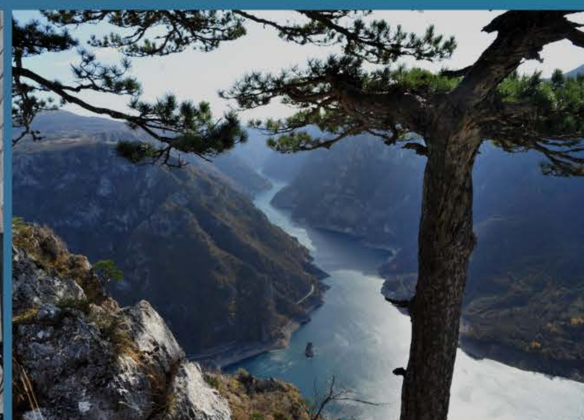
Public Disclosure Authorized

Montenegro
Policy Notes 2017







Introduction

Montenegro and the World Bank Group (WBG) have jointly prepared a robust program of cooperation for the next four years. In the past 18 months, the World Bank Group has prepared the Systematic Country Diagnostic (SCD) for Montenegro, a comprehensive analytic report outlining challenges and opportunities that the country is facing on the road to sustained growth and prosperity, and the Country Partnership Framework (CPF), a document that sets out the goals and priorities for World Bank Group program in Montenegro for the next four years. Both the SCD and the CPF were informed by extensive and broad consultations with the government, local communities, private sector, civil society and international development partners active in Montenegro. In particular, the CPF, World Bank Group strategy in Montenegro that came into force in June 2016, has been developed on the basis of the diagnostic and of the government's own strategic priorities. Bank's strategy is focused on two priority areas: Enhancing Macroeconomic and Financial Resilience, and Enabling Inclusive Access to Economic Opportunities and Jobs.

With the new Government taking office, now is a good time to discuss specific policy reforms and investments that the World Bank Group could support. While we believe that the agreed strategy remains valid, it is essential to reconfirm our common understanding of challenges and policy options so that the World Bank Group can provide timely and efficient support to Montenegro. It is also useful to agree on an initial set of advisory and financing operations that WBG could launch in the near term.

The following Policy Notes summarize the key challenges, policy options and ways in which WBG could provide effective support. These are fully consistent with the recommendations of the Systematic Country Diagnostic and goals of the Country Partnership Framework, and aim to present a concise and clear set of proposals for each priority area. The Notes form a consistent document but each one of them can be used as a stand-alone piece for discussion with the relevant sector stakeholders. There are three thematic Notes outlining key priority areas – Macro-Fiscal and Financial Resilience, Private Sector and Jobs, and Environmental Sustainability. Each of these is accompanied by a series of sector notes that provide additional detail.

Urgent fiscal consolidation is the prerequisite for a meaningful world Bank Group program in Montenegro. Given the severity of the debt crisis, Montenegro will be unable to restore the confidence of international investors without rapid and decisive policy reform that would bring the budget into balance by 2019. The World Bank stands ready to provide advice and budget support in this challenging task, and to complement it with targeted investments in priority sectors.

To further inform the discussion of specific areas for World Bank Group support, the following table summarizes the ongoing and proposed WBG operations under each priority area.

Note: Lending envelope for 2016-2020 is US$250-$300 million, of which up to US$90 million for budget support (45+45). *Advisory operations* are in italic, **IFC operations** are in bold.

Ongoing operations	**Country Partnership Framework** **Indicative lending – ASA &TF**	**Options**
Macro-Fiscal and Financial Stability		
• *Public Finance Review* • *Subnational Finance Note* • *Improving the system of public procurement*	• Tax Administration (ready) IFP • Budget support (DPLs) for fiscal consolidation • Health Reform	• **IFC advisory and Debt Resolution program** • *Strengthening of Financial Safety Net - FinSAC*
Private Sector and Jobs		
• MIDAS • HERIC • *Justice Reform*	• Sustainable Tourism • Skills (HERIC 2) • MIDAS 2 • Jobs &Competitiveness • Digital Economy Project • *Justice Functional Review*	• MSME Development (starting with diagnostic) • **IFC advisory and investments** • *Demands and Supply-s barriers to employment*
Environmental Sustainability		
• Industrial Waste • Energy Efficiency	• Energy Efficiency 2	• **IFC advisory and investments** • *Advice on environmental management*

Policy Notes

Macro-Fiscal and Financial Resilience

Pensions and Social Assistance
Health
Tax Administration
Subnational Government

Private Sector and Jobs

Education and Skills
Connectivity – Transport and ICT
Agriculture and Rural Development
Sustainable Tourism

Environmental Sustainability

Energy Efficiency and Biomass Energy
Industrial and Special Waste

Macro-Fiscal and Financial Resilience

Montenegro Policy Note 2017

The Challenge

Montenegro's current growth model is running out of steam, and public debt is unsustainably high. In 2016-2018, the economy is expected to grow on average at 3.3 percent due to credit-driven consumption and public and real estate investments, yet once Bar-Boljare highway construction ends, growth is expected to fall below 1 percent. Public debt (including guarantees) stood at 79 percent of GDP in 2015 and will likely exceed 80 percent in the near term, with external debt double that size.

Figure 1. Fiscal Deficit 2014-2016, percent of GDP

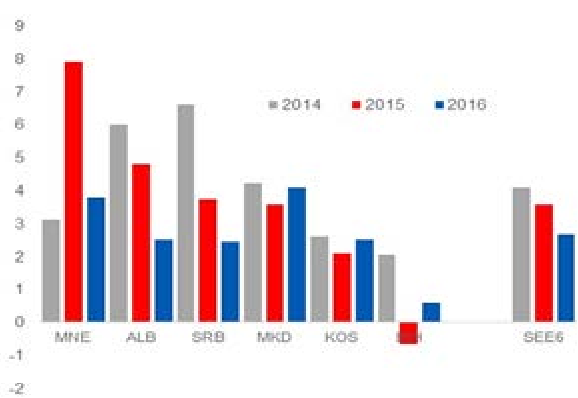


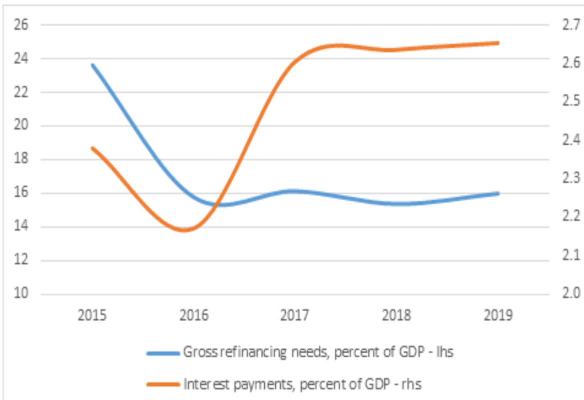
Figure 2. Public and Publicly Guaranteed Debt, percent of GDP

Sources: National statistical offices, Ministries of Finance, World Bank staff projections

The fiscal deficit is high, causing further debt accumulation. Driven by public investments in the Bar-Boljare highway, for which Montenegro took a US$944 million loan (23 percent of the 2014 GDP), the fiscal deficit reached 8 percent of GDP in 2015. Highway work delays allowed the deficit to drop to below 4 percent in 2016, but resumption of construction would reverse this effect. On top of it, recent increases in public sector wages, minimum pensions and social transfers (e.g. new benefit for mothers of three or more children) added new spending equal to an estimated 2.5 percentage points of GDP annually to already high public spending.

Without adjustment, the fiscal deficit would persist and public debt (including guarantees) increase to 83 percent of GDP by 2018. Reducing the deficit will not be easy: government annual deficit targets were missed by 2-3 percentage points of GDP on average since 2008, due to over-commitments and contingent liabilities. Debt exposure to the US dollar (US dollar-denominated highway loan) presents additional risk to public finances, as do public arrears of close to 7 percent of GDP. To meet its own fiscal rule, the country needs to bring the public debt level down to 60 percent of GDP. Immediate steps to put the debt on a sustainable path are necessary to reassure markets and allow for a successful rollover of existing obligations which amount to around 16 percent of GDP a year.

Figure 3. Government Financing Needs and Deficit, percent of GDP



Source: Ministry of Finance, World Bank staff projections.

Table 1. General Government Finance, percent of GDP

2015	EU28	EU small states*	Montenegro
Total Revenues	45.0	39.0	42.2
Total Expenditures	47.4	40.0	49.8
Current Expenditures	43.2	34.9	40.9
o/w wage bill	10.1	10.7	13.2
o/w interest payment	2.3	1.8	2.4
Capital Expenditures	4.2	5.1	9.0
Gross Public Debt	85.2	54.3	66.7
Public debt with guarantees			77.5

Source: Ministry of Finance, EUROSTAT
Note: EU small states include Cyprus, Estonia, Latvia, Lithuania, Malta and Slovenia.

The spending pattern offers significant scope for rationalization, especially in such areas as public wages and capital spending. Headline public spending has been higher in Montenegro than in the EU, including almost 10 percentage points of GDP difference in total expenditures with the small Central and Eastern European states. Combined with spending on pensions of around 11 percent of GDP, wages account for more than half of total current spending. There are longer-term pressures on pensions and health care due to an aging population, while early retirement creates further pressures on fiscal sustainability of the system, but also on the already comparatively low labor force participation. Additional 2 percent of GDP in spending for the lifetime benefit for mothers of three and more children introduced in January 2016 crowds out other better targeted spending and reduces further an already low female labor force participation. Fiscal plans are also vulnerable to potential cost overruns related to the Bar-Boljare highway construction.

Additionally, there are vulnerabilities in the financial sector. Montenegro's financial sector is struggling to recover from the 2008-2009 crisis. A vicious cycle exists of high non-performing loans (NPLs), high interest rates, low credit growth and low bank profitability, all underpinned by a stagnant economy. Growing risks in domestic banks and weaknesses in bank regulation and oversight pose fiscal and financial stability risks.

The banking sector is overcrowded and its governance need to be strengthened. The country of 630 thousand people has 15 banks in operation (one bank per 40 thousand people – close to four times the ratio in emerging European countries), which struggle with low profitability and deleveraging concerns of some international banking groups. Lending to related parties remains wide-spread, especially in domestically-owned banks, which also suffer from weak corporate governance. Although on a declining trend, non-performing loans (NPLs) remain high (12.6 percent in Q2 2016). The Central Bank of Montenegro (CBM) has progressively diluted the asset classification rules over the last several years, thus delaying the recognition of NPLs. Three banks (18 percent of the total banking system assets) are most vulnerable, yet some continue to increase market share. All had qualified external audits in 2014. Several financial sector laws were recently passed without proper consultation with CBM. Weaknesses exist in the oversight and governance of the Investment Development Fund (IDF), an important non-bank financial institution.

Figure 4. Domestic credit to private sector (% of GDP)

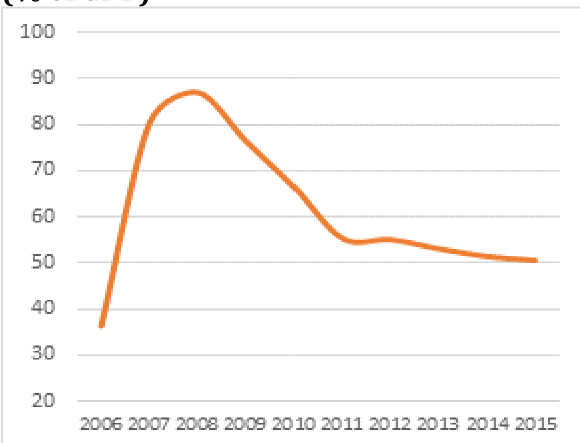
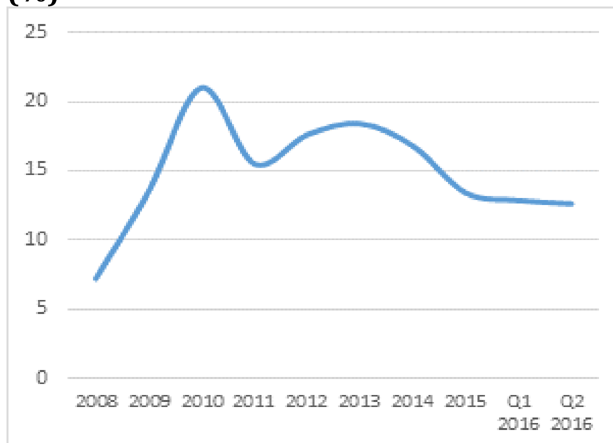


Figure 5. Non-performing Loans to Total Loans (%)



*Source: WDI,*Central Bank.

Policy Options

Fiscal consolidation equal to 2-3 percent of GDP annually in 2017-19, as a minimum, is necessary to reverse the alarming public debt trend and arrive at a balanced budget by 2019. To achieve this, Government needs to take permanent measures on both the revenue and expenditure sides, e.g., reverse recent increases of social transfers and public sector wages, optimize other expenditures, prioritize public investments, mobilize new revenues and reduce tax exemptions. Options and their potential savings are summarized in the following table:

Policy area	Immediate savings % of GDP	Cumulative savings over the medium term % of GDP
Public wage bill	**0.5** (basic wage harmonization)	**2** (staff reduction)
Pensions		**2** (rationalize early retirement and reform pension indexation/valorization)
Social benefits	**1** (rationalization/substitution of mothers' benefit)	**Over 1** (eliminate error of inclusion)
Public investment	**1** (drop non-strategic projects)	**3** (finalize highway section and reallocate to environmental acquis)
Public procurement	**0.5** (centralized procurement)	
Tax revenues	**0.5** (collection of arrears)	**2** (rationalizing exemptions)
Health	Improve efficiency, reallocate funds from pharmaceuticals and hospitals to primary care	
Local government	Improve spending and revenue efficiency and clear arrears	

There are also challenges with the transparency and the quality of public service provision. Strengthening public sector governance is a key condition of EU accession, while at the same time fiscal pressures dictate that better quality of services (e.g. in education, health, social protection, water and waste water) needs to come hand in hand with reduction in expenditures, calling for greater efficiency of public service delivery at both local and central government level. Modernizing the public sector and strengthening checks and balances are key for improved service delivery. (See *Policy Notes on Health, Pension and Social Assistance, Subnational Government and Tax Administration*).

