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Montenegro:
The Challenges of a Newborn State

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Cover photo: Final pro-independence convention leading up to the May 2006 referendum.
Back cover photo: New construction in Podgorica. All photos are taken by Maja Drakic and are property of Maja Drakic.

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MONTENEGRO:
THE CHALLENGES OF A NEWBORN STATE

MAJA DRAKIC, FREDERIC SAUTET, AND KYLE MCKENZIE

EXECUTIVE SUMMARY

After the peaceful passing of a referendum that dissolved the Union of Serbia and Montenegro in May 2006, people flocked to the streets to celebrate the establishment of Montenegro as a newly independent republic of about 630,000 people.

While still part of the union with Serbia, Montenegro had started an economic reform program. The reforms that have taken place have focused on stable monetary policy, protection of property rights, lowered barriers to trade, decreased business regulation, and equal rights for foreigners within the country.

The country is now at a crossroads. Montenegro can continue its reform process and tackle the big challenges ahead—including reforming its labor markets, public finance and public sector management, business regulations, and constitutional rules—or it can follow the path of many former socialist countries and eventually stifle the reforms. Most importantly, Montenegro must decide whether to join the European Union and whether to amend its constitution in order to protect its institutional reforms.

During this time, Montenegro can learn from other countries' experiences. The Estonian experience shows that following liberal reforms can have a significant positive impact on economic growth. The New Zealand case provides an instructive example of governmental discipline for a small and transitioning country.

Montenegro's small size puts it at an advantage to continue the liberal reforms it has already started and from which it has benefited. If it follows best practices in the reform process, the country can strengthen its institutional framework in order to foster entrepreneurial activity. Montenegro could become the first Mediterranean tiger and thereby inspire transitioning countries around the world.

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INTRODUCTION

After 88 years as part of various Yugoslav and Balkan unions, Montenegro, a small Mediterranean country with a population of 630,000 and a rich history dating back to the Roman Empire, joined the world's list of independent countries on May 21, 2006. Montenegro had lost its sovereignty in 1918 after the establishment of the Kingdom of Serbs, Croats, and Slovenes, which was renamed Yugoslavia and existed in different forms until the early 1990s. After Yugoslavia's collapse in 1992, only two of the six constitutive republics remained together—Montenegro and Serbia. But growing political differences led the people of Montenegro to vote for independence in 2006.

Montenegro began its economic reforms in the late 1990s while still politically united with Serbia. The reforms aimed at building an open economy, fostering an environment favorable to business enterprise, and attracting foreign investors. Although the quickly instituted initial reforms delivered impressive results, Montenegro can still do much to reform economic and political institutions. Montenegro now stands at a crossroads. The decisions it will make, such as whether to join the European Union, will have lasting effects for decades to come.

This Country Brief explains the challenges that Montenegro faces and charts some possible directions for its future by studying its present situation and its past choices. The paper is organized as follows. First, we introduce the immediate history of Montenegro and the emergence of post-Yugoslavia. Second, we present the main reforms that have been carried out in the last decade. Third, we examine the unfinished reforms and the factors holding back economic development. Fourth, we offer solutions for future problems, referencing the Estonian model and key policy changes carried out in New Zealand. Finally, we tackle the question of whether Montenegro should join the European Union and also undertake further constitutional reforms.

A. The Emergence of Post-Yugoslavia

The breakdown of the communist party in the early 1990s was the beginning of the end of "old Yugoslavia." Four republics seceded and declared their sovereignty. Serbia and Montenegro formed the new Federal Republic of Yugoslavia in 1992. Serbian political leader Slobodan Milosevic's several unsuccessful military campaigns to unite Serbs in neighboring republics into a "Greater Serbia" resulted in wars within the territory of former Yugoslavia. Thousands were killed during the conflict, and many more became refugees. War did not occur in Montenegro, but because it was part of the new Federal Republic, its citizens suffered from the effects of international sanctions, NATO bombings, economic collapse, and hyperinflation.

A1. What Has Happened since the Fall of Yugoslavia?

The 1990s were marked by political changes and the struggle for power. Rising nationalism led first to the establishment of the Federal Republic of Yugoslavia (the "third Yugoslavia") in 1992. During the mid 1990s, nationalists who backed the unification of Montenegro with Serbia outnumbered the supporters of an independent Montenegro, and political and economic tensions that existed since the inception of the new Federal Republic divided Montenegro's ruling party into a pro-Milosevic group and an anti-Milosevic group. However, the victory of the anti-Milosevic group in the 1997 election marked a turning point for Montenegro.

Although some attempts at economic reform had been made in the 1990s, resistance to change and the existence of conflicts in the region prevented any systemic reform process. Montenegro started substantial reforms in 1998—one of the few countries to undertake economic reforms without first achieving independence.[1] However, because of the volatile political situation, the transition process has been difficult, and more remains to be done.

A2. The Delicate Relationship with Serbia

While officially part of the same country, the Federal Republic of Yugoslavia, Montenegro had a delicate relationship with Serbia. The difference in size of the two states—Montenegro's population represented only five percent of the total population—caused a permanent disequilibrium in their relations, leading to unfavorable conditions for economic and political cooperation.

While Serbia leaned towards the protection of inherited industries and agriculture, Montenegro tried to develop a small, open, service-oriented economy based on free-market principles. Political tensions increased between Serbia and Montenegro. At one point, the two states almost abolished trade relations with each other.[2]

In 2000, political changes in Serbia, primarily the political defeat of Milosevic, caused the two countries to redefine their relationship. Trade between the two republics intensified although some problems persisted.[3] While Serbia remained

[1] Another notable country that undertook economic reforms before independence was Estonia in 1987.

[2] The ruling party in Montenegro split in 1997, and the anti-Milosevic wing won the election. Milosevic ruled in Serbia until 2000. From 1997-2000 there was permanent political tension between Serbia and Montenegro. This was also the time when Montenegro started to build its independent economic system.

[3] For instance, there were problems with payment systems related to different legal currencies and different tax systems (VAT and sales tax, in Montenegro and Serbia, respectively).

uninterested in reform, Montenegro decided to unilaterally reform its legislative and economic institutions. While technically still part of the Federal Republic of Yugoslavia, the Montenegrin government took over the economic functions of an independent and sovereign state, including monetary policy, the banking system, trade policy, and customs and border control.

Even the ordinary citizen could see the vast economic differences between the two states of the Federal Republic of Yugoslavia. While Montenegro used the deutschmark and then the euro as its official currency, Serbia clung to the dinar, one of the worst currencies in the world.[4] Montenegro also took drastic measures against inflation and had import tariffs several times lower than those of Serbia, enlarging the rift between the two countries. Nevertheless, representatives of Serbia, Montenegro, (federal) Yugoslavia, and the European Union (EU) established a political solution to the growing rift in March 2002, signing the Agreement on Principles of Relations between Serbia and Montenegro, commonly termed the "Belgrade Agreement."

A3. The Short-Lived USM

The main goal of the Union of Serbia and Montenegro (USM) was harmonization of the economic systems of Serbia and Montenegro. Legislation dealing with customs harmonization became a major test for the future of the USM because tariffs between the two countries differed greatly. Montenegro's average tariff, at the time the agreement was signed, was 2.8 percent while the tariff rate in Serbia was 11 percent. (At the time, the average tariff in the EU was 4.2 percent.) In addition, the tariff on food was only 1 percent in Montenegro, but it was 11 percent in Serbia. As EU experts argued that Montenegro would not suffer if it raised its tariffs to match those in Serbia,[5] the EU insisted that Montenegro raise its tariffs to match Serbia's. After the states harmonized their tariffs, they could then lower them to the EU's level.

In 2003 Montenegro harmonized tariff rates with Serbia for 93 percent of its imported products, increasing the tariff rate from an average of 2.81 percent to 6.13 percent.[6] It did not increase the tariff rates for the remaining imports, mostly of agricultural products, thereby failing to achieve fully harmonized tariff rates the USM sought.

[4] See Steve Hanke, "The Beauty of a Parallel Currency," Cato Institute, January 14, 2000, http://www.cato.org/dailys/01-14-00.html.

[5] See Constantin Zaman, "The Impact of Tariff Alignment Between Serbia and Montenegro" (report prepared for the Policy and Legal Advice Center, a project of the European Agency for Reconstruction, 2002), http://www.plac-yu.org/plac1archive/DownLoads/2.4ImpactAlignmentSerbia-MN.pdf.

[6] USAID WTO Accession Project in Montenegro, "World Trade Organization Accession Support," http://serbia-montenegro.usaid.gov/code/navigate.php?Id=64.

That was not the USM's only failure. The USM failed to achieve many of its goals, in part because each state within the union retained most levers of authority. The USM represented Serbia and Montenegro with regard to international organizations and could sign international agreements, but it could not implement them.[7] Since it didn't have any power to implement decisions and was a large bureaucracy running on taxes from both Serbia and Montenegro, citizens often questioned the existence of the USM. At best, the USM was seen by many as a body safeguarding the status-quo of the socialist period under the appearance of reform.

However, the Belgrade Agreement included a clause that gave each member state the right to hold a referendum in 2006 to allow its citizens to express their preference with regard to the future of the USM. Montenegro, which had been trying to recover its independence since the First World War, decided to organize its referendum for May of that year. However, after Montenegro decided to hold a referendum in 2006, the EU pushed for the adoption of new rules for referenda, which were not included in the USM agreement. For the referendum to pass, the Montenegrin law required (a) participation of at least 50 percent of registered voters and (b) a simple majority. However, under pressure from the EU, the Parliament of Montenegro adopted a new law on referenda that required not just a simple majority, but an affirmative vote from 55 percent of voters to become independent.

Around 87 percent of the electoral body of Montenegro voted on the referendum. Of those, 55.5 percent voted for independence and 44.5 percent against it. More than 3,000 observers from different international organizations supervised the referendum process, and all of their reports confirm that the process respected all democratic standards. Shortly after the referendum, almost all countries officially recognized Montenegro's independence. On June 28, 2006, Montenegro became a member of the United Nations.

The first independent local and parliamentary elections were held soon after the referendum. Milo Djukanovic's party achieved a majority in Parliament and therefore the ability to appoint members of Government (i.e., the cabinet) for the next four years. In the past, Montenegrin politicians could blame the poor results of reforms on things outside of their control. From now on, however, Montenegro's politicians must take responsibility for the success or failure of reforms.

A4. A Brief Description of the Economy

Montenegro remains a somewhat exotic destination for Western and Northern Europeans. With its relatively long coast of sandy beaches and clean water, five natural lakes, four national parks, and a sunny and warm climate,

[7] Constitutional Charter of the State Union of Serbia and Montenegro, www.mfa.gov.yu/Facts/const_scg.pdf.

Montenegro—the 21st century's youngest state

"The process to create Montenegro was evolutionary. Montenegro was created in a different way than any other new Eastern European country. After the Berlin Wall fell, new countries were created by splitting three federations: the Soviet Union, Czechoslovakia, and Yugoslavia. The Soviet Union was split by ethnic divisions; Czechoslovakia by an agreement made by the elite; Yugoslavia by war.

Montenegro was created through political debates between two equal ideas: YES (for independence) and NO (against independence). Everything was realized through civilized, democratic debate. Representatives of the EU said that the organization of the referendum exceeded the standards of the international community. Even with a lot of emotion, no disorderly incidents took place. Everything was peaceful and civilized! Is this a sign that the Balkan region is changing?

This country was not created by a king, but by individuals!

