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COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

MONTENEGRO
(2023-2025)

COMMISSION ASSESSMENT

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TABLE OF CONTENTS

1. EXECUTIVE SUMMARY

Following 2 years of strong economic growth, the baseline scenario set out in Montenegro's economic reform programme (ERP) projects real GDP growth to slow down in 2023-2025. Helped by a strong tourism sector and surging private consumption, Montenegro's economy expanded by double digits in the first half of 2022, but started to slow down in the later months of the year. The main headwind came from mounting inflation on the back of high global food and fuel prices. In 2023-2025 GDP growth is expected slow to an annual average of 4% and to be driven by a continued recovery in tourism, a strong increase in private investment and decelerating but still positive private consumption growth. The balance of risks is tilted to the downside as domestic political instability and higher financing costs could negatively affect investment, slowing growth in trade partners could dampen tourism exports, while risks related to the fallout from Russia's war against Ukraine could result in further increases in energy and food prices, eroding disposable income. Moreover, imports may increase by more than expected if investment plans in tourism and infrastructure are realised.

The ERP's fiscal scenario projects high and rising budget deficits and the debt ratio to stabilise at a high level. Recent measures weakening the revenue base as well as some new and mostly permanent increases in mandatory spending have significantly increased the deficit target in the revised 2022 budget to more than 8% of GDP. However, the actual outcome was lower, at below 5% of GDP, as high inflation and strong real growth boosted indirect revenue while spending on public investment and wages was lower than budgeted. However, in the absence of consolidation measures, the ERP projects the deficit to exceed 6% of GDP in 2023-2025, implying a loose fiscal stance, and public debt to stabilise at a high level of close to 75% of GDP.

The main challenges facing Montenegro are the following.

- **The high projected fiscal deficits and upcoming large debt repayment needs call for strong fiscal consolidation.** While the uncertainty related to Russia's war against Ukraine is high, the economic outlook is positive with decelerating but stable growth in Montenegro. A loose and pro-cyclical fiscal stance over 2023-2025 is not warranted as inflation remains high and fiscal risks are mounting. Debt repayment needs are set to increase sharply, especially in 2025, which, coupled with tightening financing conditions, raises vulnerabilities, and calls for a more prudent fiscal position. Fiscal sustainability needs to be enhanced with the help of a medium-term plan based on specific consolidation measures. Broadening the tax base, streamlining tax exemptions, and incorporating new budget revenue initiatives to offset recent revenue-decreasing measures would contribute to rebuilding fiscal space and reducing public debt.

- **Strengthening the long-term sustainability of public finances requires improvements in fiscal governance and in the management of public investment.** New spending initiatives have been adopted without properly assessing their fiscal implications. Large infrastructure projects need better management and prioritisation given the very limited fiscal space available. Following up on plans to set up an independent fiscal institution would contribute to strengthening fiscal governance and discipline.

- **Progress on the regulatory environment reforms should remain the authorities' focus in the coming years.** Dialogue between public authorities and private companies continued, but the level of engagement decreased due to political uncertainty. Digitalisation continued, but at a slower pace, hampered by political developments and a series of cyberattacks in the second half of 2022. Reforms in the area of state-owned enterprises (SOEs) were downscaled by the caretaker government and SOEs' reform ambitions need to be urgently clarified. Montenegro's green transition regulatory environment remains at an early stage of development. The country must use the adoption of the national energy and climate plan in early 2024 as an opportunity to cement its green transition.

- **Political commitment, consistency and steadfast implementation are needed to reduce the size and scope of the informal economy.** A long-delayed survey provided fresh insights into the country's informal economy in 2022, but the authorities did not take any of the other planned steps to address it. Further reforms or actions to reduce the informality are to be determined in 2023, with implementation possibly starting in 2024. The impact of the December 2021 tax reforms on the informal sector is yet to be analysed. A clear political vision and steer, and good cooperation between businesses, state and local authorities, is needed to break the current pattern of nominal progress and erratic implementation of the informality reforms.

- **Structural labour market challenges continue to undermine potential growth and improvements in living standards.** While recovery from the COVID-19 pandemic is under way, structural deficiencies in the labour market, including persistently low rates of labour market activity and high unemployment, especially among women, young people and the low-skilled, continue to undermine a just and fair economic growth. Montenegro has taken some initial steps to tackle these problems. Further efforts are needed to tackle women's labour market particiaption and high youth unemployment, and to reform the social protection system. Active labour market policies are not effective in getting people into the labour market. While some studies on active labour market measures have been conducted in the past year, their recommendations were only partly implemented and the country lacks a mechanism to continuously monitor such measures.