To preserve financial stability, Government is advised to urgently address weak banks in line with 2015 Financial Sector Assessment Program (FSAP) recommendations. CBM should conduct independent Asset Quality Reviews of all banks to review loan classification and provisioning practices, develop time-bound supervisory action plans requiring capital increase by shareholders, and prepare, in consultation with the Ministry of Finance and Deposit Protection Fund, resolution plans for vulnerable banks, aiming to minimize the use of public resources. Recent loosening of regulatory standards needs to be reversed in order to ensure timely recognition and write-off of NPLs. Actions could also be taken to enhance corporate governance at a sectoral and bank-specific level, as well as to strengthen the governance of the state-owned IDF.

To prepare for EU accession, the Government is required to transpose EU directives on bank resolution, deposit insurance, payment system and accounting. In addition, remaining weaknesses in the Anti-Money Laundering regime will have to be addressed.

World Bank Group Support

Ongoing support. **Public Finance Review** supports the Government to identify possible measures for fiscal consolidation.

Improving the system of public procurement in Montenegro advisory project supports the Public Procurement Administration to develop a performance and monitoring indicators manual and communication guidelines for small and medium enterprises.

Planned Support/Options. **The World Bank can support fiscal consolidation efforts with both advice and financing.** The World Bank could consider a series of two an annual Development Policy Loans (DPL) of US$45 million each linked to strong prior actions to reduce the fiscal deficit and improve public finance and financial sector sustainability. In addition, a Tax Administration Project has been prepared and is ready to be negotiated at Government's convenience. For additional deficit financing, the World Bank would recommend discussions with the IMF on a possible complementary program.

In conjunction with fiscal consolidation, support to financial sector strengthening could be included in the planned series of DPLs. In the absence of a DPL series, World Bank support to financial sector strengthening will be limited to advisory and technical assistance work.

A possible IFC Corporate Governance (CG) assistance program could focus on a financial sector level CG assessment and implementation of certification program for non-executive board members (of the commercial banks and insurance companies). IFC Debt Resolution program could assist government to improve the pre-insolvency and insolvency regime and stimulate the use of the insolvency framework while increasing lenders confidence and improving access to finance for new and existing businesses, particularly SMEs.

IFC Financial Institutions Group advisory may support the banks and Micro financial institutions through the "ECA - Strengthening Financial Systems" Program to improve the risk management capacity of individual financial institutions to implement best practices in Risk and NPL management and to improve the capacity of individual banks to develop their SME banking operations.

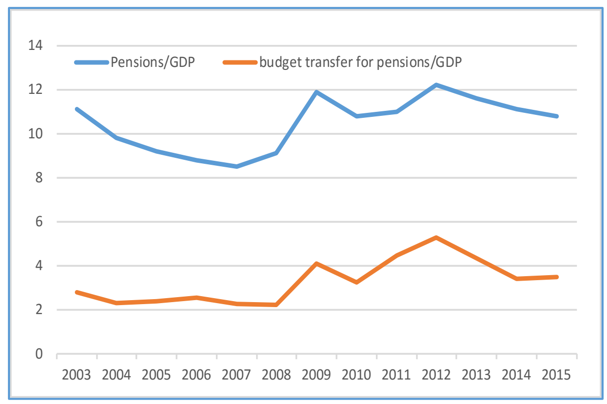
The Financial Sector Advisory Center (FinSAC), a technical unit based in Vienna, is already supporting implementation of key FSAP recommendations aimed at strengthening the Deposit Protection Fund's (DPF) legal, regulatory and institutional framework. Additional help could be provided by the center with technical advice and analytical services on financial stability, crisis prevention, macroprudential and microprudential framework, bank recovery and resolution, as well as consumer protection and financial literacy.

Pensions and Social Assistance

The Challenge

Montenegro's pension adequacy is at risk of erosion in the long run and is causing severe fiscal pressures. After the global financial crisis, pension expenditures returned to levels above 10 percent of GDP, similar to EU's average. This increase has generated additional deficit being covered by the state. The main source of increasing costs has been (i) rising pension replacement rates and (ii) declining real wages. While the current valorization and indexation pattern (75 percent CPI and 25 percent wages for both) has worked well to preserve the real purchasing power of the pensioners, in the long run it would erode pension adequacy. In order to maintain stable initial replacement rates and real purchasing power of pensioners, the current indexation pattern needs to be modified.

Figure 6. Pensions Expenditures and Budget Transfers for Pensions, percent of GDP



Source: MONSTAT; Pension Fund of Montenegro

Early retirement opportunities further weakened the pension system. The introduction in 2010 of a 5-year general early retirement option at actuarially neutral decrement (4.25 percent per year) offset the effect of retirement age increase, given the growing number of early retirees since 2011. Hazardous and arduous occupations are also eligible for early retirement with extended service period at low additional cost. Although the number of insured individuals eligible for extended service period is not large (estimated 3-4 percent of total), the list of occupations is broad and includes professions that are no longer hazardous.[1] Additional contributions by employers required to pay for accelerated service period are insufficient to finance their early retirement. Similarly, the 2010 introduction of penalty-free retirement with accrued 40 years of service is actuarially unfair to later entrants to labor market, insured individuals with shorter service periods, and taxpayers.

Other recent interventions add fiscal pressure over pension expenses. In the last couple of years, there were three interventions that added fiscal pressure. First, a temporary early retirement window between March and July 2015 that allowed employees of bankrupt public companies to retire with 30 years of service (25 for women) regardless of age. The opportunity was seized by some 1,500 employees who would have otherwise stayed active and seek new employment. Second, a decision to index pensions in 2016 above the standard formula – all pensions from July 2016 got extra 3 percent increase and minimum pensions as much as 20 percent. Third, the introduction of the motherhood lifetime benefit (that can be also considered a form of pension) for women with three and more children may appear as an attractive demographic measure, but leads to important work disincentives

[1] The list of occupations includes occupations that are no longer considered hazardous by EU countries such as flight attendants, ballet dancers and opera singers.

that will in the long run affect the pension system. None of the interventions aims to address any of the systemic design issues of the pension system.

While the Montenegrin social assistance system performs closer to the ECA average, severe weaknesses are embedded in it that result in efficiency losses and work disincentives. The social assistance system delivers both contributory and non-contributory programs, with a level of spending and key performance indicators similar to the ECA region. However, a closer look at the system reveals important weaknesses in terms of (i) program coordination with a high level of resources allocated through categorical programs as opposed to means-tested programs; (ii) various design flaws in the Family Material Support Program (FMS/MOP), the Benefits for Families with Children, and the Motherhood Lifetime benefit which results in work disincentives and inclusion and exclusion errors; (iii) lack of integration between social assistance and employment policies, which is needed to activate a considerable number of beneficiaries; and (iv) high administrative cost in the delivery of social protection.

A low portion of resources is delivered through targeted means-tested programs. In 2013, Montenegro non-contributory programs represented 1.28 percent of the GDP, when the ECA average was 2.3 percent. Less than half of these resources were delivered through targeted means-tested programs. The last resource social benefit, the FMS/MOT, represents almost 0.54 percent of GDP and it is a passport to a series of programs that in total amount almost 0.4 percent of the GDP. The rest goes to veterans and disability programs. While the FMS/MOT is of low coverage and adequate generosity for the region, the whole package of programs is quite generous leading to important work disincentives. The generosity thus comes at the cost of low coverage for the bottom quintile, which is the lowest among the countries in the region at 20 percent.

The recently introduced Motherhood Lifetime benefit creates the largest work disincentives and fiscal pressures. This categorical benefit goes to mothers with 3 or more children and is as high as the minimum wage at €193 per month if unemployed or even more (€336) if employed or retired[2]. As of November 2016, 21,444 women were receiving the benefit, leading to expenses of 76 million Euros a year. This new program has also introduced a burden on the National Employment Office as a large number of men and women are coming to register with the expectation to qualify for this program or a similar program at certain point in time but not really looking for jobs or training opportunities.

The design and implementation of social assistance programs need to promote activation of beneficiaries. Lack of enforcement of the existing activation features of social assistance programs, lack of coordination of active labor market programs with social assistance delivery, weaknesses in the design of social assistance programs that goes from the targeting method to the combination of programs, and lack of capacity of the public employment services, lead to work disincentives. It is estimated that about half of the FMS/MOP beneficiaries are of working age, and over a third are able to work. While these persons have the obligation of being registered with and contact the employment offices every month, these regulations are not enforced and they do not receive counseling or have ALMPs tailored to their needs. Moreover, the high levels of informality in the country estimated at 30 percent, as well as the qualitative evidence, suggest that there are inclusion errors as many beneficiaries must be informal workers.

[2] In December 2016, the benefit was reduced to EUR144 and EUR264, respectively.

Policy options

Pension system. To regain the balance of the pension system to make it fiscally and socially sustainable Government may consider:

- Introducing wage valorization of points and CPI indexation of pensions.
- Tightening early retirement policy to prolong labor market participation (abolishing decrement-free retirement with 40 years; rising annual decrement above 4.25 percent; higher late retirement bonus; shortening early retirement window to 2 years).
- Narrowing the eligibility to extended service pensions to those working in workplaces that include conditions with long-lasting impact on health.
- Abstaining from ad-hoc interventions in the pension system.

Social Assistance. To promote activation and reduce work disincentives that prevail in the system of social assistance the Government may consider:

- Redesigning the Motherhood Lifetime benefit, or even better substitute it for another program that better achieves its objective.
- Introducing new design features in the FMS/MOP to decrease the marginal cost of working while on social assistance, and enforcing registration of beneficiaries in NES and participation in training and job search activities.
- Increasing coordination of social assistance and labor market programs since, as described in the labor market and skills note, many of the active labor market programs do not respond to the needs of social assistance beneficiaries. The most important policies actions are strengthening the capacity of the public employment services (e.g. introduce profiling methodologies), allowing re-entry guarantees to social assistance for beneficiaries receiving on-the-job training or temporal employment, establishing one-stop-shops that coordinate social assistance and employment services.

To promote efficiency of social assistance programs, improve equity, and recover the path of fiscal sustainability the government may consider:

- Re-balancing the resources across social assistance programs with the objective of increasing the spending in targeted means-tested programs and decreasing spending in categorical programs, in particular the Motherhood Lifetime Support Program. This rebalancing is crucial to increase coverage and decrease generosity, and overall to minimize work disincentives.
- Improving the design of social assistance programs, as they are over-regulated in some aspects and under-regulated in other. As a result, the design leads to high administrative cost and large inclusion and exclusion errors.

World Bank support

Ongoing support. **The World Bank has been continuously supporting the pension reform efforts in Montenegro.** Together with the Ministry of Labor and Social Policy the pension team is updating the forecasting model for Montenegro (PROST Montenegro), which will serve as a tool for evaluating policy options. The model will be handed over to the counterparts with adequate training. A report on early retirement practices in Montenegro including extended service period for hazardous occupations is scheduled for completion in March 2017.

The World Bank has also been providing analytic support to assess the performance of social assistance programs individually and as a system of social protection. The technical assistance has been directed towards the Ministry of Labor and Social Assistance as well as the National Employment Services.[3] At present, the technical assistance is focusing on evaluating the work disincentives of the Motherhood Lifetime Support and a functional review of the National Employment Services.

Planned Support/Options. The WBG can provide further analysis on other **pension issues** of interest as needed. The WBG can continue the technical assistance related to **social protection** to design features of the system as well as the coordination with employment policies towards activation of beneficiaries. The financial support towards the re-design of social assistance and labor programs, the introduction of activation responsibilities for beneficiaries, and the enhancement of social service agencies to reduce cost of service delivery can be provided within the Investment Project Financing.

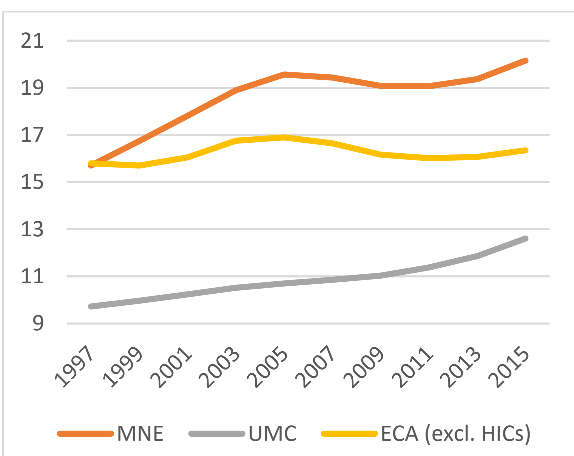
[3] A series of policies notes produced by the World Bank cover the topics of activation, active labor market programs, and labor market assessments.

Health

The Challenge

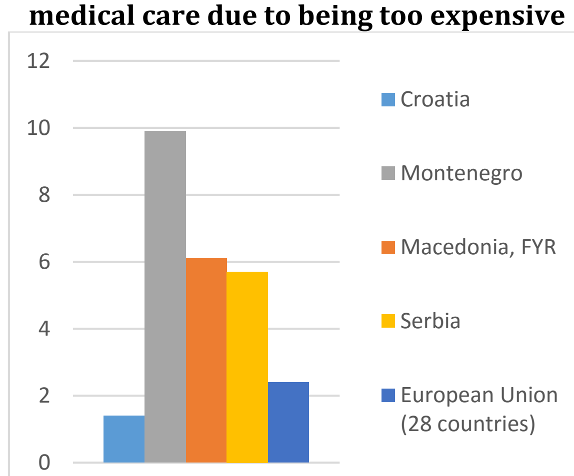
A rapidly aging population is placing increased fiscal pressures on the health system, and citizens cite health as a top priority for public investment. Montenegro is close to regional and upper-middle income country averages in terms of health spending as a percentage of GDP, percentage of private spending in total health spending, and outputs relative to the level of inputs. But further improvements in quality and efficiency will be necessary to cope with a rapidly aging population (Figure 1). In the 2016 Life in Transition Survey, a third of Montenegrin's cited health as the highest priority for additional government spending as the increasing share of private spending in total health expenditure contributes to high unmet needs for medical care (Figure 2). The productivity of primary health care (PHC) centers varies widely, however, despite reforms to improve efficiency in the sector, while hospitals continue to be financed through line-item budgets, based on historical allocations. **As in other countries in the region, the health system remains hospital-centric and not well-integrated**, a pattern of service delivery that is particularly inefficient in an ageing population with a large burden of non-communicable diseases. Inefficiencies in the procurement of pharmaceuticals remain. Public expenditure on pharmaceuticals increased by 60 percent between 2010 and 2016. The health system is yet to harness the power of health information systems to monitor the flow of inputs and outputs/outcomes, manage inventories and contractual obligations and evaluate the performance of providers, thus controlling costs and accumulation of arrears. A computerized health information system has been in place since 2004, which links all primary care providers, general hospitals, pharmaceutical purchasing agency and the reporting of public health information. However, the system is not effectively networked and does not yet produce good summary information.