. . . This is the first generation of Montenegrins that have not experienced war on its territory, but instead experienced parties, celebration, dancing and happiness in each central square of every town in Montenegro, beside rivers, in front of private houses . . . For several days thousands of people celebrated, raised flags, and cried from both happiness and excitement. Even those usually emotionless and reserved Montenegrins became emotional and excited.

Even though emotions were strong, no disparaging statements were aimed toward neighbors, or toward people in Montenegro who have a different (opposite) opinion.

The referendum was a crucial point in the process of cultural, economic and political maturity of Montenegrins. It was an internal emotional explosion experienced by each individual that voted—no matter how they voted. It was a conflict of two ideas which were deeply felt by both sides. Many people did not have decent sleep for nights prior to the referendum . . . It is reasonable to expect that a country created on liberal principles will create liberal economic and political system, and because of that Montenegro will be different than any other in the region." [8]

[8] To read more see, Veselin Vukotic, "Montenegro—the youngest state of 21st century," *Schweizer Monatshefte*, July/August 2006, http://www.schweizermonatshefte.ch/index.php?nav=frhr&heft=26.

A view of Rijeka Crnojevica

Montenegro offers the perfect setting for enjoyable holidays.

Montenegrins see tourism as crucial to the economic expansion of the country. Revenues from the tourism industry for first three quarters of 2006 amounted to 250 million euros, and they are expected to reach 300 million euros at the end of 2006 (see figure 1).[9] In addition to the money it raises directly, tourism has the potential to foster the development of small and medium enterprises and attract more foreign investments. The government considers it the highest development priority.[10]

However, the Montenegrin tourism industry is currently not competitive with similar destinations. There is a permanent shortage of adequately trained personnel and a range of infrastructure problems, including a lack of fresh water, energy, and waste management. In the last few years though, Montenegro has completed several infrastructure projects, mostly renovating and building highways as many view new highways as essential to furthering tourism and connecting Montenegro to the main airports in the region.

Montenegro's industrial facilities produce bauxite, aluminum, crude steel, coal, and sea salt. Both the aluminum and bauxite industries have been privatized. Aluminum, which made up 60 percent of total exports in 2004, is the most important

[9] Press Release from the Ministry of Tourism, Government of Montenegro, October 12, 2006, http://www.mturizma.vlada.cg.yu/index.php?akcija=vijesti&id=16295.
[10] Ministry of Tourism, Government of Montenegro, "Master Plan for Tourism Development," http://www.mturizma.vlada.cg.yu/vijesti.php?akcija=rubrika&rubrika=50.

FIGURE 1

TOURISM REVENUES 2001 – 2005 IN MILLIONS OF €

	2001[11]	% GDP	2002[12]	% GDP	2003	% GDP	2004	% GDP	2005	% GDP
TOTAL REVENUES	128.2	12.2	144.0	11.8	151.2	11.4	179.7	12.7	216.68	13.2
FOREIGN TOURISTS	108.4	10.3	124.9	10.2	61.8	4.7	82.2	5.8	86.65	5.3
DOMESTIC TOURISTS	19.8	1.9	19.1	1.6	89.4	6.7	97.5	6.8	130.3	7.9

Source: Balance of Payments of Montenegro; Central Bank of Montenegro

export of Montenegro.[13] Montenegro generates three billion KWh of electricity per year; most of this comes from hydro sources, some from thermal plants. Montenegro imports the rest of its energy needs from other countries in the region. The thermal power facilities are being privatized, and the government has more extensive plans for industrial privatization in the near future.

Forests and woodlands cover about 54 percent of the country, providing ongoing opportunities to generate income and boost exports. However, forestry needs private initiatives in order to fully realize its economic potential, a difficult task as state-owned forests make up 67.2 percent of total forestland.[14] Montenegro also has 520,000 hectares of agricultural land, covering 37.6 percent of the country,[15] with most of the arable soil located in the river valleys (Zetska Ravnica, Bjelopavlicka Ravnica, Niksicko Polje, and Ljeskopolje).

The country also has a higher ratio of livestock per capita than many countries in Europe, and the food production industry has large potential.[16] As these resources have been somewhat underused,

[11] Revenues from foreign tourists for 2001 include revenues from Serbian tourists.
[12] Revenues from foreign tourists for 2002 include revenues from Serbian tourists.
[13] MIPA, "What Should You Know About Montenegro?" www.mipa.cg.yu.
[14] Center for Entrepreneurship and Economic Development, *Montenegro Country Report* (Podgorica, 2003).
[15] Agricultural land is made up of 36.7 percent arable soil, 62.8 percent pasture, and 0.5 percent other.
[16] The Montenegrin livestock per capita ratio is 0.2. The livestock per capita ratio in Slovenia is 0.1, and Slovenia exports both milk and meat.

many new entrepreneurs have started to notice opportunities in agricultural production. The temptation to use tariffs to protect the nascent agricultural industry is high, but so far the government has resisted it.

The Fraser Institute's *Economic Freedom of the World* ranks countries mostly based on published data from international sources. This makes it difficult to rate certain countries such as Montenegro, due to lack of available data. The *Economic Freedom of the World* report doesn't include Montenegro, but the Fraser Institute licensed the Center for Entrepreneurship and Economic Development in Montenegro to estimate the country's rank in the index. If Montenegro had been ranked in 2005, it would have placed 86th out of the 127 ranked countries in the overall index.[17] In 2006, Montenegro would have been placed 64th out of the 130 ranked countries (see average score in figure 2).[18]

FIGURE 2

FRASER INSTITUTE CRITERIA AND SCORES FOR MONTENEGRO

CATEGORIES OF FRASER INDEX	2005 (AVERAGE SCORE 5.97)	2006 (AVERAGE SCORE 6.37)
SIZE OF PUBLIC ADMINISTRATION	5.82	5.97
LEGAL STRUCTURE	3.38	4.63
STABLE CURRENCY	9.23	8.66
INTERNATIONAL TRADE	6.64	6.93
REGULATIONS	4.82	5.44

Source: Center for Entrepreneurship and Economic Development estimates of the *Economic Freedom of the World Index*, authorized by Fraser Institute

[17] The Montenegrin Investment Promotion Agency (MIPA), with the support of the Fraser Institute, the Center for Entrepreneurship and Economic Development (CEED), and the Ministry of Finance of the Government of Montenegro, sponsored an international conference, "Economic Freedom and the Future of the Region," on October 18, 2005, in Podgorica, Montenegro.

[18] Center for Entrepreneurship and Economic Development, www.visit-ceed.org.

Exclusive resort Sveti Stefan located in the middle part of the Budvanska Riviera

B. An Economy in Transition

The breakdown of the Communist Party and the fall of the Socialistic Federal Republic of Yugoslavia in 1989 marked the beginning of the economic reforms in Montenegro. However, wars in the region, refugees, international isolation, NATO strikes, and political conflicts delayed the actual transition process, which finally got going in 1998. The first wave of reforms took place from 1998 to 2002, while the second wave—known as the Economic Reform Agenda, 2002-2007—is still underway.

The key pillars of the new economic system in Montenegro are: a stable currency; an open economy; property rights protection and privatization; a low level of business regulation; and a tax system that encourages entrepreneurship.[19]

B1. The Adoption of the Deutschmark and Euroization

Montenegrins went through a period of hyperinflation after the fall of old Yugoslavia and simultaneous outbreaks of war in two former Yugoslav republics. Inflation rates broke the 100 percent per annum threshold (generally seen as the floor above which hyperinflation reigns). Inflation became such a problem that, at the end of 1993, it reached the incredible rate of 3.5 trillion percent per annum, the second highest rate of inflation in

[19] The reforms, more specifically, have emphasized freedom of contract; implementing the rule of law; increasing economic freedoms; fostering entrepreneurship, private initiatives, and innovations; and promoting a fair treatment of foreign residents in Montenegro. Foreign residents in Montenegro have the same rights as citizens with the exception of the right to vote.

history.[20] It also was the longest period of hyperinflation in history. The stabilization program of 1994 reduced inflation somewhat although it remained at an extremely high level for some time. This resulted in the use of outlawed currencies, such as the deutschmark, in daily transactions.

High inflation, multiple devaluations of the dinar, the USM's official currency, and the development of informal currency markets (more then 60 percent of all transactions used the deutschmark) are the main reasons why Montenegro carried out monetary reforms. The Montenegrin government at the time considered three possible solutions: (a) a currency board, (b) the introduction of a national currency, or (c) "dollarization" (using a foreign currency as legal tender). These monetary reforms, especially the adoption of the deutschmark as legal tender in 1999, were stepping stones in the larger reform process. Adopting the deutschmark was the best way Montenegro could protect its economy from the pernicious monetary practices of Belgrade where dinars were flying off the government printing presses.

As a small, highly open economy with a history of hyperinflation, Montenegro met all theoretical requirements for a successful dollarization.[21] In November 1999, Montenegro adopted the deutschmark as a parallel currency to be used with the dinar. In November 2000, dinars were completely abandoned, and the deutschmark was the only official currency in Montenegro. In January 2002, with the end of the deutschmark, Montenegro switched to the euro.

In spite of the dollarization of the economy and the accompanying loss of monetary policy,[22] some inflation persisted due to inaccurate inflation expectations. The euro provided a strong and stable currency anchor and drove the inflation down into single digits (see figure 3). For instance, instead of the 3.0 percent inflation rate projected for 2005, the actual inflation rate was 1.8 percent. Undoubtedly the introduction of the euro as legal tender in Montenegro significantly reduced inflation and contributed to increased openness. It had a significant impact on the trade and investment flows by lowering the transaction costs associated with international trade.

B2. International Trade

As mentioned above, the second pillar of the economic reforms in Montenegro was to open the economy to international trade. Controlling its own trade policy was one of the ways that

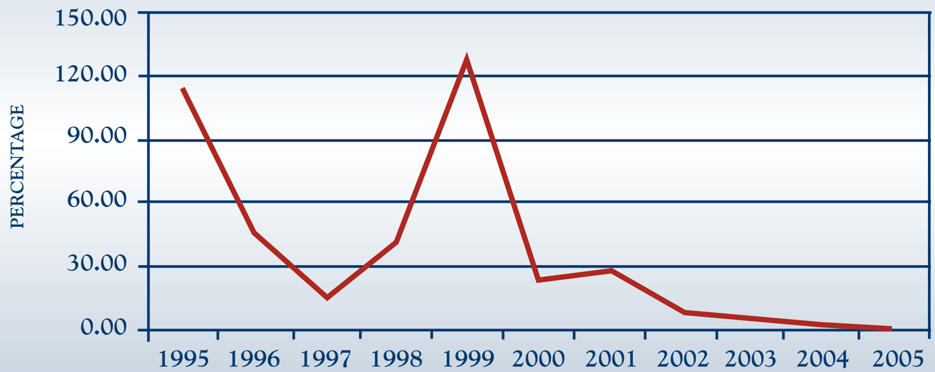
[20] The reported figure is 3,508,091,786,746 percent per annum.

[21] Ricardo Hausmann et al. "Financial Turmoil and Choice of Exchange Rate Regime" (working paper No. 400, Research Department, Inter-American Development Bank, January 1999).

[22] The Montenegrin Central Bank lost its authority to print money, which also meant that the government had lost its ability to use inflation as a policy tool.

FIGURE 3

INFLATION RATE IN MONTENEGRO



Source: Institute for Strategic Studies and Prognoses

the Montenegrin government asserted its independence while still part of the Federal Republic of Yugoslavia.