The implementation of the policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2022 has been limited. In 2022, the budget was burdened with new permanent social transfers and temporary tax reductions that were not well targeted. However, the 2022 fiscal outcome was better than envisaged in the revised budget due to the good performance of indirect tax revenue. No new medium-term fiscal strategy has been adopted. Nor has progress been made on public investment management and the review of tax expenditures. However, plans have progressed on setting up a fiscal council even if further steps still need to be taken. Montenegro has also made progress on preparing its draft Youth Guarantee Implementation Plan, but has not made significant progress on preparing a clear timeline and financial planning for the reform of the social and child protection system or on developing a mechanism to continuously monitor active labour market measures.

The ERP 2023 sets out a comprehensive programme integrating economic, fiscal and structural reform plans, but targets and plans are not fully in line with the key challenges and priorities identified by the Commission. The core of the programme comprises already-adopted initiatives. Fiscal plans lack a comprehensive medium-term consolidation strategy. On structural reforms, the ERP builds on reforms introduced in recent years, focused primarily on key challenges to the country's economy. Digitalisation, with a long-awaited reform on cybersecurity, reforms of the labour market and of SOEs remain particularly relevant. Looking ahead, the European growth model linked to the twin green and digital transitions should be better consolidated in the ERP process for Montenegro. Limited progress was made on implementing the reform measures in 2022.

2. ECONOMIC OUTLOOK AND RISKS

Montenegro's economy recorded strong growth in the first half of 2022, but the momentum slowed down in the later months of the year. Driven by strong growth in private consumption and exports, real GDP increased by 10.3% year on year (y-o-y) in the first half of 2022. Policy measures, including a sharp rise in the minimum wage and the abolition of mandatory health insurance contributions, supported a large increase in the average net wage of around 35% y-o-y in December 2022, which led to a double-digit increase in private consumption. Private consumption was also supported by Ukrainian and Russian nationals taking up temporary residence. Exports were boosted by the continued strong recovery in tourism. Headwinds came from mounting inflationary pressures, related to Russia's invasion of Ukraine, and political instability at home. The ERP estimates annual growth at 7.7% in 2022 but the actual figure turned out to be lower at 6.1% due to sharply decelerating economic activity in the second half of 2022[1]. Soaring commodity prices, in particular for food, fuel and construction materials, led to rapidly accelerating inflation, reaching 11.9% on average in 2022[2]. Labour market conditions improved with the average unemployment rate falling to a historical low of 14.7% in 2022 from 16.6% in the previous year.

The ERP baseline scenario projects GDP growth to average around 4% in 2023-2025 with a mildly decelerating trend. The ERP expects domestic demand to be the key driver of growth due to decelerating but still positive private consumption growth and sharply rising investment. Private consumption is projected to increase by an average of 2.4% per year in 2023-2025, helped by factors such as growing remittances, expanding credit activity, improvements in the labour market and higher social transfers included in 2023 budget. The ERP assumes a strong increase in investment (6.6% a year on average in 2023-2025), especially in tourism, agriculture, energy as well as to support the green and digital transition. Further support for GDP growth is projected to come from net exports, mainly tourism services which are expected to reach their pre-COVID-19 level in 2023, while import growth is set to decelerate from 16.7% in 2022 to an average of 4.8% in 2023-2025. Following 2 years of strong growth, Montenegro's GDP surpassed its pre-COVID-19 level in 2022. The ERP estimates a positive output gap of 3.2% in 2022 which is projected to rise gradually to 5.6% in 2025. Compared to the previous year, the ERP revises GDP growth downwards by 0.7 percentage points (pps) and 0.5 pps for 2023 and 2024 respectively. The ERP also contains an alternative

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(1) Macroeconomic and fiscal estimates and forecasts covering the period 2022-25 have been taken from the ERPs themselves; if available, preliminary macroeconomic and fiscal outturn data for 2022 have been taken from the relevant national sources (national statistical office, ministry of finance, central bank).

(2) Statistical Office of Montenegro.

downside scenario which assumes an escalation of the war in Ukraine and a related recession in the EU. The resulting fallout on trade, including lower tourism activity, and investment, together with elevated inflation, would result in lower GDP growth in Montenegro, ranging from 2% in 2023 to 2.5% in 2025.