Figure 7: Age dependency ratio, old



Source: World Development Indicators

Figure 8: Self-reported unmet needs for medical care due to being too expensive



Source: Eurostat

Policy Options

Given the current constrained fiscal environment, the forthcoming public finance review in health identifies preliminary recommendations for the Government's consideration:

In the short to medium term:

- Sustain and expand reforms already underway to achieve cost savings on pharmaceuticals, while building up monitoring of prescription and dispensing practices. Specifically: (i) introduce and implement managed-entry and risk sharing agreements for the high-cost, patented drugs; (ii) approach new manufacturers from outside the region and try to facilitate their market entry to strengthen competition in generic markets; (iii) strengthen monitoring of and introduce control mechanisms on volume of prescribed and dispensed medicines; (iv) revise wholesale and retail margins for medicines, including introduction of flat dispensing fees to incentivize dispensing lower-cost drugs; (v) strengthen criteria and processes for decisions to include high-priced drugs on reimbursement list (e.g., Health Technology Assessment); and (vi) prioritize registration of medicines which will increase competition on market.
- Improve bed utilization through introduction of better control of admissions. Typically, the Social Health Insurance Fund would monitor, oversight and advice about rationalized bed use.

In the medium to long-term:

- Sustain provider payment reforms already initiated. The provider payment reforms already initiated or envisaged are in the right direction: capitation for primary care and case-based payments for secondary and tertiary care. Performance pay for primary care doctors was subsequently undermined by collective bargaining agreements, and should be reintroduced. These reforms need to be implemented and efforts made to move away from restrictive, line item budgeting so as to give facilities greater flexibility in making resource allocation decisions. It is recommended that the Government continue with and strengthen provider payment and purchasing reforms already initiated: (i) capitation and performance at primary level; (ii) DRGs at secondary and tertiary levels; and (iii) rationalization of the benefit package (reimbursed drugs, sick leave policy, treatment abroad).
- Introduce service delivery reforms to address the dual challenges of a rising burden of NCDs and an ageing population. Specifically: (i) build up the quality and coverage of primary and preventive care, through better screening and treatment of chronic diseases and promoting healthy behaviors, for a healthier population and reduced costs over the long term; (ii) rationalize the hospital network to reduce excess use of hospital services and convert any excess bed capacity into long-term care facilities; (iii) create payment incentives to promote coordination of care; (iv) promote greater use of ambulatory care and day-care surgeries; (v) strengthen adherence to clinical guidelines and protocols; (vi) improve monitoring of the quality of care and outcomes at all levels of the health system through a strengthened and integrated information system.

World Bank Group Support

Planned support /Options.

In 2015, the World Bank initiated the preparation of a project that would aim to increase efficiency of health expenditures and improve quality of care for priority NCDs.

The World Bank could resume project preparation and provide an investment loan, possibly with results-based disbursements, to (1) strengthen capacity for improved health system management (including pharmaceutical sector management); (2) improve efficiency in health institutions (design and implement pay-for-performance; increase use of ambulatory surgery and diagnostic capacities); and (3) improve quality of health care, including through enhanced health information systems and strengthened accountability for quality.

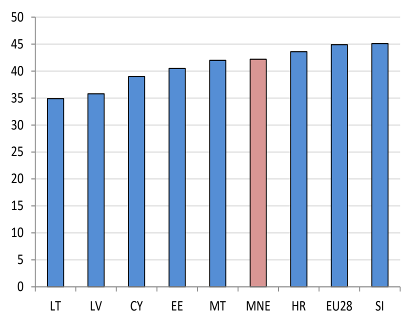
Tax Administration

The Challenge

Compared to EU New Member States, Montenegro collects a high percentage of GDP in taxes and social contributions. Especially high is the collection of VAT despite Montenegro having the lowest VAT rate.[4] Overall, Montenegro collects around 20.4 percent of GDP in indirect taxes, compared to 14.5 percent of GDP of EU NMS. The high revenue collected as a share of GDP, however, may reflect underestimation of GDP due to shadow economy, and is not likely to be sustained in the medium and long-term unless the human, financial and IT resources of the revenue administration are not used more effectively.

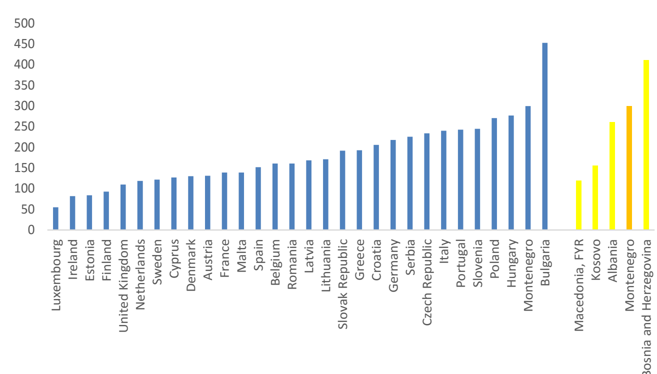
Sustaining high revenue collection would require substantial improvements in compliance. Montenegro does not measure compliance and does not have modern compliance management capacity. The analytical capacity of the MTA needs to be strengthened to identify and monitor noncompliance risks. Cumbersome business processes have meant low and hampering compliance management. The registration process is fragmented and the accuracy of taxpayer information needs to be significantly improved. An outdated and fragmented information technology (IT) system makes difficult automating business processes and collecting, processing, and analyzing information as well as using third party data. Tax audit function is not systematically using risk management in audit selection and modern tools to perform effective audits.

Figure 9. Total Revenues, 2015 (percent of GDP)



Source: Eurostat, and Montenegro MOF

Figure 10. Time to Comply with Tax Legislation, 2016 (hours per year)



Source: 2017 Doing Business, the World Bank Group

Compliance is negatively affected by large and growing stock of arrears. In the end of 2015, arrears accounted for some 20 percent of GDP and represented nearly 50 percent of revenues collected. Yet, close to two-third of these arrears are non-recoverable as they are due by taxpayers that are inactive, have deregistered, or are in a bankruptcy procedure. Most of the arrears are old and

[4] Statuary VAT rate in Montenegro is 19 percent (standard) and 7 percent (reduced). VAT rates in the EU NMS range from 20 to 25 percent.

uncollectable, but there is no legal provision to write them off. Despite measures to increase recovery of arrears, weaknesses in tax registration, enforcement and collection, as well as limitations of the IT system, represent a serious challenge to compliance.

While cost of compliance have come down lately, compared to other countries in the region, compliance costs for taxpayers in Montenegro remain significant. Time to comply with tax legislation (collecting information, completing tax returns, filing, and paying taxes) is one of the highest in the EU. The number of tax payments is also relatively high and electronic filing is rarely used in Montenegro—less than 20 percent of the VAT and corporate income tax (CIT) returns are filed electronically while in most of the EU countries e-filing for these taxes is close to or equal to 100 percent. Electronic payment of taxes is also very low in Montenegro.

Policy Options

Improving the effectiveness of MTA to collect taxes while reducing costs of compliance for taxpayers will hinge on the implementation of a comprehensive reform program:

- Enhancing the strategic focus, planning, analytical and monitoring capacity of MTA to support a modern compliance management.
- Investing in training of staff taking into account the need for new competences and aging of the current workforce.
- Improving the legal framework to ensure consistency with MTA operational needs and international best practice.
- Streamlining the registration process—by merging the existing registries and eliminating overlaps, the quality of taxpayer information will be improved, which is critical for compliance management.
- Expanding the use of electronic filing and e-payment to reduce costs of compliance.
- Increasing the effectiveness of tax audit—by introducing risk management approach and modern tools and approaches for conducting audits and thus strengthen compliance.
- Upgrading IT system and infrastructure to support modernization of core function and ensure sustainable increase in compliance and reduction of compliance costs.
- Strengthening enforcement and collection functions to reduce the stock of arrears and improve compliance.
- Expanding the scope and quality of channels for interaction with taxpayers—internet, call center, e-mails, telephone, etc.
- Introducing service delivery standards and monitor performance.

World Bank Group Support

Planned support/Options. The World Bank can support modernization of Tax Administration with both advice and financing. At the request of the Ministry of Finance, the Revenue Administration Project has been prepared and is ready for negotiations since 2015. The project aims to improve effectiveness of operational functions of the tax administration and to reduce the compliance costs on corporate taxpayers. The project would support tax administration to operate with a higher capacity streamlining risk-based business processes that contribute to the efficient collection of taxes and social contributions that are owed from all sources of economic activity. Increased compliance will generate a more robust revenue stream to provide essential services to citizens. Improvements in capacity will also support the country's goal for EU accession and economic integration with EU member states.

Subnational Government

The Challenge

Montenegro, differently from other countries in the Balkans, is highly centralized and the municipalities have limited functional competences. Major mandated tasks include local road maintenance, water services, garbage collection and treatment, street lighting, greening, culture and sports, while not education, social welfare or health services. Consequently, the share of LGUs spending in GDP was at 4.5 percent in 2014, which is less than 10 percent of the overall consolidated general government spending.

Despite having a one-tier subnational government system, the population concentration in the capital is high. There are 23 municipalities, out of which two have not yet formed their basic institutions (for more than a year), and one-sixth of municipalities have fewer than 5,000 citizens. On the other hand, with 30 percent of population, it has one of the largest concentration of citizens in the capital city.

Increasing dependency ratios and low activity rates in North municipalities will continue to burden local finances. The Northern region will continue to underperform and become more dependent on pensions and social transfers, while the central and southern regions largely stand to benefit from improving demographic trends. Overall, the country also suffers from a large inactivity of population. In municipalities like Rozaje, Andrijevica and Plav, high dependency ratio is followed by the low activity rates of the working-age population thus further eroding the tax base of municipalities and creating pressures on fiscal sustainability of the local government units.

Figure 11. Dependency Ratio, Percent of 15-64

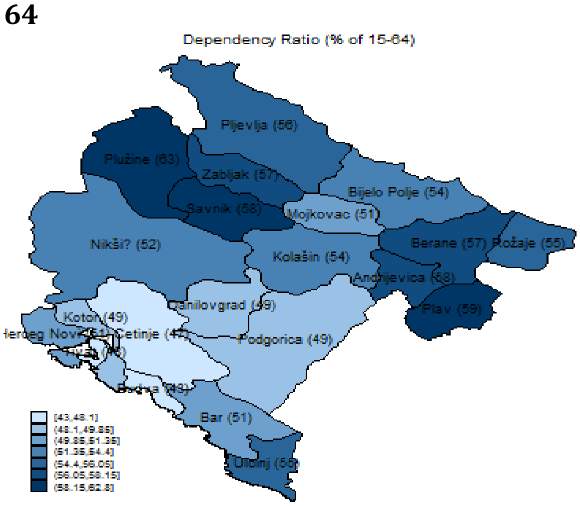
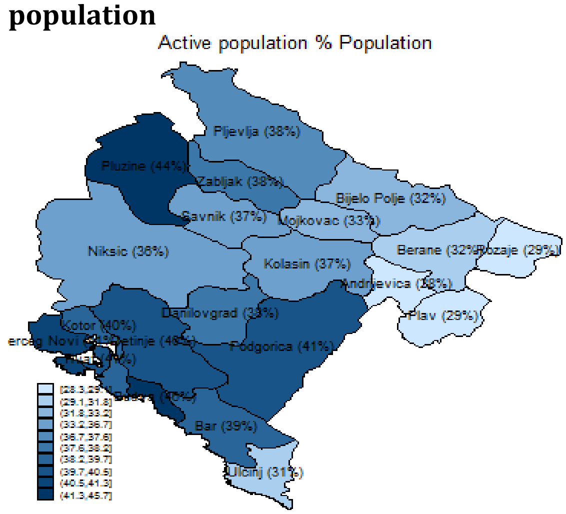


Figure 7. Active Population, Percent of population



Source: MONSTAT, EUROSTAT, World Bank staff calculations.

Fragile financial position and low capacity at the municipal level threaten both macroeconomic stability and equitable service delivery. Some (not all) municipalities exhibit a fragile financial condition and unsustainable expenditures and debt. Overall, municipalities have low overall direct debt (4.8 percent of GDP). However, in parallel they generated additional 3.4 percent of GDP in arrears for taxes and suppliers, while the debt of the local government-owned companies (which is mostly guaranteed by municipalities) has not been registered. In certain municipalities, unrealistic budgetary planning and large mismatches between spending commitments and fiscal capacity have led to financial distress. Overstaffing and excessive payroll expenses in local administrations and municipal public companies have revealed an implicit social safety net—implemented through the provision of public employment—as well as poor spending efficiency. Insufficient capacity to repay large arrears on tax liabilities and salaries and growing debts to banks and suppliers, have raised concerns about public finance sustainability and creditworthiness of some municipalities

There are large observed differences of fiscal capacity across Montenegrin municipalities, while an effective exercise of local autonomy requires a strong financial standing in municipal administration. Large differences in fiscal capacity likely leads to increasing inequality in terms of the public service delivery across regions which has been also demonstrated by the heterogeneity of social sector and infrastructure services outcomes. Legislative changes introduced in recent years intended to improve the potential for raising own-source revenues and to eliminate other traditional, distortionary local revenues; yet, the implementation was uneven. Capacity for medium term budgeting and spatial planning is limited, resulting in unplanned and unregulated construction, especially in coastal areas. Inadequate planning also results in undersupply of public services, especially for vulnerable groups.

Policy Options

Municipalities would need to urgently address their fragility. Several policy actions are proposed:

- Broaden the tax bases of own-source revenues and introduce administrative measures to expand collection of real estate and other local taxes;
- Support the debt reprogramming agreements with staff rationalization, hiring freeze, and limitation on the growth of nominal wages. In addition, consider merging utilities across smaller and distressed municipalities (or arrange for joint service delivery; e.g., water, garbage management, and road maintenance).
- Improve public financial management (PFM) systems to: introduce the medium-term budget planning, strengthen budget execution, record commitments and arrears, enforce Fiscal Responsibility Act, improve internal audit and control as well as the public procurement process at the local level (capacity building).
- Build capacity for project preparation and implementation (EU, IPA, etc).