Striving for openness, Montenegro significantly reduced all customs tariff rates on imports. In addition, it eliminated tariffs on exports and quotas on either imports or exports. However, the signing of the Belgrade Agreement required that Montenegro increase its tariffs on imports, thus raising the average tariff from 2.81 percent to 6.13 percent. This was seen as a step backwards for Montenegrin trade policy. In spite of the EU's pressure to fully harmonize the country's trade policy, Montenegro did not fully implement the plan. Montenegro never increased its tariffs on "56 strategic agricultural products" to Serbian levels. Doing so would have significantly raised the prices of widely used agricultural products and also would have reduced consumers' choices. Consumers would have turned to Serbian products of lower quality since there were no tariffs between the two countries.

In December 2004, while still part of the USM, Montenegro submitted a claim for separate accession to the World Trade Organization (WTO). The WTO accepted the proposal, and on February 15, 2005, negotiations started for the separate accession of Montenegro to the WTO. Montenegro adopted the New Law on Customs in December 2005. This law abolished all remaining non-tariff barriers to trade in Montenegro (such as variable levies and seasonal custom rates). Thus, trade policy was additionally liberalized despite the raise in the average nominal tariff rate to 6.19 percent. (The average tariff on agricultural products is 13.89 percent

Problems with Privatization before 1999

"(1) *Privatisation was oriented toward employees (insider privatisation) and domestic buyers*. No substantial improvements were made to the managment of the enterprises themselves. Instead, the new boards of directors were quite incapable of dealing with the main issues relating to enterprise organisation, restructuring, etc. In effect, managers were put in control but did not bear the consequences of their decisions.

(2) *Privatisation was not transparent enough, particularly in the case of the sale of controlling share blocks and the sale of indivisible enterprise parts*. The inadequate transparency was due to the following: rather vague procedures and rules; "exclusivity" of the process, i.e., giving preference to the existing enterprise management; inadequate information on companies, especially ones that covered up bad debts that the buyers discovered subsequently; non-observance of payment terms; direct arrangements between the funds and buyers concerning the newly made changes.

(3) *Property rights were not adequately protected*. There were many cases in which the employees of enterprises protested when the business was sold and demanded from the new owner more than was stipulated in their contracts or the collective agreement (in terms of wages, job security, and other benefits). Some buyers were prevented by the employees from entering the premises of the companies they had bought, regardless of having full ownership. In cases such as these, the bodies in control of privatisation decided to cancel contracts, often to the disadvantage of the buyers.

while the average tariff on industrial products is 3.83 percent.) The accession to the WTO is a priority of the Montenegrin government, and this accession requires further liberalization of trade policy. However, if Montenegro were to join the EU, it would have to make changes to trade policy counter to the ones in progress.

B3. Privatization, Capital Markets, and the Banking Sector

As in other transition countries, privatization was one of the first steps in Montenegro's reform process. Its privatization process can be divided into two phases. The first phase from 1996 to 1999 used insider privatization as the dominant model. State owned companies sold shares to employees at a discount, and management participated in buy out procedures. That phase didn't deliver the expected results, but it did show that the privatization process required clear and legal institutional foundations.

The new Law on Privatization, adopted in 1999, established the legal foundations. The implementation of this law marked the beginning of the second phase of privatization. Different methods

(4) *Many debates about privatisation cases adversely affected the public image of privatisation*. These debates were brought about by poor information supply (Crna Gora Coop, Danilovgrad), inaccurate and vague contracts (Trebjesa, Niksic), vague procedures (Dr Simo Milosevic Institute, Igalo), and problems of restitution.

(5) *The demand for shares was low*. The privatisation model gave preference to domestic buyers. However, domestic savings were completely depleted in consequence of the long-lived (ten-year) economic and political crisis. Moreover, individuals and some banks were moving a lot of capital outside of Montenegro. At that time, the quality of the Montenegrin banking sector (eight domestic banks and one foreign bank) was low.

(6) *Potential foreign investors were cautious*. Foreign investors were cautious because of the political situation, vagueness of some of the methods of privatisation, inadequate protection of property rights, and general slow conduct of all reforms in Montenegro.

(7) *The institutional and legal frameworks in Montenegro were inadequate for a radical phase of privatisation*. Furthermore, the management of privatisation reforms was excessively dispersed (Economic Restructuring and Foreign Investment Agency, Development Fund, Employment Office, and Old Age Pension and Disability Insurance Fund). Foreign consultants were actually suggesting increased centralisation of, and greater control over, privatisation."[23]

were used for privatizing state-owned companies from 1999 onwards, including mass voucher privatization, international sale tenders, and auction sales of companies' assets. Privatization has had very encouraging results: at the end of 2005, around 80 percent of the total value of capital in the Montenegrin economy was in private hands.[24]

Opening the privatization process to the international community brought many foreign investors to Montenegro, resulting in multiple benefits to the country. Foreign investors brought the capabilities needed to restructure privatized companies, imported new technologies, and signaled the increased attractiveness of Montenegro as an investment destination. During this period, the

[23] See Veselin Vukotic, "Privatisation in Montenegro," *Yugoslav Survey* 1 (Survey S & M, 2003), http://www.yusurvey.co.yu/products/ys/showSummaryArticle.php?prodId=1792&groupId=2440.
[24] Annual Report of Privatization Council for 2005, www.agencijacg.org.

Podgorica is modernizing and growing quickly.

main sources of foreign direct investments were investments through privatization. After a slow down in 2002, foreign direct investments increased in 2003, 2004 and even more in 2005.

In 2005, foreign investment reached 383 million euros, and the per capita foreign direct investment of 589.5 euros[25] is the highest in the region and third highest in Europe (after the Czech Republic and Estonia).[26] Many said that this was largely due to several major privatizations that took place in 2005,[27] but investments continued to grow in 2006. The total amount of investment in Montenegro in first three quarters of 2006 reached 317 million euros. At the end of 2006, it have been 410 million euros (see figure 4).

Mass voucher privatization was a very important step in developing ideas of ownership and private property in Montenegro. More than 90 percent of individuals used their vouchers and became shareholders, either in former state-owned companies or in a privatization investment fund.

Another result of privatization was the rapid development of capital markets. The creation of these markets ended up being one of the conceptual pillars of economic reforms in Montenegro.

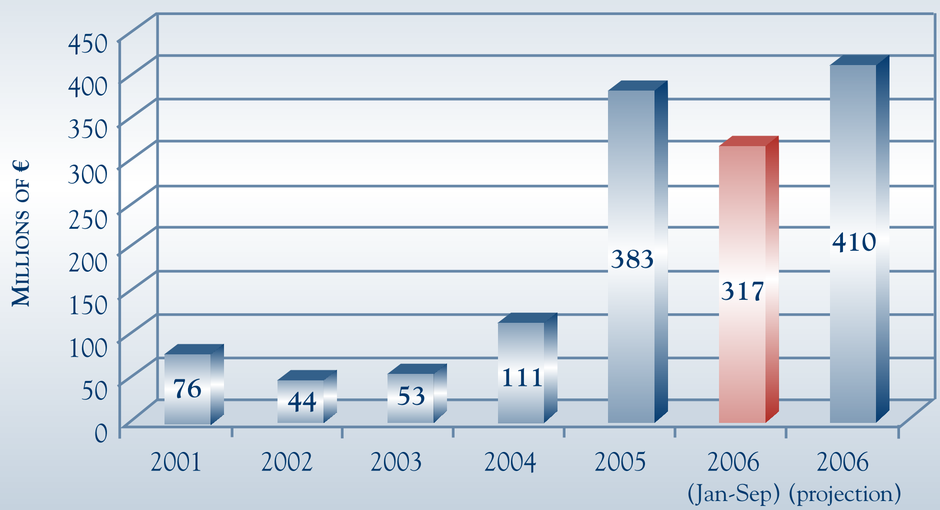
[25] Calculated using data on total amount of FDI in 2005 (383 million euros) from the Montenegro Investment Promotion Agency (MIPA), www.mipa.cg.yu, and data on the population in 2005 (625,082) from Monstat, Statistical Office of Montenegro and ISSP.

[26] In most cases, the problems foreign investors face in Montenegro are related to rigid labor legislation and the long and expensive process of obtaining permissions and licenses to build. See Montenegro Investment Promotion Agency, www.mipa.cg.yu.

[27] These were the privatizations of a telecommunications company and a large aluminum factory.

FIGURE 4

FOREIGN DIRECT INVESTMENTS IN MONTENEGRO



Source: 2001-2005, Central Bank of Montenegro; 2006 estimates and projections, MIPA

Their creation influenced the development of individualism, educated people on the workings of a free market economy, and included as many active participants as possible in the transition processes, all of which were important in the transition of an economy that had been socialist for more than five decades. The rise in the value of capital was a strong incentive for people to sell the shares they had acquired free of charge in mass voucher privatization. Subsequently, many of them saw a good opportunity to earn more money. Bearing the risks, they invested the money they had earned. Many people now trade on the stock exchange every day, have their own brokers, and regularly read stock reports.

The development of capital markets is one of the most successful achievements of the reforms. By volume and in terms of the impact of the capital markets reform, Montenegro leads the region. Over 195,000 transactions have been conducted on the stock exchange since 2001. The value of total turnover for that period is above 423 million euros. New investments into the Montenegrin economy through the purchase of securities exceeded 110 million euros. Market capitalization in August 2006 surpassed the Montenegrin gross domestic product (GDP) and amounted to 1.96 billion euros. Montenegro's newly gained independence had a very positive impact on capital market development: from May

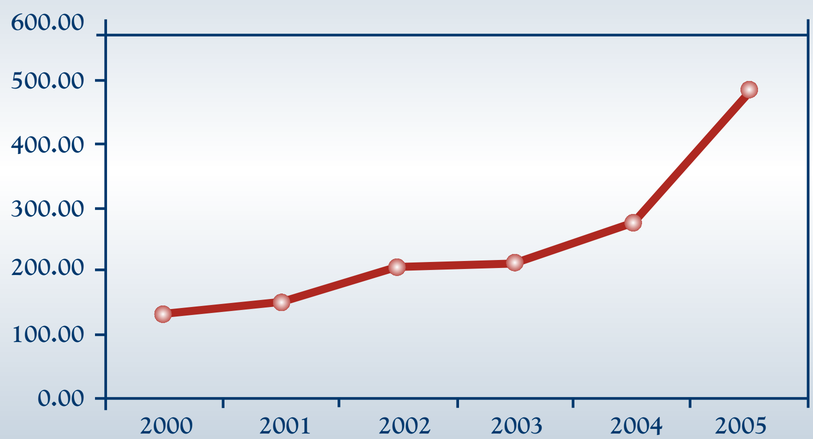
21st until the end of August 2006, the stock exchange indexes rose by about 70 percent.[28]

The completion of the pension system reform will also boost the development of capital markets. Pension system reform started in 2002 and should lead to a three-pillar pension system similar to the Swiss model: a mandatory pension fund, mandatory capitalized pension funds, and voluntary capitalized pension funds. This transition to capitalized pension funds is another very important element of reform in Montenegro because a large deficit caused by public retirement accounts presents a serious structural barrier to general economic development.