The baseline GDP growth scenario is on the optimistic side and subject to significant risks. The baseline scenario for 2023 is more positive than the Commission's autumn forecast, and the divergence widens in 2024. In particular, the programme's ambitious assumption on capital investment seems overly optimistic considering the ongoing political uncertainty, high inflation and technical hurdles to public investment experienced in the past. The strong deceleration in import growth forecast for 2023-2025 in the baseline scenario is not consistent with projected investment dynamics, as these usually require significant imports of construction machinery and equipment. Tourism exports might rise less than expected due to weak projected growth in the major source markets. The macroeconomic outlook is subject to risks stemming from Russia's war against Ukraine, in particular high food and energy prices which translate into domestic inflation. The ERP refers rightly to domestic risks related to political uncertainties, macro-financial stability and the management of public finance when there is limited fiscal space.

Table 1

Montenegro - Comparison of macroeconomic developments and forecasts

	2021		2022		2023		2024		2025	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	13.0	**13.0**	7.0	**7.7**	2.9	**4.4**	3.2	**4.0**	n.a.	**3.5**
Contributions:										
- Final domestic demand	0.0	**0.0**	6.2	**9.2**	1.5	**3.6**	3.5	**4.1**	n.a.	**3.2**
- Change in inventories	0.2	**0.2**	0.0	**3.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	12.9	**12.9**	0.8	**-4.5**	1.4	**0.7**	-0.4	**-0.2**	n.a.	**0.4**
Employment (% change)	-2.1	**-3.1**	2.9	**11.7**	1.1	**4.0**	1.6	**3.2**	n.a.	**3.1**
Unemployment rate (%)	18.9	**16.6**	16.3	**15.5**	17.4	**14.5**	15.9	**13.7**	n.a.	**12.9**
GDP deflator (% change)	n.a.	**4.7**	n.a.	**6.8**	n.a.	**3.8**	n.a.	**2.0**	n.a.	**1.6**
CPI inflation (%)	2.5	**2.4**	12.2	**13.0**	6.1	**5.0**	3.0	**3.0**	n.a.	**2.2**
Current account balance (% of GDP)	-9.2	**-9.2**	-10.2	**-12.0**	-9.3	**-10.5**	-10.1	**-9.9**	n.a.	**-8.9**
General government balance (% of GDP)	-1.9	**-1.9**	-5.6	**-4.8**	-4.3	**-5.9**	-3.2	**-6.2**	n.a.	**-6.2**
Government gross debt (% of GDP)	82.5	**84.0**	75.5	**76.1**	73.1	**73.6**	71.5	**74.8**	n.a.	**74.8**

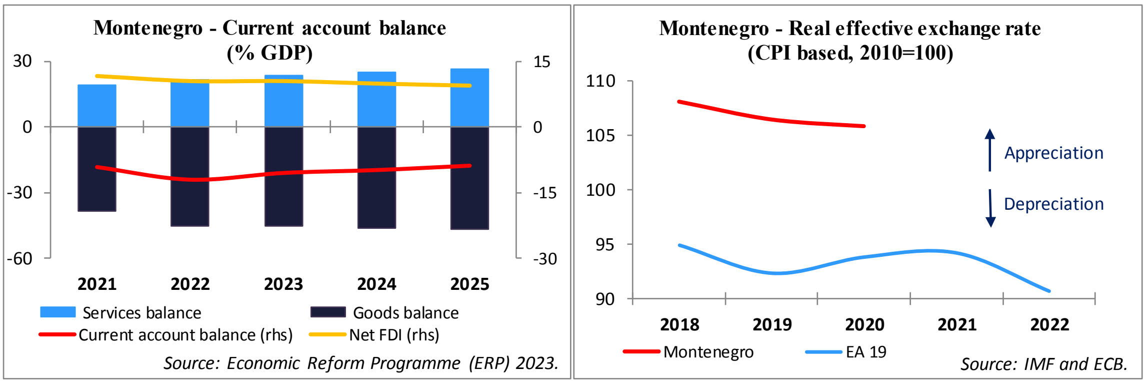
Sources: Economic Reform Programme (ERP) 2023, Commission Autumn 2022 forecast.

The ERP projects inflation to decline in 2023-2025. Driven mainly by surging commodity prices, especially for food and fuel, as well as large domestic policy-induced wage increases, inflation jumped to double digits in 2022. To mitigate the impact of high inflation on households and firms, the government adopted numerous support measures, including reduced value added tax rates for basic foodstuffs and a lower excise duty on sales of unleaded gasoline and gas oils. The ERP expects the average inflation rate to ease gradually, from 5% in 2023 to 2.2% in 2025, due to the high base in 2022, a deceleration in euro-area inflation, and growth in private consumption stabilising. This rather benign scenario is based on the assumption that import prices, in particular for food and fuels, will stabilise. The ERP rightly acknowledges external risks which could lead to a resurgence of inflation while it offers little discussion on the domestic risks related to further fiscal stimulus measures such as higher social transfers included in the 2023 budget.