World Bank Group Support

Ongoing support. **Urban Partnership Program**, with Austrian funding, will continue to support local governments in capacity building and financial management (UPP is already supporting 13 of 23 municipalities).

Improving System of Public Procurement in Montenegro supports Public Procurement Administration to develop a performance and monitoring indicators manual, which includes: 1) quality control standards; 2) advice on procedures for collecting and monitoring public procurement statistics; 3) extensive guidelines on how to fight fraud and corruption in public procurement. The Project also aims to develop a set of guidance notes for Small and Medium Enterprises to encourage their participation in public tenders.

The Bank delivered in 2015 a policy note: **Montenegro: Options to Restore Fiscal Sustainability and Improve Spending Efficiency at Subnational Level** that assessed the financial situation in municipalities and offered a reform roadmap for their operational restructuring and PFM strengthening.

Planned support/Options. **The World Bank can support municipal management and finance sustainability through the results-based operation.** The operation could support financing of key municipal infrastructure, municipal restructuring and capacity strengthening that would lead to arrears reduction and improved service delivery through cooperation and joint service delivery and service-sharing mechanisms. This can be complemented by undertaking Public Expenditure and Financial accountability assessment (PEFA) for selected municipalities.

Private Sector and Jobs

Montenegro Policy Note 2017

The Challenge

With shrinking fiscal buffers, the ability of the economy to absorb shocks and create jobs will rely almost entirely on the competitiveness of the private sector. Economic growth in Montenegro is, however, not creating jobs; the country faces high unemployment, low labor force participation, and high informality. Instead, productivity gains result in higher wages. The private sector is still relatively small, employing only half of the workers and often in less secure short-term jobs. SOEs still employ a large share of workers but new hires are rare. To increase the welfare of its people, Montenegro needs to shift to an inclusive growth model where the private sector generates most jobs and growth. At the moment, employment rate is one of the lowest in Europe, accompanied by high levels of informality and unemployment. Only 52 percent of Montenegrins 15 years of age and older are employed, compared to 65 percent in the EU and the Europe 2020 target of 75 percent. One in three jobs is informal, and seasonal jobs are largely filled by migrants from abroad. Unemployment is high for both men and women at 17.6 percent on average (2015) and of long duration (80 percent of the unemployed have been searching for a job for more than 12 months). New entrants face a particular challenge (40 percent of the unemployed), and three quarters of them take more than 2 years to find a job. Inactivity rate is also high, especially among women. There is mismatch between supply and demand for skilled labor, and people with low levels of education are finding it even more difficult to find employment. There are also persistent differences between the more vibrant coastal zone and the poorer northern regions.

There is a critical need to stimulate job creation in the private sector; however, firms exhibit low levels of competitiveness. Montenegro has one of the lowest ratios of exports of goods to GDP in the world (below 9 percent) and exports are highly concentrated in metal products with low technological content. Services exports are higher, but still lower than peer countries, at 34 percent of GDP in 2015. They are concentrated in three main types: travel, transport and financial services. No small country (under 10 million people) has achieved high-income status with exports less than 50 percent of GDP. Only 7 percent of firms export their goods, compared with 18 percent in the Balkans and 29 percent in Estonia. Further, firms' export survival rates are low: only one out of three export flows that start in a given year will survive past the first year. Exports are increasingly concentrated by geographic destination: goods trade with Serbia, Croatia and Slovenia has doubled since 2006, while trade with the EU27 contracted from two-thirds of the total in 2006/07 to slightly over one quarter. Russia alone accounts for 27 percent of services exports. Montenegro ranks 42nd on Trading Across Borders, second lowest in CEFTA.

Low levels of labor and total factor productivity are constraining, from the supply-side, firm growth and future economic growth. Labor productivity has stagnated since 2008, and the contribution of total factor productivity (TFP) to economic growth has been negligible (over the 2000-

2013 period) or negative (in 2008-2013), meaning that output growth has been primarily driven by factor accumulation. Low TFP growth can be attributed to the presence of private sector constrains that don't allow firms to upgrade their internal capabilities (e.g., managerial skills, innovation capacity, technology adoption efforts) or to the presence of distortions, understood as heterogeneity policy treatment at the firm-level, which doesn't facilitate the reallocation of factors of production (e.g., labor and capital) and, therefore, economic activity towards the most efficient firms. ICT usage among private firms is low, and private firms lag on innovation: R&D investment in the country amounts to only 0.45 percent of GDP, of which three quarters come from the government.

Skills shortages and difficulties to get access to external sources of funding to finance innovation constrain firm growth. There is a skill mismatch that disproportionately affects innovative firms: 28 percent of the firms that are at the top percentile of the distribution of innovative firms reported that the main problem with hiring professionals was the lack of relevant skills, and 45 percent noted difficulties to hire skilled workers. Young workers lack soft employability skills, such as language, leadership and initiative, critical thinking, as well as advanced hard skills like technical knowledge. Further, Montenegrin firms claim that they have difficulties accessing to external sources of funding like credit (despite evidence of high use of trade credit) due to high interest rates and high collateral requirements. Access to equity finance is also limited.

At the same time, employers are able to hire people informally, in particular for seasonal jobs, for example in the tourism industry, and thus prefer to rely on migrant workers from other countries, paying no taxes or social contributions, and sometimes observing no labor standards. This effectively creates a disincentive to employ the available local labor force, as well as having adverse implications for budget and pension funds revenues, in addition to putting these informal workers into a vulnerable position. It is important to address the disincentives on the employee and employer side in parallel to achieve the maximum effect.

Disincentives for formal work are significant—and in the case of recipients of social assistance prohibitively high. Work disincentives are highest for low-income earners or those in part-time work (the latter more likely to be women), and are very high for those receiving social assistance. The main disincentives for formal work apply to single parents or single-earner couples with children who receive social assistance and family benefits: for them, a part-time low-paying job would actually decrease net income, while a full-time job at minimum wage would pay about as much as social assistance and family benefits with no employment. Furthermore, this group of the population is not investing in skills upgrades that puts them into a vicious cycle of dependence on the state. As a result, Montenegro is not using its workforce to full capacity, which is important given the size of the country and the demographic transition, which will further reduce the working age population.

Business environment hurts firm entry and performance. Product market regulation lags behind the OECD and smallest EU states. Issues include state control, barriers to investment, and lack of harmonization with international standards. There is high and widespread public ownership and low information access for foreign parties. On average, 12 percent of management time is spent dealing with regulatory authorities; and firms perceive a relatively high level of corruption in the granting of licenses and permits, and expect to make unofficial payments when dealing with customs, taxes and regulations.

Despite improvements, governance and rule of law in Montenegro lag behind EU member states and continue presenting challenges to private sector growth. One of the main factors behind private sector development in successful small states is institutional quality and good governance. Firm level data from the 2013 Enterprise Surveys (BEEPS) suggest that, although Montenegro's regulatory environment significantly improved, more progress is needed on implementation of reforms and transparency of procedures. The gap remains largest when it comes to government effectiveness, regulatory quality, control of corruption, and justice sector performance. Despite reforms to align legal frameworks with the EU Acquis, the gap between laws on the books and laws in practice remains wide. Enforcement of contracts is weak and processing of cases is slow and inefficient, which undermines business confidence.

Policy Options

Private Sector Development. **Improve the business environment and level the playing field** by improving the conditions for competition, product market regulation, contract enforcement and intellectual property rights. Lower regulatory burden by streamlining permits, inspections, and market regulations. Support contract enforcement and intellectual property rights. Increase communications and reduce discretion, including through enhanced accountability for regulators and e-government solutions. Facilitate exit of unproductive firms through entrepreneur-friendly bankruptcy laws.

Boost firm-level productivity and sector growth by facilitating transfer of knowledge (technical, managerial, and market) to firms, through technology extension services and export development assistance. Through accelerators, endow innovative start-ups and small and medium-sized enterprises with funding and increased capacity to build their business (investors, mentors, partners, etc.). In tourism, assess demand and destination competitiveness, then design interventions to fill gaps.

Improve trade facilitation to expand connectivity. Streamline risk management and post-clearance audit procedures, and develop an authorized operator program, both of which will simplify and speed up the import process. Develop measures for improved performance based on a time release study (forthcoming from the WBG team) that will measure border and inland terminal procedures and processing/clearance time.

Facilitate private sector investment and job creation in the areas of agriculture and sustainable tourism. This can be achieved through interventions that address the sector-specific regulatory framework, firm capabilities and productivity, and market linkages in these sectors. This would substantially benefit rural communities and vulnerable groups, including women and youth.

Skills, Labor Market Flexibility and Disincentives. **Improve education and training systems and strengthen active labor market policies.** Actions could include (i) reforms of VET/Gymnasium education system, by clarifying expected skill outcomes from each type of education and promoting collaborations with private sector employers; (ii) better labor market information system to simplify firm-worker matching and help youth choose the right education track (level of education and field of study); (iii) reform the Employment Agency of Montenegro to be more efficient and efficacious; and (iv) roll-out and evaluate innovative capacity building and employability programs that increase access to global employment opportunities and income generation, in particular among women and youth. More fundamentally, investment in a stronger general education system, from early childhood development though adult education, would be an excellent investment in Montenegro's long-term competitiveness.

Incentives to work can be promoted through a series of reforms. Reduction of effective marginal tax rate, in particular for low-wage earners, part-time, and seasonal workers (women, youth and poor) would make it easier to employ these groups (rather than foreign/informal workers). At the same time, an effective enforcement of labor standards and other relevant norms would level the playing field between the local and foreign laborers. Rationalizing/targeting of benefits would reduce the reservation wage and prompt more people to seek employment. For women, who are even less likely to participate in the labor market, family-work balance support policies could help. Evidence from European countries suggests that combining subsidized/free quality childcare, flex-work (telework and part-time work), and adequate parental leave have a higher impact on female labor force participation that the sum of the effects of each of these policies.

World Bank Group Support

Private sector development

Ongoing support. ***Montenegro Institutional Development and Agriculture Strengthening Project (MIDAS)***: MIDAS, Investment Loan Project (US$ 19.04) assisted in establishing the capacity of Montenegro to implement an Instrument for Pre-Accession Assistance in Rural Development (IPARD)-compatible system, a paying agency, a farm registry, and a pilot IPARD-like grant scheme supporting investments in agriculture holdings and promoting agri-environmental measures through five rounds of grants. In September 2016, the World Bank approved an additional financing loan in the amount of €3.0 million to further strengthen rural areas and increase the country's preparedness for EU accession requirements.

Planned support/Options. ***Montenegro Institutional Development and Agriculture Strengthening Project (MIDAS 2)*** in FY 20, supporting the country in closing Chapter 11 and 12, with a stronger emphasis on Food Safety requirements, including inspection capacities as well as border controls, handling animal by-products, developing a more effective vision and strategy for its extension services, and looking at the fishery sector.

Sustainable Tourism Project *(preparation initiated)* to increase competitiveness of destinations along a tourism circuit that would result in increased overnight stays in Montenegro and diversification within the sector (e.g. bringing tourists from the coastal zone inland). Support the tourism value chain leads to job generation, growth of local suppliers and MSMEs linked to the tourism industry, including those in agriculture.

Micro, Small and Medium Enterprises Development Project (MSME) *(proposed new TA and new lending operation)***:** TA to do a deeper diagnostics of the binding constraints to productivity and firm growth. Based on this diagnostic, a new lending operation could be developed focusing on improvements in MSME policies and the entrepreneurial ecosystem. Such an operation would contribute to firm upgrading and export diversification through activities such as adoption of standards, innovation assistance, investment readiness, technology extension and absorption, increased knowledge, and others as identified in the diagnostic.

Business Environment technical assistance *(proposed new TA)*: technical assistance to improve the effectiveness of regulatory reforms (through monitoring and evaluation of implementation of government's regulatory reforms, strengthening accountability and incentives for regulators, and strengthening awareness of reforms); expand opportunities for the private sector through public-private partnerships (PPPs); further cut the regulatory burden on firms (in areas such as permits, inspections, contract enforcement, intellectual property rights, product market regulation, etc.); and improve the effectiveness of investment incentives. Within these areas, priorities for such TA would be agreed on with government. Technical assistance on trade facilitation is currently ongoing through a regional project.

Education and Skills

Ongoing support. ***Higher Education Research for Innovation and Competitiveness (HERIC),*** investment loan project (US$15.98) continues to support reforms to improve higher education monitoring and service delivery, including in terms of financing and quality assurance, and to increase cooperation with the private sector through the establishment of a Center of Excellence that resulted in several international R&D partnerships and business start-ups.

Justice Technical Assistance aims to conduct preparatory work for a possible Functional Review of the criminal justice system of Montenegro sector-wide survey of the experiences and perceptions of the justice system's end users (citizens and businesses), institutional stakeholders (lawyers and prosecutors) and providers (judges, expert associates and staff). The results from the survey supported implementation of the National Judicial Reform Strategy Action Plan and the Chapter 23 Accession Action Plan.

Planned support/Options. ***Jobs and Competitiveness Projec****t*: address disincentives in the social protection system and expand access to employment services by linking employment services with last-resort social assistance so that the poor would access these services, and addressing information barriers to accessing productive employment faced by vulnerable groups. In parallel, the project would support measures to reduce disincentives to employ people in the formal sector by encouraging registration, enforcing labor standards, and levelling the playing field between local and migrant workers. These activities may be combined with those listed under MSME development above, in one project that would also address firm-level competitiveness along with job creation.

Higher Education Research for Innovation and Competitiveness (HERIC) investment lending project could be expanded as HERIC2 to focus on vocational/post-secondary education reform linking education results more closely to private sector needs.

Employment and Pension Technical Assistance: propose measures to reduce workers' disincentives for work in the design of social assistance and pensions, especially early retirement.