The establishment of the Central Bank of Montenegro through the adoption of the Law on Central Bank of Montenegro in 2000 was another major step in reforming the country's monetary policy. The Central Bank has done much to reform the banking sector, including creating a new legal framework to achieve financial stability and completely restructuring the laws governing

FIGURE 5

DEPOSITS IN MILL €

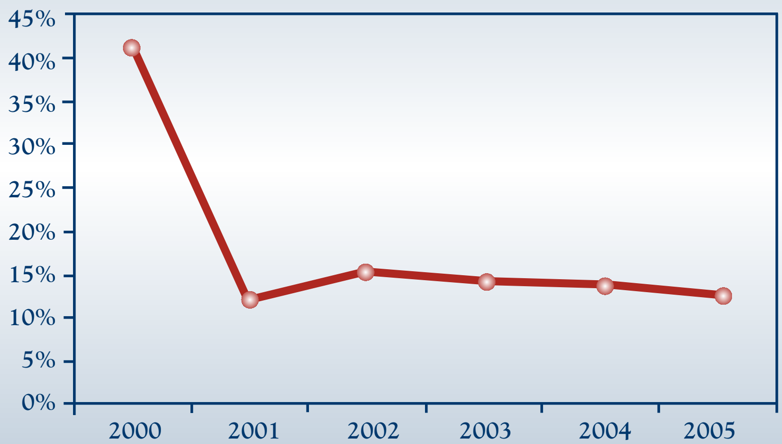


Source: Central Bank of Montenegro

[28] Index MOSTE (price index of companies' shares) rose by 72 percent in that period while Index NEXPIF (price index of investment funds) rose by 74 percent.

FIGURE 6

ANNUAL INTEREST RATE ON LOANABLE FUNDS



Source: Central Bank of Montenegro

the banking sector. All of the newly adopted banking laws are in accordance with the first and second set of Basel principles.[29]

A very important part of the banking sector reform in Montenegro was the successful reform of the payment system. Before the restructuring, all payment operations in the country were centralized and governed by the ZOP (House for Settlement and Payments). Now payment operations are decentralized and transferred to commercial banks. The decentralization drives competition among the banks, which has resulted in lower prices for banking services.

Privatization of the banking sector is now complete. Interest rates are freely determined, and foreign banks have free access to domestic markets, further increasing competition in the banking sector.[30] Since the reforms, there has been a rise in deposits and a fall in interest rates (see figures 5 and 6).

[29] Bank Supervision Department, *Bank Supervision Department Annual Report 2005* (Podgorica, Montenegro: Central Bank of Montenegro, May 2006).

[30] NLB Group (Slovenia) and Société Générale (France) came to the Montenegrin market through privatization. Opportunity Bank with capital from the United States has been in operation since 2002. Recently, Hypo Alpe Adria Bank (Austria) opened a bank in Montenegro, while ITP bank (Hungary) bought Crnogrorska Komercijalna Bank, which was previously owned by domestic private owners.

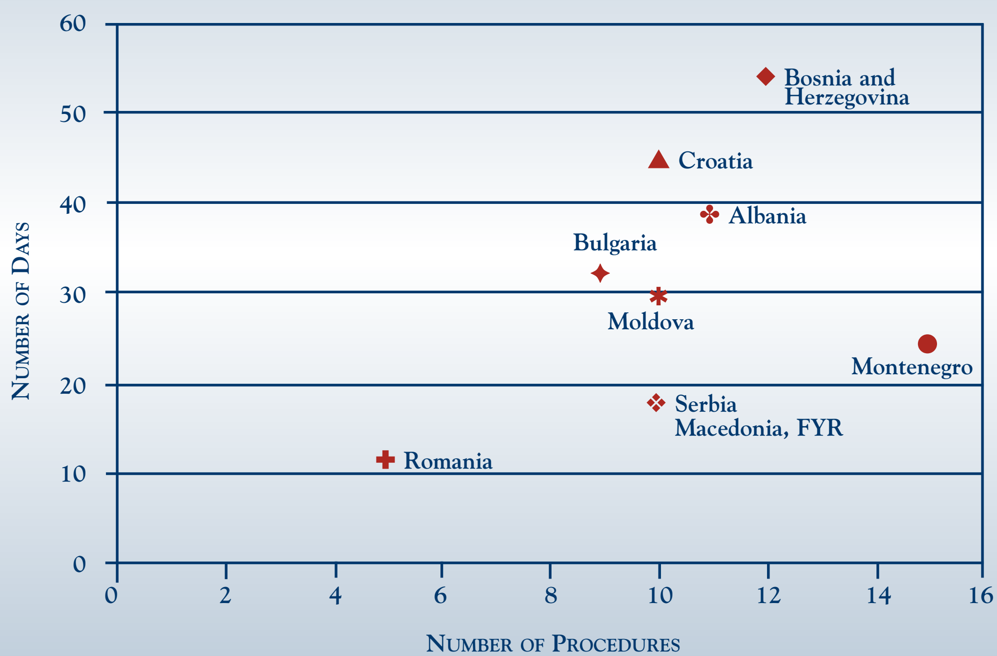
B4. Business Regulation

In addition to pursuing privatization, Montenegro has conducted regulatory reform in order to improve the business environment. The first step toward the deregulation of business was the adoption of the Law on Enterprises in 2001. This law eases business entry and provides incentives for greater entrepreneurship. As a result, business registration became less costly. According to the World Bank's *Doing Business 2007*, these reforms have improved Montenegro's business environment relative to the region, but room for improvement still exists.[31]

According to *Doing Business*, starting a business in Montenegro takes about 15 procedures and 24 days (see figure 7).

Figure 7

Number of procedures and days to register a business



Source: World Bank, *Doing Business 2007*

[31] World Bank and International Finance Corporation, *Doing Business 2007: How to Reform* (Washington, DC: World Bank Group, 2006). See also the "Doing Business" website, http://www.doingbusiness.org.

Another long standing problem in Montenegro was the liquidation of insolvent businesses. In the past, bankruptcy procedures could last more than ten years. The newly passed Law on Bankruptcy simplifies the process by capping the procedure period at eight months.

As it has done with the bankruptcy laws, Montenegro has also made business regulations friendlier to entrepreneurship than they were in the past by changing regulation in the following areas: the status of foreign investors in the Montenegrin economy,[32] the free movement of capital, and tax-free profit repatriation. Montenegro has adopted the euro as its legal currency. In addition, the prices of goods and services are (almost) entirely freely determined.

Moreover, the legal framework in Montenegro seeks to encourage foreign investment. Foreign investors can establish companies and invest capital in the same way as Montenegrins. Foreign investors are given national treatment; the same regulations apply for domestic investors and foreign investors. Also, there are no restrictions on the ability to remit profit, dividends, or interest.

B5. The Tax System

Like many of its other reforms, Montenegro's tax reforms seek to stimulate entrepreneurship,

Montenegrin law permits the establishment of six types of companies:[33]

Limited Liability Company
Minimum capital requirement: €1
Registration fee: €10

Joint Stock Company
Minimum capital requirement: €25,000
Registration fee: €10

General partnership
Two or more people
Minimum capital requirement: none
Registration fee: €10

Limited partnership
Two or more people
Minimum capital requirement: none
Registration fee: €10

Entrepreneur
Minimum capital requirement: none
Registration fee: €10

Part of a foreign company
Minimum capital requirement: none
Registration fee: €10

[32] The legislation is based on the national treatment of foreigners; foreigners have the same rights as domestic citizens, including the right to buy and own land in Montenegro.
[33] See Montenegrin Investment Promotion Agency, http://www.mipa.cg.yu/aktiv.asp?str=startbus.

as well as make the country an attractive business destination. In July 2002, a value added tax (VAT) replaced the old sales tax system.[34] The VAT general rate is 17 percent, with a 7 percent rate for basic food, books, and other commodities.

In 2005, Montenegro replaced its two-tier corporate tax rate of 2002, which taxed corporate profits below 100,000 euros at 15 percent and those above that threshold at 20 percent, with a single flat rate of nine percent, the lowest rate in all of Central and Eastern Europe and one of the lowest rates in the world (see figure 8).

Taxation of personal income is currently progressive, ranging from a tax free threshold at the bottom of the income distribution to a tax rate of 23 percent in the highest income brackets (see figure 9). However, the Ministry of Finance has announced a reduction of the personal income tax schedule and the introduction of a unique, low proportional rate (i.e., a flat tax).

Figure 8

Marginal corporate tax rates of some Eastern European countries

Czech Republic	26%
Albania	23%
Estonia	23% & 0%
Bosnia and Herzegovina	20%
Croatia	20%
Slovakia	19%
Hungary	16%
Macedonia	15%
Serbia	10%
Montenegro	**9%**

Source: PricewaterhouseCoopers Corporate Tax Guide, 2005

[34] The old sales tax system had rates of 15 percent and 24 percent on goods, as well as 12 percent on services.

FIGURE 9

TAX SYSTEM IN MONTENEGRO (2006)

TAX RATES	
VAT	17% & 7%
CORPORATE TAX RATE	9%
PERSONAL INCOME TAX :	
UP TO 785 €	0%
785 – 2,615 €	15% OF INCOME HIGHER THAN €785
2,615 – 4,577 €	€274 +19% OF INCOME HIGHER THAN €2,615
MORE THAN 4,577 €	€647+23% OF INCOME HIGHER THAN €4,577

Source: Ministry of Finance, Government of Montenegro[35]

The Ministry of Finance decided to reduce the personal income tax schedule because a corporate tax rate of nine percent and a concomitant marginal tax rate on personal income of 23 percent would likely create some "boundary" issues. Some taxpayers might attempt to avoid paying taxes on their personal income by re-characterizing their labor income as capital income (e.g., by setting up fake companies). Such boundary issues have been a problem in jurisdictions, such as the Nordic Countries (e.g., Sweden), where capital income is much less taxed than labor. A large difference between personal and corporate tax rates can create incentives that lead to income tax flight and avoidance. As said above, in 2007 and 2008, a 15 percent marginal tax rate on personal income will apply. In 2009, the rate will drop to 12 percent, before finally declining to nine percent in 2010, thereby eliminating the wedge between labor and capital taxation. These policy changes will simplify the tax system and make it more robust by creating a broad-base, low-rate tax system.

[35] See Ministry of Finance, Government of Montenegro, "Economic Achievements and Challenges" (presentation at the Business and Investment Summit, Milocer, Montenegro, October 2006), http://www.ministarstvo-finansija.vlada.cg.yu/.

A horse-drawn work vehicle in a suburb of Podgorica

B6. How Has the Economy Fared?

GDP growth and other results illustrate the impact of the policy changes. GDP was sinking before the reforms (1989-1992) and continued to do so until 1993. However, since the mid 1990s, the trend has been reversing, and the growth of the economy has accelerated in the early 2000s. The growth of GDP between 2002 and 2005 reached almost 15 percent in real terms (see table in figure 10).[36] In 2006, the economy is predicted to grow at the same rate as that of 2005 and perhaps more.

Another important macro-variable is the rate of inflation. Though still double digits until 2001, the inflation rate has since then reduced down to around two percent per annum.

While economic growth has recently been strong, as of 2003 the economy was still below its level from 1989 (see figure 11). This could be used as an indictment of the reforms—i.e., growth has not been sufficient to reverse the contraction of the pre-reform period. However, the comparison between the 1989 and 2003 data must be made with caution. Measurement of GDP in a socialist economy suffers from many problems. The observed GDP in a socialist economy doesn't have the same meaning as the measurement of GDP in a market economy. In other words, the value of GDP was likely overestimated until the 1990s.

