliamentary Board have been

<b>REALIZATION OF ECONOMIC REFORM AGENDA</b>	
	established.
<b>WTO accession process:</b>	Consultative working group established.
<b>Fulfillment of the Privatization Plan:</b>	Ongoing privatizations of tobacco company, winery, Hotel Crna Gora. Privatization of the last bank with a majority state ownership (Podgoricka bank) was initiated.
<b>Assessment of the Banking sector according to the Basel II Core Principles:</b>	On-track. Assessment completed and preliminary report developed, Final report due by the end of September. Important for the: Money Val evaluation of Montenegro and Reduction of the cost of capital in Montenegro due to a reduction of risk if the findings of the assessment are positive.
<b>Reform of the Tax System: Review of Tax Rates:</b>	Proposals for reduction put forth and options are being discussed.
<b>Implementation of Local Self-Government Laws:</b>	Commission on a Republic level is to be established.
<b>Streamlining administration processes and improving economic freedoms:</b>	Pilot case on streamlining property registration system ready for execution.
<b>Macro Statistical system:</b>	Process initiated to establish a statistic system in Montenegro.
<b>EPCG Unbundling:</b>	Started, on-track, to be completed by the end of 2004. Some key policy issues need to be resolved quickly in order to maintain on track.
<b>Airport Master Plan:</b>	Initial draft completed. Set for review to major stakeholders.
<b>Budget Reform:</b>	<p><u>Unified Revenue Collection</u>: unit that will coordinate more state institutions is being established;</p> <p><u>Revenue control system</u> :General agreement reached at the Working Group level in the Ministry of Finance</p> <p><u>Budget for 2004</u>: Ministry of Finance developed Fiscal Policy guidance</p> <p><u>Development of Activity Based Budget</u>: Process initiated. Pilot spending units selected and training started.</p> <p><u>Medium Term Expenditure Framework</u>: Under development for a period 2004 to 2007. Part of the budget planning</p>
<b>Management of Public Debt</b>	The first version of the Law has been drafted.
<b>Implementation of the VAT Law :</b>	New procedures have been adopted, public education is completed.

**REALIZATION OF ECONOMIC REFORM AGENDA**

**NOT STARTED, STALLED OR DELAYED**

**New Administrative and Appellate Courts**

The Judicial Council made recommendation for staffing levels for the new Administrative and Appellate Courts on 24 June. The Government adopted the proposal and has agreed to allocate the space by 03 September.

**Sale of residual shares:**

Process initiated and shares placed on stock exchanges, but no significant progress due to the high, non-market based, prices.



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