The Challenge

The education sector is not equipping graduates for evolving labor market demand. While job creation has historically focused on low-skilled sectors such as construction, mining, retail trade, and tourism; in the last five years most new jobs have been in high-skilled sectors such as finance and other sophisticated services. Employment grew more than 40 percent among tertiary educated workers, illustrating the premium placed on higher skill development, but much of the benefits of this expanded employment went to tertiary graduates who had attended gymnasium secondary schools. It is critical that Montenegro equip its workforce with adequate and job-relevant skills for the new economy, including socio-emotional skills for which employers report shortages (e.g. leadership and initiative, entrepreneurship, creative and critical thinking)[5], and digital skills. This skills development should be accompanied by efforts to strengthen foundational skills given that, despite progress, more than half

[5] ibid.

of Montenegro's students are not attaining basic proficiency in reading, science and mathematics. Importantly, inequalities remain in educational outcomes of students by socio-economic status.[6]

Although test scores in the OECD's Programme for International Student Assessment (PISA) improved between 2006 and 1015, Montenegrin students continue to underperform in science, mathematics, and reading relative to students in countries around the world. The difference in the average performance of 15-year-olds Montenegrin students compared against the OECD average is equivalent to more than 2.5 years of schooling in science, roughly 2.5 years in mathematics, and over 2 years in reading. About half of Montenegro's students lacked basic proficiency in mathematics and science, while forty percent lacked basic reading competences according to the PISA 2015 results. Equity challenges persist as students from the top income quintile learn the equivalent of two years more schooling than students from the bottom quintile.

Figure 8. Student Performance, 2006 and 2015

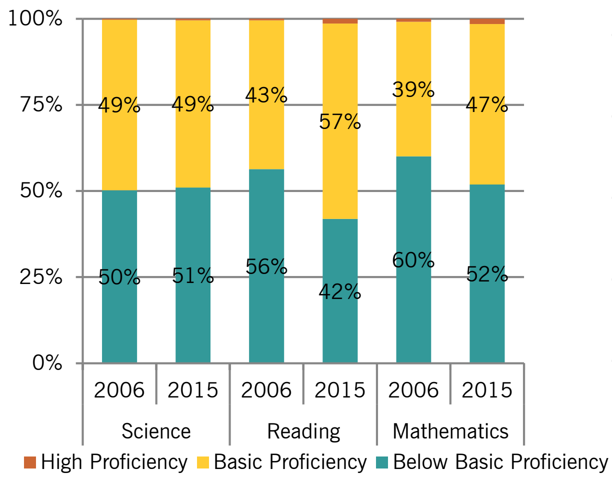
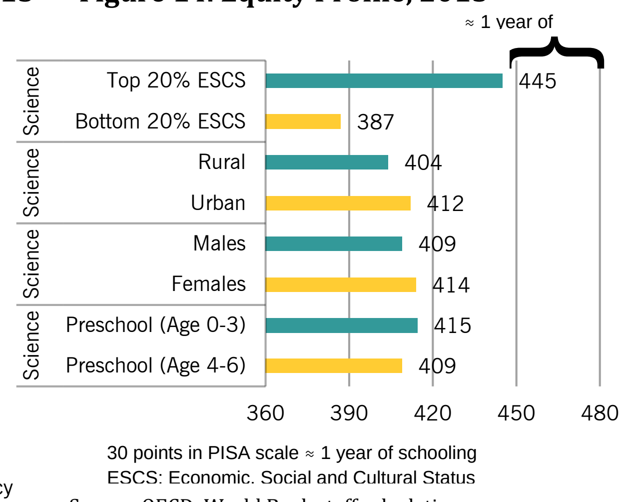


Figure 14. Equity Profile, 2015



Source: OECD; World Bank staff calculations

Relevance and improved outcomes from education remain challenges, particularly in ensuring that tertiary and vocational education students transition effectively from school to work. The sector also needs to adapt to support the long-term unemployed by providing opportunities for retraining and re-entry into the labor market.

Given the data on both high levels of youth unemployment (about 40 percent)[7] and the high enrollment of secondary technical vocational education and training (TVET) graduates into tertiary education (about 50-60% of enrolled first-year university students)[8],, there is an imperative for understanding the ecosystem that has promoted this apparent skills mismatch. TVET schools currently enroll, by law, two-thirds of the total (enrolled) secondary student population. The remaining one-third of the student cohort attend the more academically rigorous secondary schools (Gymnasium). Based on historic norms, the articulation between secondary to tertiary was meant to promote transition to university only from the Gymnasium schools. Unfortunately, high overall unemployment levels—38 percent for non-graduates and 19 percent for secondary TVET graduates—and low skills development among TVET graduates have led to two particular challenges acknowledged by the Montenegrin Ministry of Education: (i) high levels of enrollment of under-prepared TVET students in tertiary education—creating quality assurance challenges and financing burdens for the universities for provision of tertiary education to this expanded student body—and (ii)

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[6] World Bank based on 2015 PISA results.

[7] About 40 percent of individuals between 15 and 24 years old are unemployed compared to 20 percent between 25 and 49 years old and 12 percent in the older cohort of 50 to 64 years old. (World Bank, Systematic Country Diagnostic, 2016)

[8] According to data provided by the Ministry of Education, 2016.

relatively high levels of under-employment-un-employment (currently under 10 %) among tertiary graduates, compared to tertiary graduates in the EU and the Western Balkans.

Policy Options

To address skill constraints, the Government could focus on improving the quality of education and training systems and strengthening active labor market policies. Actions could include:

- Reforms of secondary TVET/Gymnasium education system, by clarifying expected skill outcomes from each type of education, supporting efficiencies in both the distribution of students across TVET/Gymnasium institutions and programs and in spending across the entire sector, and promoting collaborations with private sector employers;
- Reviewing the spending norms in the tertiary sector, based on higher education financing reforms that are being proposed and which should result in major shifts towards a more outcome-driven approach (e.g. employability of the graduates); and
- Focus on evaluating education outcomes by mainstreaming graduate tracking and establishing a labor market information system to understand program outcomes, simplify firm-worker matching and help youth choose the right education track (level of education and field of study).

World Bank Group Support

Ongoing support. The WBG has provided support for comprehensive education reforms for more than fifteen years, spanning from kindergarten and primary school all the way through tertiary education and post-graduate research and development**.** Currently, the World Bank is engaged in an ongoing Investment Loan Project (US$ 15.98) - **Higher Education and Research for Innovation and Competitiveness (HERIC**), effective as of May 2012, focused on the improving outcomes from the tertiary sector by supporting reforms both in higher education financing and quality assurance and in the promotion of innovation and competitiveness through expanded research capacity and partnerships. The HERIC project will continue through December 2018, supporting reforms to improve higher education monitoring and service delivery, and to increase cooperation with the private sector through the establishment of a Center of Excellence and expanded national research grants, which have resulted in several international R&D partnerships and business start-ups.

Planned support /Options. Indicative lending program options under the CPF include a project on **Training and Education for Improved Skills, and project on Jobs and Competitiveness.** Future WBG support (potential HERIC2) could focus on building upon the foundations laid by the HERIC project to support development of vital soft and applied skills and to promote effective school-to-work transition for graduates of the education system (in particular, of higher education and TVET students). This could be done by ensuring labor market relevance of education through curriculum revisions, national strategic planning and policy support for TVET, strengthening the linkages between occupational standards and educational standards, and further fostering academic/industry collaboration. In parallel, the development of these proposed activities plus the successful completion of HERIC would allow TVET and higher education to further improve their relationship with the labor market, promote greater efficiency and relevance in education spending and program delivery across all levels of education, and improve the transition from both TVET and tertiary education to employment.

Connectivity - Transport and ICT

Connectivity—both virtual and physical—is essential for Montenegro's economic and social development and integration into the European Union and beyond. Efficient transport systems move goods and services, connect people to economic opportunities, increase the attractiveness of the country as a tourist destination and enable access to healthcare and education services. Likewise, information and communication technologies (ICT) connect people to knowledge, ideas, and services that drive economic growth, engage citizens, and create jobs. Coordinated policy making in transport and ICT creates synergies that further reduce the cost of connectivity.

The Challenge

About 50 percent of the National and Regional road network is in poor condition. Montenegro has chosen to invest in large-scale new road construction with low economic rates of return while under-investing in routine and periodic maintenance and rehabilitation that would safeguard investments with high economic rates of return. This situation is unsustainable and will undermine the condition of the existing road network and its ability to support economic growth. Improving road conditions requires addressing the backlog of rehabilitation while ensuring that the rest of the network receives the necessary maintenance. The average annual rate of total expenditures on National and Regional roads, based on a large group of OECD and Mediterranean countries, is about 1.7 percent of GDP; and that for asset preservation is about 0.8 percent. While Montenegro has spent an average of 0.7 percent of its GDP on asset preservation between 2006 and 2013, the annual cost of asset preservation (including the annual cost of addressing backlog rehabilitation over a 15-year period) is about 40 million Euros (1.2 percent of GDP), leaving little room for new investment in the next few years (about 17 million Euros per year). The Bar-Boljare highway project, whose construction started last year has a low rate of economic return and puts an additional burden on public finances.

Montenegro has been improving regulations on regional connectivity, but barriers persist. There are still some physical and non-physical barriers to Montenegro's transport connectivity and regional integration that need to be addressed. Physical obstacles include road and rail sections requiring rehabilitation, a few road sections that may require upgrading, and the expansion of terminal capacity in Podgorica and Tivat airports. Non-physical barriers include delays at border crossings, limited use of intermodal transport and limited administrative capacity in transport and safety agencies. Given the limited resources available to the road sector at present, addressing the remaining needs will require careful prioritization, the use of private resources when possible, but will be a challenge nonetheless.

Road safety practices need to be improved to reduce fatalities and serious injuries and to converge to EU averages. Despite recent strong progress, the fatality rate per million inhabitants in Montenegro is 90 (2015), compared to the EU28 average of 55.

Only 3.6 percent of Montenegrins (1 percent in rural areas) have access to high-speed broadband connections; broadband rollout in rural areas is constrained. Low population density network deployment costs are too high in rural areas, which results in the existing demand being insufficient to justify private investment despite high social returns. Subsequently broadband penetration in urban areas is up to 4 times higher compared to rural areas. Low investment in broadband infrastructure results in the slowest broadband connections in the region. Another concern is affordability of high-speed connections: basic broadband (below 10 Mbps) costs above the affordability threshold of 5 percent of disposable income (established by the UN's International Telecommunication Union), while 10 Mbps connection costs around 10 percent of monthly household expenses.

Policy Options

Selectivity and prioritization and leveraging private financing are critical given the limited fiscal space. Addressing the non-physical "soft" barriers mentioned above is not costly and is to a large extent also required to conform to EU *acquis.* And they have benefit/cost ratios ranging from 2-7. It is also consistent with Montenegro support to the Joint Action Plan on trade and transport facilitation endorsed at the Western Balkan Paris Summit in July 2016. Large physical investments should be based on detailed feasibility studies (FS) and sound socio-economic principles. While the FS for the Bar-Boljare highway project indicated unsatisfactory rates of economic returns, the project is under implementation. This will deprive the economy from the resources that could be used for investments yielding high economic rates of return in transport and other sectors. In addition, costs could be reduced through better procurement practices, while sector revenues could also be increased, e.g. from registration fees and time-based charges using vignettes or distance-based charges using tolling. Utilizing private resources in financing airport expansions and other transport investments needs to be considered.

Improving the condition of the National and Regional networks requires strengthening the planning and management of the asset preservation process, and possibly adopting new practices for performing maintenance. Introducing a medium term expenditure framework where asset preservation and new construction are considered at the same time would result in clear multi-year binding budgets. Ensuring sufficient resources for maintenance and rehabilitation through the Government's budget and user fees is necessary to improve and sustain the condition of the networks.

Introducing Road Asset Management System (RAMS) and Output and Performance-based Road Contracts (OPRC) would allow the Transport Directorate to preserve assets and reduce life cycle costs, provide better and/or more consistent services levels to users, and reduce the administrative burden on public road companies and enterprises.

Making roads safer. In order to sustain the improvements in road safety, the Ministry of Interior and Affairs and the Ministry of Transport and Maritime Affairs need to review the design of ongoing road safety programs/initiatives to assess the reasons for the reduction in road accidents and fatalities. This requires establishing a system for diagnosing the cause of each accident, which would in turn enable the design of targeted measures in each of the four main areas of road safety: engineering design, enforcement, education and emergency response systems as the need may be. Improving road safety performance is also one of the main areas identified for improvements under the Berlin process.

Government could improve broadband accessibility by offering financial and policy incentives to providers. A PPP arrangement could attract private investment into broadband connectivity. A regulatory review will be equally needed to lighten the bureaucratic and financial burdens related to the construction process of broadband infrastructure, making it more coherent and efficient. For instance, by introducing a new procedure for joint infrastructure deployment across different sectors (a "dig once" policy), by streamlining infrastructure deployment process, introducing requirements for housing deployments among others.

World Bank Group Support

Ongoing support. The Bank Group has completed in September 2015 an update of the Regional Balkans Infrastructure (Transport) Study (REBiS) that identified physical and non-physical barriers to regional integration and connectivity. This update was an input in developing the targets for non-physical barriers in the Vienna Summit. The Bank Group is supporting the South East Europe Transport Observatory (SEETO) in the implementation of these measures in the Western Balkans 6. The Bank Group is currently preparing a regional project in trade and transport facilitation building on this support. The project will initially involve Albania and Serbia and then possible extend to other countries. The project could address road and rail network efficiency and asset management planning, border crossing, network resilience and capacity building.

Planned support/Options. IFC could provide a PPP advisory support for terminals in Podgorica and Tivat airports (structure and execute a PPP transaction advisory mandate) as well as provide financing to the winning bidder. IFC is also considering a potential investment to Global Ports, a Turkish sponsor that has the concession of the cargo terminal of Port of Bar, aimed at upgrading of the port facilities, as well as engaging in Bijela shipyard project to transform the existing shipyard into a yacht service center.

The Bank Group could provide advisory and financial support to rural broadband deployment, including a PPP; policy incentives for broadband investment; design and implementation of training programs for Digital Economy jobs, in particular among unemployed women and youth.

The Bank Group could also offer technical assistance and support in developing road management systems for rehabilitation and maintenance and could provide financial support for the rehabilitation of national and regional roads supporting tourism and agricultural development and employment generation services following up on the Road Policy Note that the Bank prepared in June 2015.

Agriculture and Rural Development

The Challenge

Over the past 8 years, agricultural exports increased by around 4 percent annually; while imports increased by around 16 percent annually in that same period. The agricultural trade deficit meanwhile increased threefold to over US$500 million. The growth of the unfavourable trade balance is due to the highly variable foodstuff demand seasonally related to tourism. However, this is a potential market that Montenegrin farms and processors need to take advantage of even if the peak demand might never be fully met.

In spite of its weakness in meeting local demand, agriculture is a major contributor to employment generation and it also generates around 10 percent of GDP. The 2010 Agriculture Census data shows that nearly a fifth of the working age population works in agriculture, which provides 18-22 percent of employment.