[36] The increase in the total estimated economic activity in 2005 was due to higher production within the sectors of tourism (growth rate of 17 percent), retail trade (growth rate of 16.6 percent), forestry (growth rate of 20 percent), shipping and trucking of goods (growth rate of 3.7 percent), and construction (growth rate of 31 percent). On the other hand, industrial production—which represents 21.2 percent of GDP—fell by 1.9 percent in 2005, and transportation was also lower.

Figure 10

Key macroeconomic indicators

	2000	2001	2002	2003	2004	2005	SOURCE
GDP in nominal prices (mil€)	1,022.20	1,244.80	1,301.50	1,433.00	1,535.00	1,644.00	Monstat and Secretariat for Development
GDP per capita in nominal prices (€)	1,668.10	2,023.46	2,107.26	2,310.75	2,465.43	2,638.00	ISSP
Real GDP growth in %	3.10	-0.20	1.70	2.30	3.70	4.10	Monstat and Secretariat for Development
Inflation rate in %	24.80	28.00	9.40	6.70	3.00	1.80	Monstat and ISSP

Source: Monstat (the official statistical office of Montenegro); Institute for Strategic Studies and Prognoses (ISSP); Secretariat for Development, Government Bureau for Development.

C. The Struggle for Change: the Unfinished Reforms

While the reforms have delivered solid results so far, many challenges remain. In the sections below, we examine the challenges of the unfiished reforms.

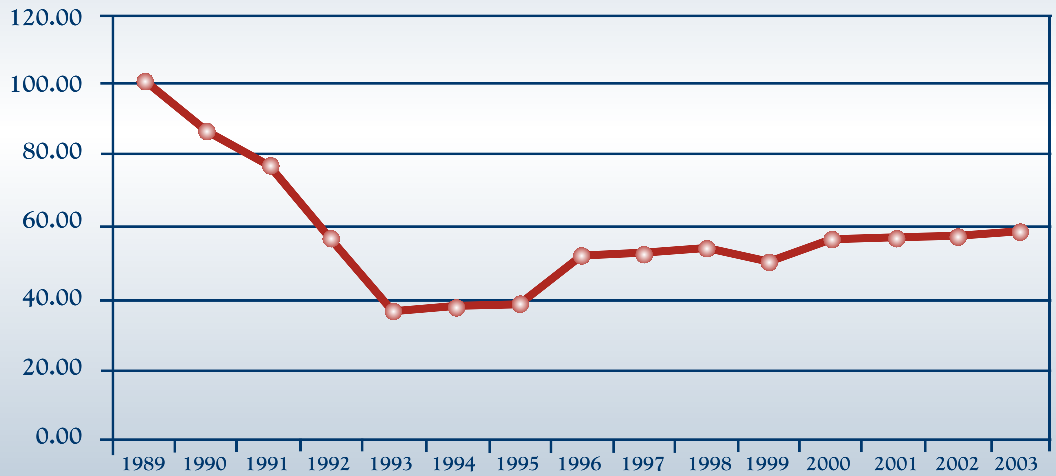
C1. The Sorry State of Public Finances: Balancing the Budget with Foreign Aid

Since the collapse of the Socialist Federal Republic of Yugoslavia, Montenegro has faced budget deficits and short term liquidity problems. After the collapse, Montenegro's GDP decreased, dropping tax revenues. At the same time, demands on the government's budget increased drastically: unemployment was up, state-owned enterprises needed new investment, and large numbers of refugees entered the country. Until 2002, the trend was toward increased government expenditures and smaller tax revenues.

In 2000, the central government's tax revenues amounted to about 21 percent of GDP. Total central government public expenditures (including foreign aid) reached 28.4 percent of GDP while

Figure 11

GDP in Montenegro 1989=100
in constant prices



Source: Institute for Strategic Studies and Prognoses

the deficit represented 7.5 percent of GDP. Although international aid mitigated deficit costs,[37] this situation could not last. Montenegro made balancing the budget a priority, which required responsible fiscal policy, lower government expenditures, and stable tax revenues.

The 2001 adoption of the Budget Law and the Public Procurement Law was the first step in public finance reform. The new budget law established a centralized treasury system operating within the Finance Ministry, which led to increased transparency, better control of government expenditures and costs, and a reduction in corruption. The new public finance law sought to make the budget process more public, transparent, and sustainable in the long-run.

[37] The political changes in Montenegro in 1997 created the basis for direct and sustained financial aid from the international community. Most of this aid goes to balancing the budget. From 2000-2002 the central government received almost 100 million euros in international aid. More than half of this amount was received in 2000 alone. This aid took the form of donations from USAID, EAR, the UN, and governments of foreign countries, etc. Montenegro could not take loans at the time due to it not being an independent country.

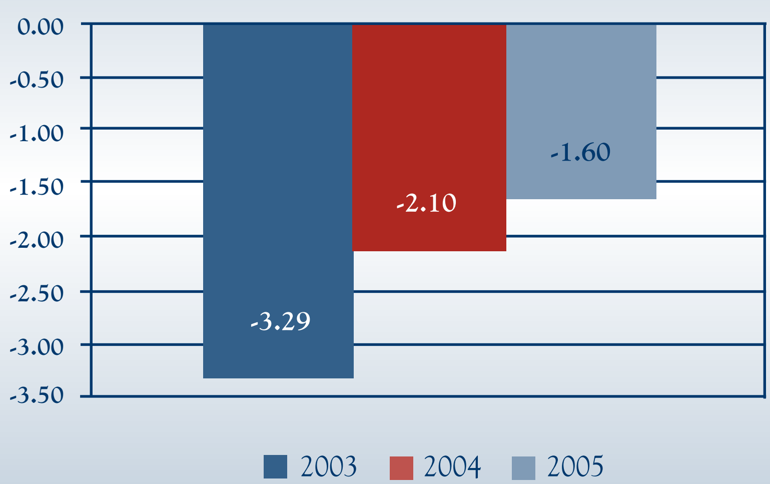
As a consequence of these measures, the central government's expenditures decreased to 20.9 percent of GDP in 2002. The budget deficit was also reduced to 2.1 percent of GDP in the same year. In 2003 the government had limited new lines of spending but increased expenditures for repayment of interest on old foreign debts.

Since 2002, the budget deficit has fallen in line with the IMF recommendations, reaching 1.6 percent of GDP in 2005 (see figure 12). In the first three quarters of 2006, budget revenues amounted to 403.9 million euros, which was 13 percent higher than expected, while expenditures for the same period amounted to 382.4 millions euros, which is almost 2 percent below what was expected.[38] Consequently, Montenegro was projected to reach a budget surplus by the end of 2006.

Despite the fact that public finances are recovering, the share of total government spending relative to GDP remains very high. It amounted to 46.22 percent in 2003, 45.51 percent in 2004, and 45.18 percent in 2005. Predictions were

FIGURE 12

BUDGET DEFICIT AS % OF GDP 2003-2005



Source: Ministry of Finance, Government of Montenegro

[38] Ministry of Finance, Government of Montenegro, “Consolidated Public Spending in Montenegro in the period I - IX 2006,” http://www.gom.cg.yu/files/1160731467.pdf.

made that the budget would reach a surplus of 0.6 percent of GDP by the end of 2006. However, the Ministry of Finance of Montenegro announced that public spending would reach 44.6 percent of GDP by the end of the 2006,[39] not the 43 percent initially planned.[40] Montenegro's failure to reach its target is partly due to the large expenditures of local governments, but the main sources of the high level of public spending are the public services and state administration bodies that remain, due to the socialist past, large employers in Montenegro.[41]

C2. Labor Market Reforms

The government has been reluctant to reform significantly Montenegro's highly regulated labor

CELEBIC is one the most successful companies in Montenegro. Tomislav Celebic, the founder and owner of the company, started the construction business in 1998 at a time when the business environment was not friendly. CELEBIC has built numerous business and residential buildings in Montenegro and is now expanding into other lines of business.

Mr. Celebic thinks that the business environment has improved significantly and is not even comparable with the conditions he experienced when he began back in 1998. However, he still sees space for a lot of improvement, especially the local bureaucracy, which still produces a lot of red tape and unnecessary regulations (e.g., licenses, permits, complicated procedures, and fees). While the central government has made a lot of progress improving business conditions, local municipalities have not.

Moreover, CELEBIC, like any other employer in Montenegro, finds labor regulation very burdensome. A flourishing construction environment requires flexibility in its labor contracts, but this is hardly the case in Montenegro. For instance, when CELEBIC tried to fire an underperforming employee, the current labor law's protection of employees made it less costly to initiate disciplinary action against the employee than to simply fire him.

[39] Ministry of Finance, Government of Montenegro, "Economic Achievements and Challenges" (presentation at the Business and Investment Summit, Milocer, Montenegro, October 2006), http://www.gom.cg.yu/files/1160732245.ppt.

[40] Government of Montenegro, "Economic Reform Agenda 2002-2007" (2005), 19.

[41] See Veselin Vukotic, *Montenegro-Microstate* (International Conference, "Economic Policies for Viable Microstate," Institute for Strategic Studies and Prognoses, Podgorica, Montenegro, 2003), http://www.vukotic.cg.yu/Papers.htm.

Late night coffee establishment on Hercegovacka Street

market. In 2003, legislation was passed that sought to bring more flexibility to the labor market and alleviate employers from the past burdens they've inherited, but the law didn't bring any significant changes.

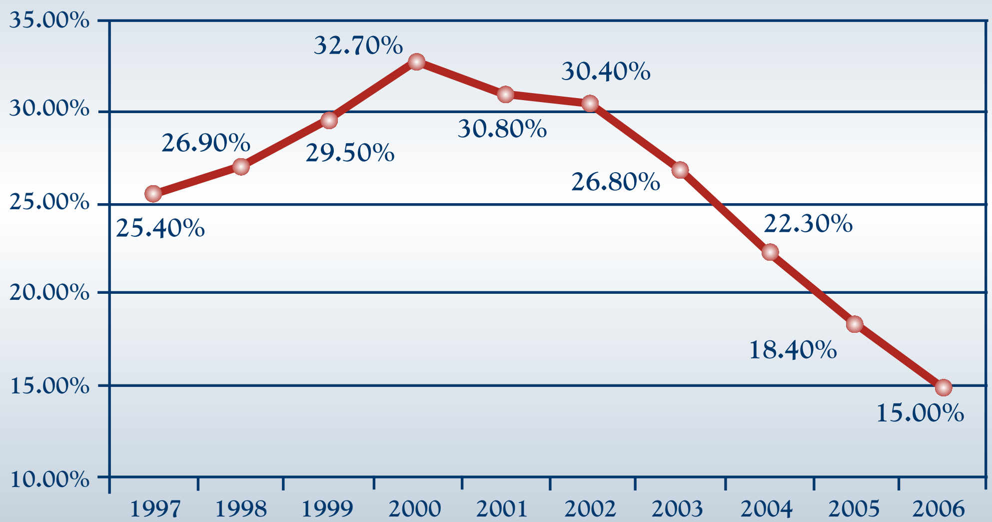
Economies in transition go through the same pattern. During the Soviet era, governments employed most people, directly or indirectly, so unemployment was low. With the transition to a market-based system, unemployment rose, as people were forced out of jobs that the government could no longer support. Because labor reforms initially bring high unemployment, they are not popular. In addition, Yugoslav socialism was based on workers' self-management.[42] This unique institutional setting is still ingrained in people's view of their workplace, reducing the chances for more western-style reforms.

The poor quality of labor statistics in Montenegro prevents reliable analyses of the labor market. However, while different sources report different figures for the unemployment rate, they all show a decreasing trend—the result of comprehensive reforms in other parts of the economy (see figure 13). While Montenegro's rigid labor law remains a serious barrier for employers, tax reforms such as the introduction of tax exemptions and tax reductions helped lower unemployment. In addition, the rise of investment activities resulted in the opening of new places to work, which pushed

[42] In theory, the Yugoslav system was based on collective worker ownership, instead of state ownership, of the means of production. Furthermore, all workers were to be involved in the decision-making process of the firms at which they worked and therefore partially owned the firms. In practice, workers' self-management in Yugoslavia was often in tension with the theory.

FIGURE 13

UNEMPLOYMENT RATE IN MONTENEGRO



Source: Employment Fund of Montenegro, official unemployment rate; data for 2006: unemployment rate in September 2006[43]

the employment rate higher. However, the main source of the increase in the employment number was the official registering of previously unregistered workers.

In the first nine months of 2006, more than 37,000 non-residents received employment in Montenegro.[44] For all of 2005, the number was about 26,000.[45] Whether these are seasonal jobs in tourism, jobs in construction, or permanent jobs, this rising number may indicate that people are finding a better work environment in Montenegro than in other countries of the West Balkan region. Moreover, the number of announced job openings in Montenegro in the first nine months of 2006 was quite close to the

[43] Different sources provide different figures for the unemployment level in Montenegro. The *CIA World Fact Book* reports 27.7 percent unemployment in 2005.

[44] From January 1st to October 2nd 2006, the exact figure was 37,404 according to the Employment Fund, a state agency for employment, whose role is to register unemployed people and give them monthly unemployment compensation.

[45] The exact figure is 25,938 according to the Employment Fund.

number of unemployed people registered with the Employment Fund.[46]

Montenegro faces one more serious problem with its labor market: structural unemployment. Younger people educated in the ways of the new system usually find jobs easily. But older people who worked in formerly state-owned companies have a much harder time finding employment. The Employment Fund is trying to bridge this gap between demand and supply in the labor market by organizing different programs and courses where the unemployed can develop new skills and qualifications.

While the new labor law introduced in 2003 did not bring a major change, it did introduce two incremental changes. First, it reduced the amount of severance pay from 24 times the national average wage to six. Second, under the new law, women can obtain a year of maternity leave with full wage compensation and paid social insurance contributions for every child. The former system gave a year for the first child, 18 months for the second, and 24 months for the third.

Despite these changes, an employer who needs to let an employee go still faces as many hurdles as before. There are four main steps to letting an employee go:

- find another job for the employee (in the same or a different company);
- provide retraining for the employee for the new job;
- pay six months wages to the employee if no other job can be found; and
- pay the remainder of an employee's service if he is within five years of receiving a pension.

These requirements make hiring and firing employees extremely difficult, if not impossible. Thus, labor market regulation remains a huge barrier to doing business in Montenegro.

Labor Law

Official Gazette of Montenegro No. 43/03
Article 3

1. Employees and potential employees are to be treated equally regardless of nationality, race, gender, confession, political or other beliefs, education, social background, property status, or any other personal characteristic.

2. The employer is required to respect the rights and equality of employee, as well as his privacy and dignity.

[46] On October 2nd 2006, the number of unemployed persons, according to the Employment Fund, was 38,734, and from January 1st to October 2nd 2006, the Employment Fund announced 38,254 job openings in Montenegro.

C3. The Informal Economy

Despite Montenegro's substantial economic reforms, the informal economy continues to flourish in many areas, mostly through the illegal import and distribution of excise goods, the selling of goods and services for cash without evidence, non-registered employment, the illegal construction of buildings, and illegal forestry exploitation. All the estimates of the size of the informal economy indicate that it is not small. In spite of efforts to create a favorable business environment and attract businesses into the formal economy, the cost of doing business remains high enough to prevent entrepreneurs from officially registering their activities.

Rigid labor laws, badly designed labor-market regulations, and costly administrative burdens are among the main obstacles to the growth of the formal sector. The existence of an informal sector

In Podgorica, Niksic, Cetinje, Budva, as in many other towns in Montenegro, one can buy cigarettes and chewing gum from people on the streets. Informal vendors usually keep their goods in cardboard boxes, small enough to be portable if the vendors need to run away from the police or from financial inspectors. "The black market, that's how government officials call us," says a 49-year old woman who has been selling cigarettes for more than five years in the main streets of the capital. "They should offer me a job in state administration, and I wouldn't be in the black market any more. I'd have a permanent and secure job. It'd be great."

Street vendors are always ready to pack up their products and move quickly in case of harassment from authorities.

"The state is responsible for me," she explains. "They sold my company, and I was one of the first employees who took the 5,000 deutschmarks.[47] I made them a favor then; they could make me a favor now. Selling cigarettes is not as profitable as it was before."

[47] After privatization, the new owners often offered severance payments to employees who wanted to leave their jobs voluntarily. After the first privatization wave in 1995 and 1996, severance payments usually amounted to 5,000 deutschmarks, a large sum of money for most people. (To put this amount in perspective, if you lived as a non-owner in a state-owned two bedroom apartment in the early 1990s, when the apartment was privatized, you could buy it for around 1,500-2,000 deutschmarks.)

side by side with the formal economy displays the disjoint between the *de facto* rules that people follow in their lives and the *de jure* ones written into law. Informal activities may also display how entrepreneurial individuals can be in spite of the difficulties they encounter within the *de jure* context. It follows that entrepreneurship could be channeled in even more productive ways into the formal economy.

Those in the formal sector, who have to bear business costs such as paying taxes, contributing to health insurance, etc., see the informal sector as a competitive threat. More importantly, the incentives for socially-beneficial activities do not always exist in the informal economy where people may be less inclined to respect property rights. This being said, for a long period the informal economy was the only way for many in Montenegro and Serbia to prosper, which is why the government has tolerated the informal sector for so long. It was only after the reforms took hold that the informal economy became an undesirable part of the economy. It will be difficult for everyone to move into the formal sector, especially as the informal economy is a consequence of the problems in the Montenegrin economy, not the cause. The only solution is for the government to continue reducing the costs of doing business in the hope that the lower costs encourage most informal entrepreneurs to register their business activities in return for the inherent benefits of participating in the formal economy.

C4. Doing Business in Montenegro

Montenegro has greatly improved its business environment in the last few years. It is now the "champion in the region in registering new businesses."[48] However, obstacles still exist, and many unregistered businesses continue to operate.

According to the Center for Entrepreneurship and Economic Development, the main barriers to doing business in Montenegro in 2000 were frequent changes in the law, administrative burdens, and the informal economy.[49] In 2002, the same survey identified bureaucratic procedures as the main obstacle for businesses. Taxes and levies also appeared to be a barrier to businesses, a situation that improved in 2004 with the tax reforms.

Access to financial markets and the protection of property rights are also seen as problems for businesses. Access to financial markets is gradually improving. Further improvement is crucially dependent on the definition and enforcement of property rights, which is dependent on reform of the judiciary.

[48] Ministry of Finance, Government of Montenegro, "Doing Business in Montenegro," http://www.ministarstvo-finansija.vlada.cg.yu/vijesti.php?akcija=vijesti&id=9301.
[49] Center for Entrepreneurship and Economic Development, "*Barriers to Doing Business in Montenegro*" (Podgorica: CEED, 2000).

Figure 14

Starting a business

Indicator	Montenegro	Serbia	Estonia	New Zealand	USA
Number of procedures	15	10	6	2	5
Time (days)	24	18	35	12	5
Cost (% of income per capita)	6.6	10.2	5.1	0.2	0.7
Min. capital (% of income per capita)	0	7.6	34.3	0	0

Source: World Bank, *Doing Business 2007*, IBRD/WB, Washington, DC, 2006.

The *Doing Business 2007* database, which compares business regulations in 175 economies, shows that Montenegro still lags behind Serbia, Estonia, New Zealand, and the United States in terms of the number of procedures and the number of days (with the exception of Estonia) to open a business (see figure 14). The cost of the whole process is also higher than in Estonia, the United States, and New Zealand.

Another issue is the barriers that exist at the municipal level. While the central government has been improving its business legislation, local administrations, who have not yet realized the benefits of light regulation, have implemented an assortment of special fees and licenses required to open businesses.

C5. The Legacies of the Past

While the reforms that have taken place in Montenegro in recent years have delivered positive results, many challenges to reform in Montenegro still remain. Many formal rule changes do not necessarily reflect the way people actually arrange their lives. After all, "rules are only rules if customary practice dictates."[50] Policy

[50] Pete Boettke, "Why Culture Matters: Economics, Politics, and the Imprint of History," *Nuova Economia e Storia*, no. 3 (September 1996): 189-214.

discussions often neglect the cultural change needed to pull a country through a transition, but cultural change can be one of the most important factors in a transition. If the underlying culture does not support the policy changes, the changes will not be effective.[51]

Generations grew up in the labor self-management approach to socialism that was unique to Yugoslavia. Although that system is often seen as a fusion of socialism and the idea of western markets, the state would bail-out unprofitable companies and people could never lose their jobs. The government would not only guarantee salaries and positions, but would also pay for housing and other aspects of life. Because the social system provided job security and benefits, those who grew up in the system find it hard to give it up.

Yugoslavian workers' self-management bred a labor culture that was distinct from that of the Soviet Bloc, but at the end of the day, the systems shared the major trait of "we pretend to work, you pretend to pay us." A general cultural shift towards reform started in the late 1990s. During this time of international isolation, NATO bombings, and severe political and economic crises, people started to realize that the economy needed new investments and a better managed government.

Svetozar Pejovich, who has written on the transition economies of Eastern and Central European countries with close attention to the cultural aspect of change, has great insight into the Montenegro experience when he says:

> Since informal rules are not a policy variable, transition has to mean the enactment of new formal rules; that is, constitutions, statutes, common law precedents, and/or governmental regulations. The results of transition then depend on the interaction of new formal and prevailing informal rules. Of course, the rules do not interact. Individuals do. New formal rules create new incentives and opportunities for human interactions. How individuals react to those new opportunities for exchange depends on how they perceive them. And how individuals perceive new opportunities depends on the prevailing culture.[52]

For example, privatization, one of the first steps in the reform process, meant that employees had to give up all the benefits the state had formerly given. Because of the culture in which they had lived for so long, workers, who had enjoyed guaranteed jobs and other benefits, and managers, who were used to running companies without the risk of losing their jobs, perceived privatization as a threat without concomitant benefits.

[51] Luigi Guiso, Paola Sapienza, Luigi Zingales, "Does Culture Affect Economic Outcomes?" (working paper 11999, NBER, February 2006), http://www.nber.org/papers/w11999.
[52] Svetozar Pejovich, "Understanding the Transaction Costs of Transition: It's the Culture, Stupid," *The Review of Austrian Economics* 16, no. 4 (December 2003): 348.

Architectural detail from the medieval town of Kotor

The *de jure* rules had changed, but the *de facto* norms hadn't. Before Montenegro adopted privatization in 1999, workers organized strikes. In order to keep social peace, the government tended to fulfill all of the workers' conditions (keeping their jobs safe, certain salary levels, etc). As many new investors couldn't accept these conditions, they simply broke their contracts and left Montenegro. Many workers opposed to the privatization and the transition processes found these departures encouraging. Even after almost a decade of reforms, worker strikes and protests continue to interfere with the enforcement of property rights. For instance, workers for the company Lovcen AD refused to accept its new owner and did not go to work for two full years after it was privatized.[53]

Others have argued that the market space and the social community space, often seen as opposing forces, actually act in conjunction with each other and foster each other's strength and diversity.[54] Cultural rules that permeate the social sphere overlap with and have great influence on the structure of the market. When viewed this way, culture becomes an even more important factor to consider when changing or constructing policy.