Most households practice farming as secondary largely informal supplementary income. This situation along with the strong seasonal draw by the tourism related service industry, as well as the substantially older population in rural areas, limits willingness of many farming households to invest and increase production. While many farms are not likely to significantly grow and adjust to the EU's competitive environment, there is significant untapped potential for local artisanal products (various cheeses and smoked dried meats) and supplying of fresh produce to the summer tourism industry in summer when production potential is highest.

The small farm size with a highly diversified and low yielding production that prevents economies of scale, requires effective agglomeration and logistics in order to effectively compete in the modern European food markets. In order to access potential markets but also to modernize the sector, Montenegro has steadfastly moved towards EU convergence gradually putting in place the systems and institutions necessary to access IPA funds but also professionalizing and improving productivity of agriculture. Convergence towards EU standards allows local producers and processors to increasingly supply the local hospitality sector in the summer, while providing increased opportunities for accessing European markets during the rest of the year with higher value niche products.

Since its independence, Montenegro's agriculture has seen an increase in productivity with value added per worker increasing by almost 60 percent. Much of the gains in productivity could be probably driven not so much by investments and modernization of farms operations but the departure of working age population to find work in the more prosperous coastal areas. The IPARD like grant mechanisms developed with Bank funded Montenegro Institutional Development and Agriculture Strengthening (MIDAS) project assistance first, and continued with the support provided by the EU through the World Bank (namely the IPARD-like 1 and 2 projects) later, has rekindled interest in farming by a number of younger rural households who see farming as their economic mainstay. The rather impressive increase in value added per worker has led to an overall recovery of the contribution to GDP albeit also because of recent lower overall economic growth. In line with that statistics, the share in goods exports from agriculture rose from 21 percent (average data of 2009-

2013) to 25 percent (average data 2011-2015), while imports remained steady at about 27 percent. This change in dynamic puts the sector at a more competitive footing, which in combination with progression towards EU compliant food safety standards and modernization of primary production and local processing could provide opportunities for higher growth.

Figure 15. Agriculture Productivity

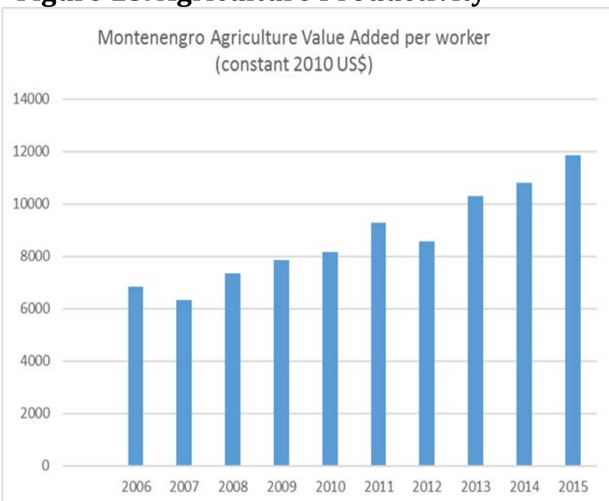
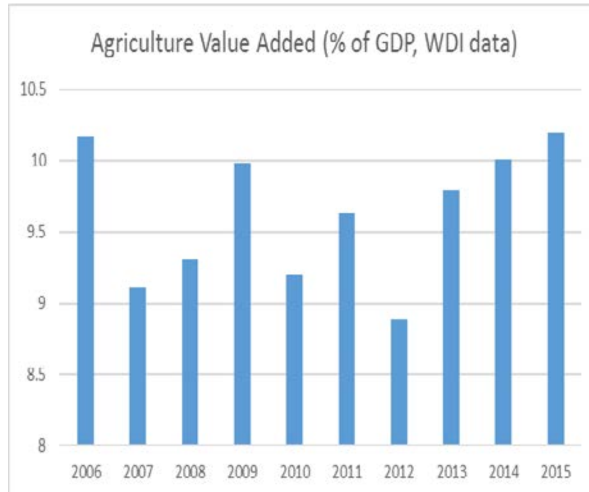


Figure 16. Agriculture Value Added



Source: MONSTAT, World Bank staff calculations.

Policy Options

Maintain the policy focus on EU accession with continued support required for meeting Montenegro's closing benchmarks of Chapter 11 (Agriculture and Rural Development) and Chapter 12 (Food safety, veterinary and phytosanitary policy) of the EU's Acquis Communautaire as it relates to payment systems and food safety. To this end, for meeting its Chapter 11 closing benchmark, Montenegro has to present an implementation plan: (i) for the establishment of an Integrated Administration and Control System (IACS) to be fully operational by the date of accession, including the establishment of the Land Parcel Identification System (LPIS); and (ii) for the setting up of a Paying Agency to be fully operational by the date of accession. With regard to Chapter 12 Montenegro has to (i) submit approved national program for the upgrading of establishments for products of animal origin, including establishments for animal by-products; (ii) provide guarantees for the establishment of an EU-compliant system for official controls of live animals and animal products, including its funding; and (iii) continue to set up and develop, in accordance with the acquis, the relevant administrative structures, in particular as regards food safety controls, and to further increase its administrative capacities and infrastructures. Further Montenegro should demonstrate that it will have sufficient administrative capacity to correctly implement and apply all the acquis covered by this chapter upon accession.

Build stronger links between agriculture and potential of off-farm employment and tourism. Developing IPARD like measures that help attracting tourism into the hinterland, offering day trips with hiking, climbing and adventure tourism combined with consuming locally produced specialties and possibly spending a night on the farm.

Build stronger links with environmental management and preserving water quality with the introduction of agro-environmental measures as part of the IPARD programing.

World Bank Group Support

Ongoing support. **Montenegro Institutional Development and Agriculture Strengthening Project (MIDAS),** Investment Loan Project (US$ 19.04) aims to: (i) to improve delivery of government assistance for sustainable agriculture and rural development in a manner consistent with the EU's pre-accession requirements; (ii) to increase the experience of Montenegrin authorities in administering rural development grants in accordance with EU-IPARD core rules, and (iii) to support a selected number of agricultural holdings and food establishments in upgrading towards EU standards.

Around 660 farmers, 60 percent of whom live in the poorer north, received IPARD-like grants to enhance their agricultural production. The project also supported the strengthening of the country's Food Safety System, including developing the regulatory framework, building a Border Inspection Post, and upgrading national reference labs. Since the beginning of the project, in five rounds of grants, 1,465 applications have been received, 747 approved, and all funds available for grants amounting to around EUR7 million have been contracted, overachieving the target of €5m. As of March 2016, about EUR6.5 million of grant funds have been transferred to beneficiaries, in reimbursement for investments that had been completed.

Building on the successes of the original MIDAS project, in September 2016, the World Bank approved an additional financing loan in the amount of €3.0 million to further strengthen rural areas and increase the country's preparedness for EU accession requirements. This additional financing will allow for an expansion of the institutional capacity building achieved to date in order to manage public funds dedicated to agricultural support.

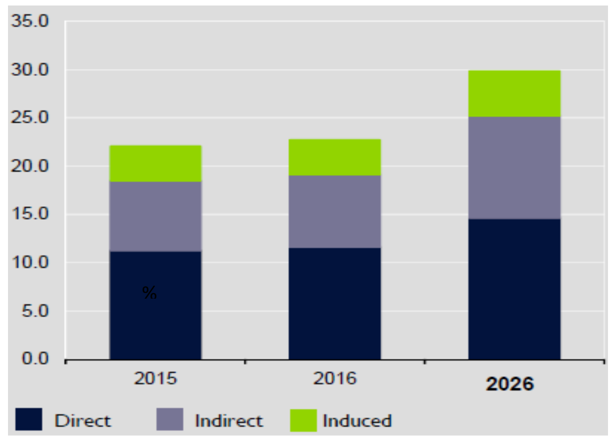
Planned support/Options. The indicative lending program building on successful experiences in the agriculture sector include Montenegro institutional development and agriculture strengthening Project (MIDAS 2) in FY20. The WBG will continue discussion for the preparation of an effective MIDAS2 project supporting the country in meeting the demanding requirement already identified and listed above to reach both Chapter 11 and 12 closing benchmarks, with a stronger emphasis on Food Safety requirements, including inspection capacities as well as border controls (in so far as necessary), handling animal by-products, developing a more effective vision and strategy for its extension services, and looking at the fishery sector.

Sustainable Tourism

The Challenge

Although tourism is one of the fastest growing sectors in Montenegro, contributing about 25% to the country's GDP, it has not yet reached its full potential. The constraints to growth include: (i) a short tourist season (primarily July and August); (ii) limited accessibility of tourism offerings outside coastal areas – 97% of tourists spend their holidays at the coast; and (iii) limited investments in the marketing and infrastructure needed to attract tourists to the country's diverse offerings.

Figure 17: Contribution of Tourism to GDP in Montenegro, percent



Some of this growth and development has come as the expense of the protection of the natural environment – a critical component of Montenegro's offering. For instance, only 18 percent of all collected waste water is treated according to standards. In the coastal area, waste water is mostly discharged directly into the sea, which might adversely impact the water quality in beaches / bathing waters. Some of the environmental hotspots are also in proximity of highly touristic areas (the shipyard in Bijela is a mere 20km from the Budva – Kotor tourists centre and the KAP Aluminium plant in proximity of the lake Skadar). The government acknowledges that development should not be unfettered, but rather should be planned and balanced to bring sustainable, long term benefits.

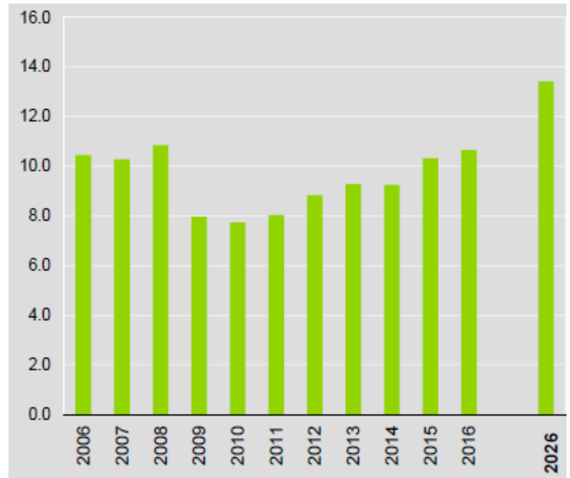
Government capacity to leverage private sector capital to support the implementation of the Sustainable Tourism Development Strategy of the country could be improved. The impact of aggressive development along the coastal zone may deter tourists and threaten the environmental sustainability of the area. Resort developments along the Budva coastline are an example of unsustainable development, which was approved by the Montenegrin Government in the past. Instead, proactive and targeted public investments should be used to attract and leverage private capital that supports sustainable tourism and job creation.

Tourism in Montenegro contributes to job creation, but the potential for job-creation is not fully tapped and should be further unlocked. An ever-increasing portion of local jobs are to be found in the tourism sector - it employs over 10% of the formal workforce (20 000 jobs).

To maximize the job-creation potential of public and private investments, efforts to promote private sector growth – for instance, in sectors such as tourism or agribusiness – should be linked to infrastructure development. Job creation will not be maximized if investment decisions are made in an uncoordinated way by different line ministries, municipalities and other organs of the state.

Sustainable tourism requires the underpinning of an integrated approach to territorial development – ensuring that infrastructural investments, like municipal service provision and urban regeneration, are linked to other strategic priority areas like promotion of private sector growth, job creation, revenue regeneration, environmental stewardship, and private sector participation.

Figure 18: Contribution of Tourism to Employment in Montenegro



Increased employment and increased access to economic opportunities will be vital to reducing poverty in Montenegro. This will require skills development and re-skilling of the workforce – particularly youth and other vulnerable groups. A growing tourism industry will place increasing demands on the labor force to provide a new range and higher quality of skills (e.g. translation/language, guides, online media, etc.). Linking these skills development programs to the hinterland will allow rural communities and vulnerable groups (such as women and youth) increased participation in the job market and thereby promote more inclusive and pro-poor growth.

Branding and marketing of Montenegro's tourism offer are well advanced, but require better coordination. To extend tourist stays, promote a diversity of offerings and maximize job creation, a more coordinated institutional response to tourism is required from the tourism sector. This would require that effective promotion structures are established across spheres of governments, and across regions – for instance, establishing a stronger country brand and marketing functions within destination management. The private sector's marketing capacity may also be enhanced.

Policy Options

Link Sustainable Tourism Development to Territorial & Local Development to ensure coordination, efficiency in the use of resources, equity in benefits and support by local communities. Reduce ad-hoc activities and investments by building on the ongoing efforts by the Ministry of Sustainable Development and Tourism to introduce a new law on planning, to update the Montenegro Tourism Promotion Strategy and subsequently, by December 2017, also update the National Territorial Development Plan. Ensure that municipal services and infrastructure investments (for example in urban regeneration and/or heritage preservation) are be planned in a way that will promote the growth of tourism *and* improve local service delivery, leveraging the benefits of such public investments to achieve a multitude of strategic goals. Coordination and consensus building with other line ministries and Local Government is required to ensure support in implementing the strategic vision and build consensus with line ministries, local governments and the public.

Strengthen the capacity local governments to plan for, deliver and maintain the local infrastructure and services necessary to support tourism development, while also meeting the needs of local populations. Mobilize the tourism economy to support the generation of reliable streams of local revenues to be reinvested in the sector.

Foster and promote coordination between agencies to build synergies to maximize results. To successfully link sustainable tourism to local development, the strengthening of and coordination among sector stakeholders (government, private sector, and local tourism agencies) is vital. Effective tourism management and marketing structures (e.g. destination management, among others) are needed to be able to link tourism and local development. This will support the development of destinations as a whole, rather than the promotion of isolated tourist attractions.

Increase private sector investment and job creation in the areas of sustainable tourism and contributing sectors (e.g. Agriculture, Environment, Cultural Heritage). Private investments should be guided by a sound sustainable tourism vision and policy and supported by targeted public investments which aim to provide opportunities for rural communities and vulnerable groups, including women and youth, and preserve environmental assets that play a key role in diversifying Montenegro's tourism offering and earnings.

Provide skills training to support job-creation in Tourism sectors. (Re)Training the labor force is required to ensure that labor skill sets remain relevant and responsive to an evolving tourism sector. More relevant skills will enhance productivity and efficiency gains for the sector as a whole, but also make workers more resilient to changes in market demand. Training efforts should be developed with private sector participation.