Granting credible property rights to people may help change their beliefs about the market s ystem.[55] One of the important outcomes of the privatization process in Montenegro was that more than 90 percent of the adult population used vouchers, exchanging them for shares in the

[53] Veselin Vukotic, *Privatization in Montenegro* (Vienna: The Vienna Institute for International Economic Studies, 2001), http://www.wiiw.ac.at/balkan/files/Vukotic.pdf.
[54] Virgil Storr, "The Market as Social Space" (working paper, 2006).
[55] Rafael Di Tella, Sebastian Galiani, and Ernesto Schargrodsky, "The Formation of Beliefs: Evidence from the Allocation of Land Titles to Squatters," *Quarterly Journal of Economics* (forthcoming).

privatized companies or for investment units (later transferred to shares) of privatization funds (which later became investment funds). Montenegro used this method of privatization more than any other transition economy. Mass voucher privatization helped make privatization understandable and acceptable to people in Montenegro. While attitudes towards privatization were negative before the mass voucher privatization, they improved afterwards, and the media campaign behind the mass voucher privatization program very effectively showed the ways in which people could benefit.

The development of capital markets was another very important way in which people started to accept the market order. One of the goals of the privatization process was to develop a so called "ownership democracy"[56] by involving as many people as possible as active participants in transition. Despite capital markets not being very active in the beginning, with reforms in other areas of the economy, the number of transactions started to rise, first slowly and then rapidly. Both foreign investors and ordinary citizens are actively trading in the capital markets. The possibility of gaining profits, and also of incurring losses, will help people develop a sense of ownership and responsibility over their own money.

Still, the legacies of the socialist past are visible in the differences in cultural attitude between the younger and the older generations. The generation gap in Montenegro is big and manifests itself especially in the attitude towards the free-market. Transitioning from a socialist economy to a free-market oriented economy entails more than just a *de jure* change in the institutional setting. The

Jelena, a 22 year old law student, also sells cigarettes in the streets. Beside cigarettes, she also sells hand-made jewelry—earrings, rings and necklaces—which is very popular among young people. "You are not from financial police?" she asks. "Great! Because I don't have a license for selling here." This job is a way for Jelena to earn some extra money. "I just want to finish school, and then I'll try to get a loan to start my own store of hand-made jewelry. You see, I am making these. Of course selling cigarettes is not that bad too, but I am worried that inspectors will take my stuff if they catch me. I was thinking of obtaining a license and a counter in the market place. But this way my stuff is cheaper, and I have regular customers. I'll obtain a license some day, and afterwards I'll open my store as soon as I am finished with school. I don't want to end up in a bureaucracy. I don't want to become a boring administrative moth."

[56] Vukotic, *Privatization in Montenegro.*

transition process can only be realized if changes in mental models and ways of thinking occur as well. The younger generation is growing up in a different atmosphere, which will pave the way for future changes. For instance, most capital market firms in Montenegro employ people who are younger than 30, creating a fast moving culture of people who understand capitalism and markets.

The way out of the trap is entrepreneurship. Instead of aiming for a policy objective or trying to affect culture through policy, the government must allow a business environment that permits entrepreneurs to take the risk of defying cultural norms. Rules of the game that allow such risk to be taken are very important.

The creation of a favorable business environment is an ongoing process. When new businesses come to life, they reinforce that process. As Pejovich and Vukotic explain, the "most important role of new private companies is that they create a culture of capitalism in areas where that culture did not exist. Companies are making a feeling of ownership, a feeling that individuals, not the community, have rights and liabilities, that individuals and not the community have an economic life, a feeling of self-initiative, self-responsibility, self-decision making and the acceptance of risk. Together those are the characteristics of the culture of capitalism based on individualism."[57]

D. The Birth of the First Mediterranean Tiger?

Montenegro covers a surface of 13,812 sq km (5,331 sq mi) and has a population of 617,740, making it a very small state both in size and population.[58] People have often used Montenegro's small size as an argument against its self-sustainability—especially when it comes to independence. This argument ignores evidence from other places. Estonia and New Zealand are two small countries that have carried out reform programs, which could be inspiring for Montenegro.

The case of Estonia is especially similar to that of Montenegro as the two countries seem to follow a similar path a few years apart with some differences in the sequence of events. After regaining its independence in 1991, Estonia started its reform process. The new Estonian government[59] pushed through a range of economic reforms based on privatization, deregulation, and a fundamental restructuring of the economy.

[57] Svetozar Pejovich and Veselin Vukotic, *Transition and Institutions* (Belgrade: Institute of Social Sciences, 2002). See paper no. 175, http://www.vukotic.cg.yu /Papers.htm.
[58] The Census was held in 2003.
[59] The Estonian government was quite young. The Prime Minister was 33 years old, and the youngest minister in the Cabinet was 27 years old.

In June 1992, Estonia introduced the kroon, the new national currency. [60] The kroon is pegged to the euro under a currency board agreement.[61] In addition to its monetary framework, Estonia also owes a large part of its success to the creation of a favorable business environment based on tax reforms and the abolition of all tariffs and other barriers to international trade. Moreover, in 1994 the Taxation Act created a new across-the-board income tax rate of 26 percent, replacing the previous three-tiered progressive income tax scale. The tax rate has now been reduced to 23 percent. The government taxes profits only when they are paid to shareholders as dividends (i.e., the marginal tax rate on reinvested corporate profits is zero), making it attractive for Estonian companies to reinvest their profits. All this fostered foreign direct investment.

D1. Labor Market Reforms in Estonia and New Zealand

Following privatization, property reform, and the

The experiences of Estonia and Montenegro during the socialist era were different. However, five decades of heavy government planning and labor self-management have strongly influenced the way people think in both countries. In order to succeed in the transition, Estonians' mental model had to change. This was an essential part of the reforms. As Mart Laar, the ex-Prime Minister of Estonia and one of the creators of the Estonian economic reform program puts it:

> "The most basic and vital change of all, however, had to take place in the hearts and minds of Estonia's people. Without a major readjustment of attitudes, the postcommunist predicament would become a trap, and the nation would never move forward to become a "normal" country with a free government and free markets under law. In the era of Soviet-imposed socialism, most people withdrew into a kind of private quietism; associations seldom extended beyond small circles of relatives and close friends, and the public realm was dominated by the communist party-state and its enforced conformities. People were not used to thinking for themselves, taking the initiative, or assuming risks. Many had to be shaken out of the illusion—common in postcommunist countries—that somehow, somebody else was going to come along and solve their problems for them. It was necessary to energize people, to get them moving, to force them to make decisions and take responsibility for themselves."[62]

[60] The Currency Law of the Republic of Estonia.
[61] At rate 1 EUR = 15.6466 kroons.
[62] Mart Laar, "Estonia's Success Story," *Journal of Democracy* 7, no. 1 (1996).

Figure 15

Unemployment rates in Estonia (%)

1993	1994	1995	1996	1997	1998	1999
6.6	7.6	9.7	9.9	9.6	9.8	12.2
2000	**2001**	**2002**	**2003**	**2004**	**2005**	
13.6	12.6	10.3	10.0	9.7	7.9	

Source: Estonian Statistical Office[63]

growth of private enterprise, Estonia quickly reformed its labor market regulations. In 1990 around 95 percent of the labor force worked in state-owned companies and on collective farms. Private cooperatives or private farms employed only 4.3 percent of the labor force. The Privatization and Employment Contracts Act adopted in 1992 has proved a success, as it reduced the burden of regulation for employers.

For example, when workers in Estonia are laid off, they receive only four months pay if they have been employed by a company for more than five years and only two months if employed for less. This contrasts sharply with the required 24 months of severance pay in Montenegro and other stringent obligations, making Estonia clearly a more desirable location for employers.

As one would expect, Estonia first experienced an increase in unemployment since the labor market was reformed in 1992 (see figure 15). However, the economy is now creating real jobs that are absorbing many of the unemployed workers. Since 2000 the unemployment rate has been steadily declining. Most governments know that a reform of labor regulations is likely to lead—in the short to medium run—to a rise in the unemployment rate, which is why they generally eschew labor market reforms. However,

[63] Estonian Statistical Office, "Annual indicators of Estonian economy," http://www.eestipank.info /dynamic/itp2/itp_report_2a.jsp?reference=503&className=EPSTAT2&lang=en

Montenegro should follow the example of Estonia and liberalize its labor laws in order to reduce the costs to employers of laying off redundant workers and to make it easier to fire workers who are guilty of negligence or unprofessional conduct. The best way to do this is to explain to the population that the unemployment rate will rise in the short run while the economy is being improved. In the long run however, everyone will benefit from a better labor market, reduced unemployment, and the creation of real jobs.

Similar reforms took place in New Zealand, which had very regulated labor markets. In 1991, the government implemented the Employment Contracts Act. Among other things, the act allowed most industries to replace centralized bargaining with decentralized enterprise (or individual) bargaining. It gave employees and employers a choice of individual employment contracts or collective ones. The parties did not need a special agent, such as a trade union to represent them in negotiations. In many cases, individuals chose to represent themselves.

The Employment Contracts Act, alongside other reforms, had an enormous impact. The unemployment rate fell from 11 percent in 1991 to six percent in 1996 and to less than four percent by 2004. During this period, the nature of contracts changed dramatically: multi-employer contracts virtually disappeared, and direct contracts between employer and employee became the norm. The labor market became much more flexible and responsive to the needs of firms and individuals.

While the 1991 Act improved the labor market situation, it contained some restrictions on contractual freedoms that worsened over time. Moreover, the Labor-led government elected in 1999 repealed the act and replaced it with the Employment Relations Act (ERA), which introduced restrictions on the ability of entrepreneurs to contract out for labor services and facilitated collective bargaining and multi-employer agreements.

Montenegro is in a similar situation to Estonia and New Zealand in early 1990s. It should use the labor legislations passed in these two countries as models and implement labor laws that would respect freedom of employment contracts, which would eventually reduce unemployment and make Montenegro more competitive in international markets.

D2. Public Finance and the Structure of Government: The New Zealand Model

Montenegro also needs to improve the way it spends money. Many countries in the world have, in the last two decades, streamlined their government processes and reformed the incentives bureaucracies face. The transition to a modern, small, and open economy requires a deep transformation of the workings of government. The Montenegrin government should limit itself to what governments do best, instead of being the major economic actor in the country. Restructuring the government should make it more efficient and more accountable, thereby ensuring that it uses its resources better, which will yield better outcomes for the intended results.

New Zealand was one of the first countries to strive for these goals and serves as good model for Montenegro, for not only is it a small country, but it was heavily regulated before the start of the reforms in 1984.[64] At the end of the 1980s, the New Zealand Parliament adopted the State Sector Act and the Public Finance Act, and in 1994, Finance Minister Ruth Richardson introduced the Fiscal Responsibility Act. The State Sector Act focused government on the efficiency and effectiveness of public service management and performance. The act introduced a structure aiming at reproducing the incentives found in the private sector especially in the process by which government departments are managed. The Public Finance Act replaced an input focused system for controlling government spending with an output-focused one. By further rationalizing government spending decisions, the Public Finance Act helped departments be more responsible with taxpayers' money. For example, whereas under the old system all spending increases were indexed, departments now must prove that nominal spending should be increased because cost increases outweigh productivity gains. This helped reduce government spending by constraining increases in non-indexed government spending.

While the Public Finance Act focused on how individual departments spent money, the Fiscal Responsibility Act provided rules for the conduct of fiscal policy. Its goal was to improve policy by establishing principles of fiscal management and strengthening reporting requirements. The Fiscal Responsibility Act contributed to the fiscal stabilization of New Zealand during the 1990s. The increased transparency of the government's short-term and long-term fiscal intentions and the high standards of financial disclosure improved government's incentives. Since 1993, the New Zealand government has consistently run budget surpluses. Moreover, net public debt in 2004 was down to approximately 10 percent of GDP (from more than 50 percent 10 years earlier) and was forecast to decline further in the years to come.

While the New Zealand experience is not perfect, it should serve as a guide for Montenegro's reform. First, reformers should push for more efficiency in public service management. Second, even if progress has taken place in public finance reform since 2001, more needs to be done to reform government spending.[65] Third, reformers should constrain fiscal policy by using adequate incentives.

While reforming government structure and fiscal incentives is necessary in a transition, it is not enough. As the experience of New Zealand shows, reforming government improves the use of public resources, but it may still leave the size and

[64] See Frederic Sautet, "Why Have Kiwis Not Become Tigers?" *The Independent Review* 10, no. 4 (2006): 573-597.
[65] See also "Shadows at Europe's Heart," *The Economist*, October 14, 2006, 58. As *The Economist* puts it: "For all the strides made in the past years, the sad truth is that no ex-communist country has fully reformed its public administration. Voters may be richer, but they also feel cheated and put upon by bossy bureaucrats and snooty politicians."

A billboard in the capital showing reaction to the European Union. The billboard depicts Ljubo Cupic—a World War II hero who was executed by the Nazis—in handcuffs with the EU symbol.

scope of government untouched. The government in Montenegro should also reduce its size and scope, reducing public spending and devolving part of its activities to the private sector.

D3. The European Union Option

Many economies in transition in Eastern and Central Europe see joining the EU as one of the main goals of their reforms, but this goal might not be the optimal solution to solving some of their problems. Many countries within the EU (especially the founding countries such as France, Germany, and Italy) are not in great shape. Budget deficits are ever present; public debt is growing; welfare systems are in crisis; pension systems are on the verge of bankruptcy; and real growth rates are small on average. Moreover, since the Maastricht Treaty was signed in 1992, the European project has gone from mainly a free trade zone (i.e. the European Community) to a political and monetary union (the EU). In essence, the EU has become a supra-national government, which legislates endlessly in order to harmonize the economic conditions of its member states.

Under these conditions, it is not clear what the small transitioning economies of Eastern and Central Europe would gain from joining the EU. While it is true that Estonia joined the EU in 2005, it remains to be seen what the influence of the EU will be on the Estonian economy. Montenegro has already felt the influence of the EU in its relations with Serbia when the EU forced it to reform its economy through harmonization, which was clearly not beneficial to the people of Montenegro. What would happen then if a small state like Montenegro were to implement the 120,000 pages of EU legislation?

Like most ex-socialist countries, Montenegro views joining the EU as an ultimate goal of transition. People see the EU as a panacea—a solution for all their problems. It is widely believed within Montenegro that the country should make every effort to become an EU member as soon as possible. However, some people are raising the issues of the real effects of EU accession—its benefits and costs—as well. Moreover, Montenegrins are debating how much time it would take before they could join the EU and how they should use that time to enhance their country.

Montenegro is not alone in the Western Balkan Region in facing the choice of whether to join the EU.[66] The countries could join separately (in independent procedures, one by one) or form some kind of regional integration first, and then, after considering the pros and cons, join the EU. However, the history of war and conflict in this region does not lend itself to the idea of regional integration. Besides, at this point, the level of integration in this area remains small, even among neighboring countries.[67]

Considering the requirements to join the EU and the present political and regional conditions, joining the EU will be a painful process.[68] This holds true even though some see the accession to the EU as an inevitable future for the countries in the region. In light of this, the countries could use the period until accession to foster some kind of regional integration based on light business regulation, low taxes, and freedom of trade and migration. This would undoubtedly attract investors to the region and would foster economic development. If Western Balkan countries were to follow through with this process, then the idea of joining the EU would likely be not as attractive as it is today.[69]

D4. The Constitution of a Free Micro-State

Focusing on the size of Montenegro and the size of its public expenditures, Professor Veselin Vukotic proposes a potential solution for further economic development in Montenegro: Montenegro as a free microstate. In a microstate, the "state plays a

[66] The term Western Balkan refers to five countries of the ex-Socialist Federal Republic of Yugoslavia (Croatia, Bosnia and Herzegovina, Serbia, Montenegro, and Macedonia) and Albania.

[67] See EM Team, "Benefits for All" (*Ekonomist* magazine's conference on regional economic union in former Yugoslavia, "Regional Economic Union in the Former Yugoslavia: Inevitable or Optional" Nov. 14), http://www.ekonomist.co.yu/eng /magazin/broj_339/eid1.jsp ; and Claudia Grupe and Sinisa Kusic, "Integrating the Balkans—Promoting Competitiveness?" *South Eastern Europe Journal of Economics and Business* (University of Sarajevo, School of Economics) 2 (2006): 6-19.

[68] Another issue exists and needs to be considered. *The Economist* explains that joining the EU is accompanied with a tacit agreement to become a member of the Monetary Union ("An Uncommon Current: East European Countries are Struggling to Join the Euro. What if They Give Up?" *The Economist*, November 16, 2006). Countries should thoroughly examine whether they want to give up the freedom to change base currency for their currency board or to adopt any currency they like.

[69] Veselin Vukotic, "Internal Globalization of Western Balkan" (paper presented at an Economic Forum in Milocer, Montenegro, 2006), http://www.vukotic.cg.yu /Papers.htm.

minimal role in the economy and has limited political power."[70] As the share of public consumption in GDP and the level of economic freedom show, Montenegro still leans towards its communist past. In contrast, Vukovic argues that Montenegro should consider another path: the "key idea of the microstate is to build, instead of a paternal and all over present but weak state as we have now, a minimal but efficient state."

A microstate must be open to remain innovative and offer the best environment for the growth of business firms. Moreover, because the internal market is small, openness is a necessary condition to the success of the micro-state.

At a practical level, this means that Montenegro should keep the euro as its official currency in order to keep the traditional levers of monetary policy out of the hands of its government. The country should aim at abolishing all tariffs, quotas, and other barriers to trade. Taxes should be further reduced and the tax base enlarged as much as is economically feasible in order to limit the distortions arising from tax policy and attract foreign direct investment.

The organization of the government and its administration should follow the principles New Zealand established almost 20 years ago:

- output-focused public spending (Funding is based on results to be obtained, not the inputs to be used.);

- fiscal discipline (Public spending remains within the tax base while maintaining a fast growing economy.);

- responsive administration in the service of the public (Department managers are accountable for their decisions.);

- transparency (Government implements its decisions openly.); and

- professionalism (Civil servants are part of the general labor market instead of being a separate caste.).

Montenegro may need to change its constitution in order to create the right government structure. Constitutional change would also enable Montenegro to deal with two problems that characterize many transition economies:

1. a relatively weak Parliament and a strong executive (which allows special interest politics to dominate the public scene) and

2. a relatively weak civil society under the power of a strong executive.

[70] See Veselin Vukotic, "Montenegro-Microstate" (International Conference "Economic Policies for Viable Microstate," Institute for Strategic Studies and Prognoses, Podgorica, Montenegro, 2003), http://www.vukotic.cg.yu /Papers.htm.

The Millennium Bridge, opened in 2005, has become one of Podgorica's most prominent landmarks.

As Vukotic puts it, the

> "real power is in the leading committees of the political parties in power. The president's parties or even presidents of parties in ruling coalition are the people with the greatest power in Montenegro today . . . If executive power is dependent on the will of political parties, it cannot implement the "rules of the game" impartially and transparently. Is anybody in the executive power courageous enough to fire 5,000 people and to expect the victory in the next election?"[71]

If Montenegro bases the concept of further economic development on the idea of a microstate, there are a few political structure options available to achieve this outcome. One of those options is a presidential system that, while not necessarily guaranteed to provide the desired micro-state outcomes, might be more in line with the culture of Montenegro.[72] Professor Vukotic proposes this solution as an integral part of the concept of a microstate, mostly as a method of controlling public spending. However, presidential systems have not always been the key to successful public management in other countries. Rather, what has mattered in places such as New Zealand was the quality of their laws on public finance and a much improved governance structure.

[71] Veselin Vukotic, "Presidential System in Microstate," (Liberty Fund Colloquium, Bozeman, Montana, 2005), http://www.vukotic.cg.yu /Papers.htm.

[72] This system would resemble one in which the president is elected by popular election and is free to control the executive powers of the government. The parliament would be elected separately and control the legislative power of the government.

Now that Montenegro has gained its independence, crucial constitutional decisions lie ahead. While constitutional issues attract some attention, most of the debate is focused on short-term daily political topics mostly inherited from the pre-referendum period. If Montenegrins want to reap the benefits of further reforms, decision makers will need to tackle the larger constitutional questions.

CONCLUSION

Montenegro is unique among the Central and East-European countries that are transitioning from communism. It is one of the few economies that started a reform process while still part of a larger union. It is the only European country in transition that uses the euro as legal tender. Montenegro gave up all levers of monetary policy and successfully fought inflation. Last but not least, it is the first independent country of the 21st century. It was not born in a revolution or in a war, but established using democratic means: the polls.

Significant economic reforms were started in the late 1990s, and the results have been encouraging. In 1993, while Montenegro was still part of Yugoslavia, inflation was measured in millions of percentage points. The inflation rate is now less than two percent. The euro as legal tender is attractive to tourists and foreign investors. Tourism has become a very important sector as the economy strives to exploit the advantages of Montenegro's natural beauty and unspoiled environment and is poised to become one of the most important levers of development for the country. The privatization process delivered satisfying results, especially as it led to the development of capital markets. Other policies improved the costs of doing business in the country, especially in comparison to some of its neighbors—including some EU members. Finally, the tax system has become much less complex and favors investments and profits—with a single digit flat corporate tax rate of nine percent.

The vote for independence in 2006 took place after the government had enacted many significant reforms. However, if Montenegro is to take advantage of its current situation, it still needs to make further reforms. The enthusiasm and energy liberated after Montenegro became a sovereign state can be used to continue the reform process in the right direction. While in the past, reforms (with their successes and failures) were driven at a supranational level, now Montenegro can take full responsibility to finish the process of social change.

The experiences of countries such as Estonia and New Zealand are valuable resources for Montenegro as it continues to address its problems. Montenegro stands to benefit from policy reforms such as: reforming the structure of government (i.e., addressing the problem of the huge public administration inherited from the socialist system) and constraining its spending and size; reducing labor market regulations; continuing to improve business regulations; and following through with the plan to lower taxation on personal income, bringing those taxes in line with the taxation level on corporate profit. Since many obstacles remain in place because of local governments, they should also be included in the reform process.

Finally, Montenegro faces two main political challenges. First, its leaders will have to decide whether to join the European Union. Second, it must decide whether to implement constitutional changes to overcome the structural political difficulties that are the legacy of years of socialism.

While its challenges are great, so is Montenegro's potential. A newly independent and vibrant country, if it follows best practices in the process of reform, Montenegro could build and strengthen its institutions and become the first Mediterranean tiger.

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