World Bank Group Support

Planned support/Options. **Tourism Based Local Development** represents a brand new engagement in Montenegro that emerged as part of the CPF dialogue. It aims to integrate Tourism and Local Development building on the experience and international best practices of other similar projects from across the regions (e.g. Georgia, Albania, Macedonia, Russia). Project could provide a combination of lending and advisory support. The program is proposed to be cross-sectoral in nature, and works across government line departments to ensure that the investment benefits are leveraged to achieve multiple strategic goals, and also to enhance support to the vision and implementation support by other line ministries (for example the Ministries of Agriculture, Culture and Economy). Additionally, the proposed project addresses a number of strategic priority areas for the Government of Montenegro:

- Supports the creation of new jobs.
- Targets lagging regions and links them to the economic engine of tourism through major public investments targeted to improving the market competitiveness of destinations/circuits (road upgrades, restoration of cultural heritage sites, façade redevelopment, public space upgrades, etc.).
- Capacity building for multiple stakeholders to ensure the long-term sustainability of investments (municipalities, tour operators, hospitality establishments, other public and private entities).

The proposed Project would provide support for both Infrastructure Investments and Institutional & Capacity Strengthening to promote the upgrading of sites and connectivity along identified tourism circuits to connect and enhance the competitiveness of priority tourism attractions, strengthen the link between the tourism sector and local development – with a territorial focus on the hinterland – identify and address barriers to diversifying sources of financing, promoting reform and improving public-private dialogue.

Environmental Sustainability

Montenegro Policy Note 2017

The Challenge

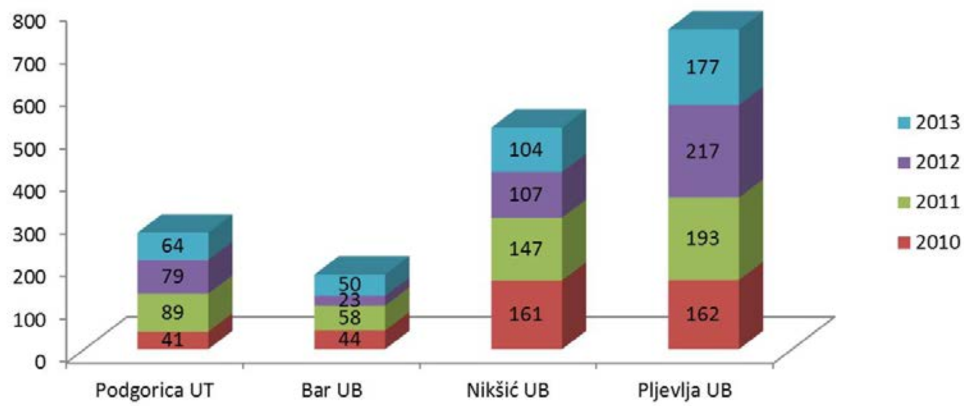
Environment sustainability in Montenegro is essential (i) to ensure the well-being of the Montenegrin population and improve further living standards, (ii) to protect the strong natural heritage that is the foundation for tourism growth and its related economic development and (iii) to further move Montenegro toward EU accession. Montenegro has made positive strides in improving environmental sustainability, notably in improving the environmental legal framework and in starting investments in sanitary waste disposal. Further improvements are required, in particular in relation the management of air quality, and improvements of waste, water and wastewater management that can positively affect public health, living standards and tourism potential. Air quality improvement will require modernisation of energy and heating management, and better waste and wastewater management will require sustained investment in new and modern infrastructure. With only 18% of population covered by any form of wastewater treatment, Montenegro has also a significant work and investments ahead before reaching EU standards.

The country is also facing a number of risks related to the environment, with environmental hotspots requiring immediate actions, especially with regards to the management of industrial waste such as the Shipyard in Bijela a mere 20km from the the Budva – Kotor tourists centre or the KAP Aluminium plant in proximity of the lake Skadart. The country is also at risk from flooding and from extreme weather events that will require better-coordinated approaches and development of policies dealing with Disaster Risk Management.

Air quality. The Government has made significant progress in transposing the EU directive on Ambient Air Quality and has adopted a strategy on Air Quality Management that include an action plan defining 54 measures for improvements. Air quality in urban areas and nationwide assessed in terms of the concentration of SO_2, NO_2 and O_3 is within the prescribed threshold limit value, with no major concentration variations on an annual basis. However, there is a high concentration of PM_{10} and a large number of exceeded permitted daily concentrations take place during the heating season, mainly due to the use of solid fuels (coal and wood). Annual mean concentration of PM_{10} in Pljevlja is twice as high as in Podgorica or Bar. Concentrations in Niksic are in the middle of the range, and only there a declining trend in concentrations can be noticed. WHO air quality guidelines level (20 $\mu g/m^3$) is exceeded in all cities. In Pljevlja, Niksic and Podgorica, daily mean concentration of PM_{10} exceeded 50 $\mu g/m^3$ on 64-177 days in 2013, markedly more often than allowed by EU AQ directive (35 days/year) or recommended by WHO AQ guidelines (3 days/year).

Recent analysis indicates that over 250 premature deaths and 140 hospital admissions per year, and a number of other health outcomes are associated with the exposure exceeding the level of particulate matter recommended by WHO air quality guidelines. More than half of these effects are associated with elevated levels of pollution in the winter caused mainly by combustion of solid fuels for heating. As a result, a recent analysis shows that that almost 6 percent of all mortality cases in Podgorica, 12 percent in Niksic and 22 percent in Pljevlja could be attributed to the existing level of air pollution in these cities. To reduce health effects of air pollution in cities of Montenegro, a significant decrease of solid fuels combustion for household heating and cooking is necessary. For instance, there are significant economically viable opportunities to invest in efficient wood stoves and pellets and chips fired heating boilers in Montenegro (see the Energy Efficiency and Biomass Energy note for additional details).

Figure 19. Number of exceedances of daily limit values of PM_{10} particles



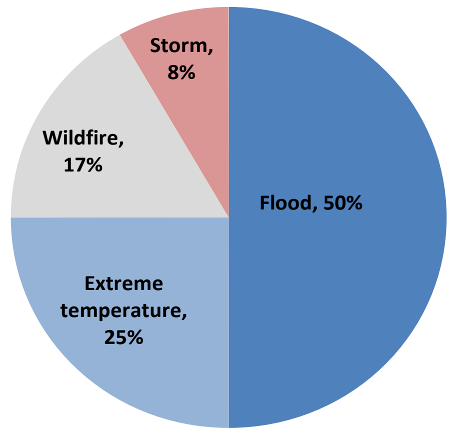
Source: Environment Protection Agency

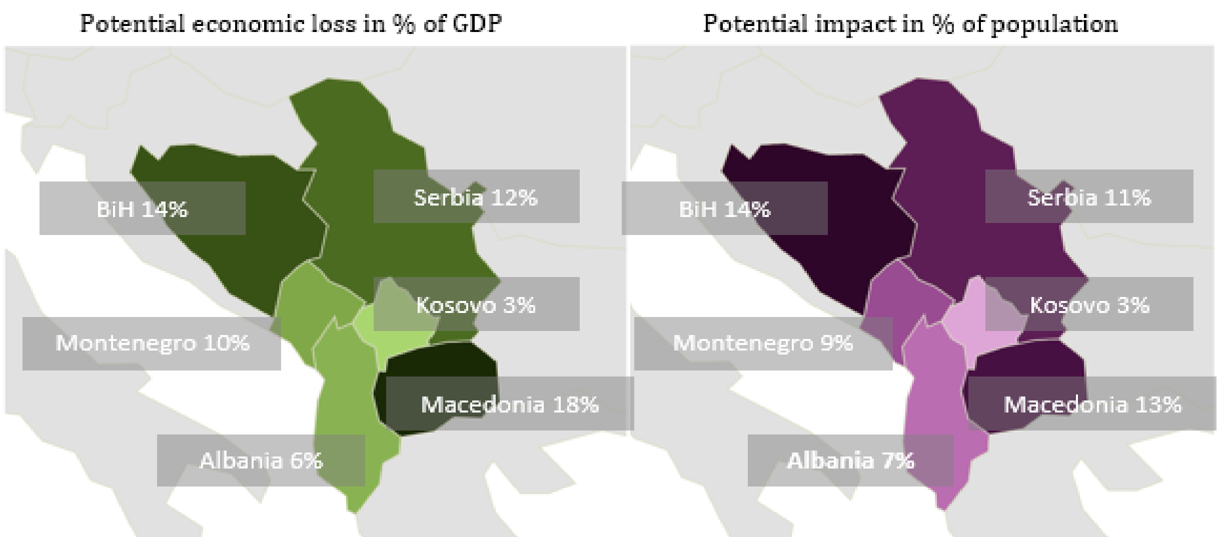
Water and waste water management. Low wastewater treatment standards are a serious impediment to further sustainable development of tourism and have negative impact on health. Only 43 percent of the total population of Montenegro is connected to a public sewage network and wastewater treatment is extremely low, with 18 percent of all collected wastewater treated according to standards. In the coastal area, wastewater is mostly discharged directly into the sea, which might adversely affect the water quality in beaches/bathing waters. The increase in population in the coastal zone around the summer season, due to tourism is exacerbating the problem when it matters most. This is linked to the significant investment deficit in the sector, especially with regards to Wastewater Treatment and is compounded by the overall financial status of the sector. Revenues generated by water tariffs are not sufficient to cover operation and maintenance costs. As a result, operating costs are covered by national and local subsidies, and investments are funded by international loans and grants, complemented by subsidies from both national and local budgets. The efficiency of utilities performance is also below desired level, with overstaffing an important issue in most water utilities, the average collection rate at only 72 percent, indicating that utilities have significant difficulty recovering bills, and nonrevenue water at 59 percent which is higher than regional average. To reach EU standards and directive requirements, Montenegro will have to invest nearly €640 million, which can come from the EU funds and own sources.

Industrial and special waste. Poorly controlled industrial waste sites pose a constant threat to public health and the environment. One of the most important issues is the treatment of industrial waste generated in the past. Industrial waste disposal sites pose risks not only to immediate environment and sensitive natural and tourism resources, but also to public health in the surrounding communities through groundwater contamination and risk of dam failure with release of large waste quantities, like in Kombinat Aluminijuma Podgorica (stabilization and remediation of red mud basin and industrial waste landfill). Other critical sites for remediation are Shipyard Bijela (site clean-up and removal of large quantities of hazardous waste), the ash disposal site of the thermal power plant in Pljevlja and the mine tailings disposal site in Gradac. The latter is continuously releasing heavy metals into the Ćehotina River. Montenegro is also lacking infrastructure for adequate management of the ongoing production of industrial and special waste. Further details are presented in a separate note on this topic.

Flooding and DRM. Montenegro is vulnerable to natural disasters, especially floods and earthquakes. Floods are the most frequent hazard. According to Emergency Events Database (EM-DAT), during the period 1991–2013 there were six destructive floods out of 12 total natural disasters. The country is also prone to extreme temperatures, storms, and droughts. A 100y flood event would have the potential to result in an economic loss of 10 percent of GDP and impact 9 percent of the population.

Figure 20. Natural Disasters in Montenegro, 1991-2014





Changes in the quantity and regime of precipitation influenced by the climate-related hazards will in a long-term lead to: (i) reduced flows and abundance of water resources; (ii) a higher frequency and intensity of floods are expected; (iii) movement of vegetation zones, reduced number of species, drying out of forests and more frequent forest fires. In agriculture, significantly reduced yields due to sensitivity of crop production to changes in temperature and precipitation reduced available agricultural land and lower content of organic matter in soil. Climate-related hazards disproportionately affect lower income cohorts both from the perspective of income loss and from the perspective of coping with consequence from a disaster.

Montenegro has made substantial progress in transposing EU legislation into national laws. However, **s**ubstantial further implementation efforts remain, including those required by the EU climate acquis. Alignment with EU environmental standards would cost 36 percent of Montenegro's GDP (EUR1.43 billion), mostly in the fields of water, waste management and air quality. The most of the costs will refer to the water sector EUR840 million or 59 percent of total costs, with solid waste management accounting for EUR368 million.

Policy Options

Prioritize national planning and implementation of the national strategy for transposition, implementation and enforcement of the EU acquis on environment and climate change and its action plan for period 2016-2020, based on economic efficiency of social and environmental improvements.

Develop sustainable energy efficiency implementation and financing mechanisms such as energy service agreements, energy efficiency revolving funds and utility obligation schemes.

Promote increased use of biomass for heating in efficient stoves and boilers through certification and labeling of biomass fuels and appliances, adoption of a forest roads development plan, establishment of biomass logistics and trade centers, and provision of financing.

Upgrade and expand Water and Wastewater infrastructure. In the coming period the country will have to: (i) Secure additional financial sources to invest in upgrading the water and wastewater sector infrastructure and move it closer to EU standards, and to secure foundations for sustainable development of tourism, (ii) Improve the efficiency and cost-effectiveness of water utilities, and (iii) Implement sound cost recovery principles, as currently water utilities do not generate sufficient revenues to ensure proper maintenance and sustainability of even existing infrastructure.

Disaster Risk Management. In the last 10 years, the country has not suffered a severe adverse natural event and risk perception is very low. Better understanding of these risks would allow government to prioritize actions in short medium and long terms to build resilience in the country.

At the same time, and as these disasters are a contingent liability, the country could start preparing financial mechanisms to respond more efficiently when disasters of larger magnitude hit the country.

Implement priority industrial waste disposal site remediation. The scope and financial means of the Bank-funded Industrial Waste Management and Cleanup Project enable Montenegro to remediate the priority industrial waste disposal sites in the country, develop a national scheme for management of ongoing industrial and specials waste generation and further work on policies in the field of waste and industrial pollution management

World Bank Group Support

Ongoing support. The World Bank currently finances two operations addressing the Environmental Sustainability management issues in Montenegro. **The Industrial Waste Management and Cleanup Project** (US$68.90 million) has a sector development and technical assistance component that can be used to support national planning in fields such as waste and chemicals management, and industrial pollution control.

The Energy Efficiency Project (US$15.67million) could be expanded to support implementation of the 2nd National EE Action Plan (NEEAP, 2014). Such an EE project could also support the NEEAP key action on development of alternative financial mechanisms (e.g. through introduction of Energy Service Agreements (ESA) and NPV based procurement as steps towards development of an Energy Service Companies (ESCOs) and/or as part of establishment of an energy efficiency fund.

Planned support/Options. A possible Biomass Heating project could be prepared (and potentially combined with any extension/expansion of the EE project). It could be focused on replacement of old heat only boilers in multistory buildings with efficient pellet or wood chip boilers, and scaling up replacement of inefficient wood stoves with efficient ones.

The World Bank can support the implementation of national strategy through advice bringing in international experience in environmental management and EU pre-accession support on (1) industrial pollution and waste management; (2) improvements in environmental monitoring and enforcement and climate policies; (3) energy efficiency, biomass and other renewables; (4) energy market integration and system planning.

International Finance Corporation could support financially sustainable municipalities to invest in waste management projects. Where appropriate, IFC will pursue PPPs as other efficient private sector solutions.

Energy Efficiency and Biomass Energy

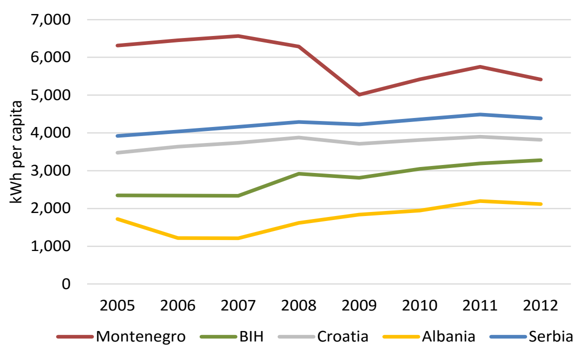
The Challenge

The Montenegrin economy has high energy intensity measured as energy used per unit of gross domestic product, remaining 3.3 times higher than the EU28 average. This is primarily due to outdated technology in the aluminum smelting process and inefficient energy consumption (especially with regard to heating) among households and the many public buildings. Furthermore, energy expenditures as a percent of household income in Montenegro are among the highest in the region.[9] Improved energy efficiency would not only reduce public and private expenditure but also global CO_2 and local (NO_x, SO_x, particulate matter) emissions.

Investing in energy efficiency boosts the economy and saves fiscal resources. Every €1 invested in energy efficiency results in €4-5 in other co-benefits (e.g., increased tax revenues, lower operating costs, reduced unemployment/subsidies, energy security, reduced pollution etc.) Building renovations in particular can be labor-intensive and create mostly non-exportable jobs, generating up to 27 jobs for every €1 million invested. The Montenegro EE Project (MEEP) has achieved 35-65 percent energy savings per building and just the 25 MEEP buildings alone are estimated to save ~€3.5 million in energy costs over a 15-year period. A significantly scaled up, sustainable buildings EE program would yield significant budget savings for the Government.

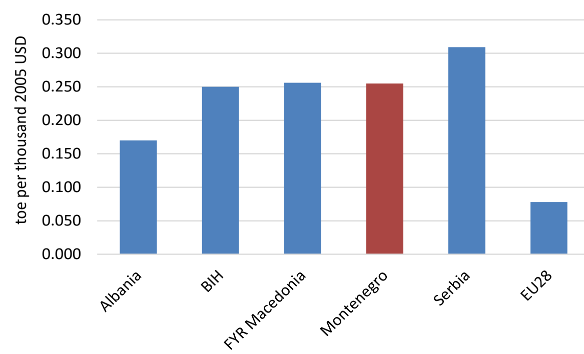
[9] Overall household energy expenditures in Montenegro are estimated to represent about 15.3 percent of average household income, the highest level among the neighboring countries; annual electricity expenditure alone is estimated to average over EUR 600 per household. Source: Annual household expenditures in the W-B, from Household Budget surveys of W-B countries; Assessment of the Residential Energy Efficiency Investment Potential in the Western Balkans, 2015, ECO; expenditures for electricity, WB Data

Figure 21. Electricity Consumption Per Capita



Source: World Development Indicators.

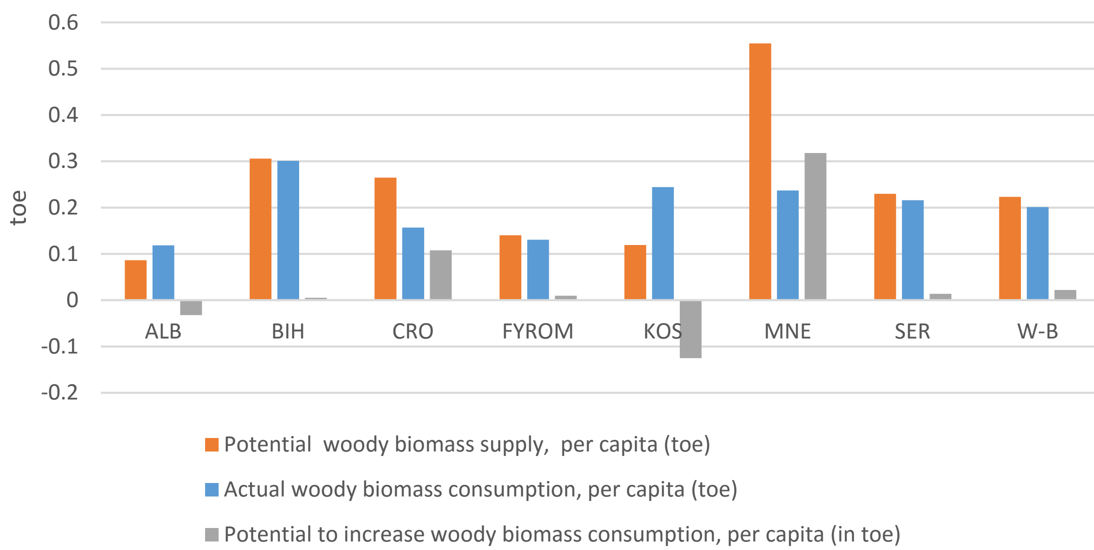
Figure 9. Energy Intensity in 2012 measured in Total Final Consumption (in toe) per Unit of GDP (in 2005 USD)



Source: IEA World Energy Statistics and Balances.

Biomass energy is underutilized and inefficient. Montenegro has in per capita terms the highest potential in the Western Balkans to increase woody biomass use for heating. This is a missed opportunity to develop local economy and create jobs.

Figure 10 Biomass Energy



There are significant economically viable opportunities for investments in biomass heating. Up to 266MW of electric heating could be economically replaced with biomass heating in single-family homes and multistory buildings (estimated 89 percent of current electric heating systems). The needed investment of ca. €15 to €60 million[10] could save as much ~ 670,000MWh /year, equivalent to ~25% of MNE's annual electricity consumption, and would also reduce both local emissions and CO2 emissions by ~330,000 tons/year. Similarly, as much as 360MW in inefficient wood stoves could be replaced with efficient ones (roughly 36,000 stoves) through an investment of ~€19 million over 10 years. Through

[10] The range based on 56 EUR/kW for efficient stove produced in Western Balkans and 200 EUR/kW for efficient stove imported from Western Europe.

such a program annual energy savings of ~3.4ktoe (or 22,000m^3 of wood) and fuel wood cost savings of ~€1 million/year could be achieved. Demand in the market exists as illustrated by the small, grant supported Energy Wood project which has provided several hundred small loans to households.

Policy Options

Energy Efficiency. Reducing energy intensity and increasing renewable energy production are essential for enabling sustainable growth as well as reducing public expenditures. Public sector should continue an action on improving energy efficiency to increase awareness of energy efficiency among the population and to demonstrate the benefits of energy saving, including reduction of expenditures and emissions. As noted in Montenegro's National Energy Efficiency Action Plan (NEEAP), key actions would be the development of alternative financial mechanisms, such as an energy efficiency fund, and utility obligation schemes.

Biomass: The Government should promote the increased and more efficient use of biomass in heating. Highly economic options would include policies and schemes that promote switching inefficient heating stoves to efficient ones (e.g. through a significant scale up of the Energy Wood program or a similar initiative) and switching of oil and coal boilers to wood chips in multistory and public buildings; in northern Montenegro some opportunities for development of district heating also exist. Certification and labeling of biomass heating appliances and biomass, adoption of a forest roads development plan, and establishment of biomass logistics and trade centers would boost the heating appliances market and the development of domestic supply (of pellets, briquettes and properly dried firewood) and use of biomass.

World Bank Group Support

Ongoing support. Energy Efficiency Project (US$15.67million) could be expanded to support implementation of the 2nd National EE Action Plan (NEEAP, 2014). Such an EE project could also support the NEEAP key action on development of alternative financial mechanisms e.g. through introduction of Energy Service Agreements (ESA) and NPV based procurement as steps towards development of an Energy Service Companies (ESCOs) and/or as part of establishment of an energy efficiency fund.

Planned support/Options. A possible Biomass Heating project could be prepared (and potentially combined with any extension/expansion of the EE project). It could be focused on replacement of old heat only boilers in multistory buildings with efficient pellet or wood chip boilers, and scaling up replacement of inefficient wood stoves with efficient ones.

The World Bank can support the implementation of national strategy through advice bringing in international experience in energy efficiency, biomass and other renewables. The World Bank could also advise on the establishment of a wholesale power market and potential integration with neighboring countries through a market coupling. Such support would consider different options, and its potential impact on consumers, of designing, developing and implementing the wholesale power market.

Industrial and Special Waste

The Challenge

Montenegro has made some important progress in the field of waste and industrial pollution management, particularly in the development of the (environmental) legal framework, but also with investments in sanitary disposal for domestic waste in Podgorica and Bar/Ulcinje and the issuance of the first integrated environmental permits for the industrial sector. Further improvements are required to deal with the still present critical environmental issues and meet EU requirements as stipulated under Chapter 27 on Environment and Climate Change, which puts specific emphasis on waste management and industrial pollution control. While alignment with EU environmental standards would require investments equal to 36 percent of Montenegro's GDP (EUR1.43 billion), after investment needs in the water sector at EUR840 million, requirements for improvements in waste management come second at estimated investments of EUR368 million in the period 2016-2020.

Besides further investment needs in domestic waste management, Montenegro is still lacking infrastructure for the collection and treatment or disposal of special waste categories such as hazardous and industrial waste. Arguably even more critical are the historic industrial and hazardous waste disposal sites in the country, lacking environmental control measures and thus creating unmitigated sources of contamination for the immediate surroundings and sensitive groundwater and surface water resources. In Montenegro, 82 percent of the population depends on water supply from groundwater systems.

Poorly controlled industrial waste sites pose a constant threat to public health and the environment. The highest risk environmental hotspots in Montenegro have been identified, already, including the solid waste disposal site and the red-mud basins within the premises of the KAP aluminium plant which are contaminating groundwater systems connected to Lake Skadar. Of these, the massive red-mud basins --if not remediated-- need sustained maintenance to prevent deterioration and collapse with potential disastrous consequences, to people living in the vicinity and Skadar Lake with its importance for the tourist sector. A second hotspot site is the shipyard in Bijela at the Boka Bay, some 20-30 kilometres away from tourist centres of Budva, Herceg Novi and Kotor. The shipyard has heavily contaminated soils and hazardous waste piles, which have locally polluted the Boka Bay seabed, an important asset for tourism in Montenegro. The Old City of Kotor, together with part of Kotor Bay, is a UNESCO protected site. Other hotspots sites are the coal ash disposal site in Pljevlja and the mine tailings disposal site in Gradac. The latter is continuously releasing heavy metals into the Ćehotina River that runs into Bosnia.

Montenegro has adopted the Industrial Waste Management and Clean-up Project to remediate the hotspots sites and develop a national system for industrial and hazardous waste management, with $68.9 million World Bank funding. This project became effective in November 2014. Preparation for remediation has progressed only for the Bijela shipyard with works now (January 2017) ready for tendering, but to date no clean-up operations have started.

Policy Options

The European Commission, in its 2016 Status Report on Montenegro, noted the substantial efforts needed for implementation of environmental regulations and enforcement, in particular in water, nature protection and waste management and for the latter with the legal framework largely in place puts specific emphasis on implementation of the national waste management strategy and plans.

The OECD in its Third Environmental Performance Review (2015) also commands Montenegro for its strong legal framework and investments made to develop the first sanitary landfills. It recommends to focus policy efforts on the further development of regional landfills, improve data collection on both domestic and industrial waste (currently only based on estimations and verification is mostly lacking); waste tariff collection to create a financial basis for investments and operations (currently only 56% of households and 68% of companies pay for waste services) and to develop the infrastructure and improve market conditions for waste recycling. It further asks attention for the lack of options for treatment and disposal of medical waste, PCB waste and radioactive waste.

Prioritization of investments is key to implement the existing waste management strategy and plans. With plans in place, but also limited resources and time until 2020, an important first step is to prioritize and sequence sector interventions for both the domestic (non-hazardous) waste sector and the industrial and hazardous waste sector and based on service standards and economic efficiency of social and environmental improvements. For the domestic waste sector, financial sustainability is key which requires stable incomes from waste tariffs to fund day-to-day ongoing operations and finance future investments.

The ongoing Industrial Waste Management and Cleanup Project has the scope and resources to cover requirements for industrial and special waste management. The Project has been designed and funded to help addressing the remediation of industrial pollution sites but also has the resources to support the government, through its technical assistance component, with developing a national scheme for management of ongoing industrial and specials waste generation and further work on policies in the field of waste management and industrial pollution control.

World Bank Group Support

Ongoing support. **Accelerate implementation of the existing Industrial Waste Management and Cleanup Project** (US$68.90 million). This Project, despite having all the resources to remediate the existing hotspots and support the Government with further sector development has had a poor record of implementation since effectiveness in November 2014 with only a few percent of funding utilized. Remediation at the Bijela shipyard is now expected to start before the summer of 2017 but no progress has been made for the other hotspots. Work on the national scheme for special waste management has not yet commenced. It is strongly recommended to accelerate implementation by making the project a national priority and together with the parties involved in project implementation define steps to start the works at the project sites other than the Bijela shipyard. This would entail: (1) a Government decision to recognize that public funding is required for the remediation of the Gradac site; (2) entering an agreement with EPCG for the remediation of the coal ash disposal site in Pljevlja; and (3) development a remediation plan with all stakeholders including the current private operators of former KAP facilities for the remediation of the two project sites with the KAP location.

Potential support. The World Bank can further support the implementation of national environmental strategies through advice bringing in international experience from working in other EU candidate countries in environmental management and EU pre-accession support for industrial pollution control, waste management and improvements in environmental monitoring and enforcement.

International Finance Corporation could support financially sustainable municipalities to invest in waste management projects. Where appropriate, IFC will pursue PPPs as other efficient private sector solutions.