The ERP optimistically projects a sizeable decrease in the current account deficit. In 2022 the current account deficit rose to 12% of GDP, higher than the 10.5% projected in the previous ERP, as the high growth in services and goods exports was outweighed by rapidly rising imports due to price effects. Driven by recovering tourism, favourable global demand for Montenegro's goods exports (electricity and non-ferrous metals), and higher output in agriculture, the trade deficit is forecast to fall from 21.7% of GDP in 2023 to 20% in 2025, while the secondary income surplus is projected to remain at some 8% of GDP. The current account deficit is thus expected to decline from 12% of GDP in 2022 to 8.9% in 2025. This is a more benign scenario compared to the previous year's ERP, which assumed the current account deficit to stay at some 10% of GDP over the forecast period. High import dependency and poor diversification of the production base remain structural weaknesses of the Montenegrin economy. The ERP's assumption of a deceleration in growth of imports seems at odds with Montenegro's large investment needs and the projected investment profile. In terms of the savings-investment balance, a 1.8 pps rise in investment as a percentage of GDP is expected to be outweighed by an even larger increase in national savings, driven exclusively by the private sector, which however is not explained in the programme.

Foreign direct investment (FDI) is set to remain high and fully cover the projected current account deficit. Net FDI inflows increased sharply, by 70% y-o-y in January-September 2022, with 38% of these inflows going into real estate, driven partly by purchases by Russian citizens. Total net FDI inflows are estimated at 10.5% of GDP in 2022 and are projected to stay at the same level in 2023. In 2024 and 2025 net FDI is assumed to fall slightly below 10% of GDP. Downside risks to this outlook stem from political instability at home coupled with a tightening of global financing conditions. At the end of 2021, Montenegro's net international investment position was negative at 168.4% of GDP. The external debt declined to 165.8% of GDP in the third quarter of 2022 (driven mainly by the denominator effect, as GDP increased by 13% in nominal terms in 2022) from 191.5% in 2021. There was also a small decline in the nominal value of external debt as the government repaid maturing credit obligations without undertaking new borrowing in the first three quarters of 2022.

Graphs: external competitiveness and current account



The banking system remains stable and liquid, but the quality of banks' balance sheets needs close monitoring in a rising interest rate environment. Despite the expiry of the pandemic-related support measures, the banking system maintained strong capital and liquidity buffers, both of which exceeded pre-COVID-19 levels. Due to the risks stemming from high inflation and the spill-over effects of Russia's invasion of Ukraine, the central bank has adopted 12 packages of temporary measures aimed at preserving the liquidity and solvency of domestic banks. As a precautionary measure, the central bank secured a repo line from the European Central Bank to meet exceptional liquidity needs. Banks continued to fund themselves mainly through domestic deposits which increased by 23.2% in 2022. Credit growth continued at a similar pace as in 2021 (6.1%). Borrowing costs increased with the nominal weighted averaged lending rate reaching 5.3% in early 2023 as compared to 4.3% at end-2021. The non-performing loan ratio declined moderately to 5.7% of total loans at the end of 2022, as compared to 6.2% in 2021. There appears to be scope to increase the financial sector's role in reaching climate and energy targets in line with European and international commitments by adopting policy measures in the area of sustainable finance (such as sustainability disclosures, sustainable finance taxonomies etc.).

Table 2

Montenegro - Financial sector indicators

	2018	2019	2020	2021	2022
Total assets of the banking system (EUR million)	4 407	4 604	4 587	5 329	6 407
Foreign ownership of banking system (%)	74.3	67.9	80.3	80.0	82.0
Credit growth (aop)	10.6	4.2	5.0	6.6	6.1
Deposit growth (aop)	12.2	1.8	-2.5	12.8	23.3
Loan-to-deposit ratio (eop)	84.7	88.1	93.7	80.0	70.1
Financial soundness indicators (%, eop)					
- non-performing loans to total loans	6.7	4.7	5.5	6.2	5.7
- regulatory capital to risk-weighted assets	15.6	17.7	18.5	18.5	19.3
- liquid assets to total assets	22.6	20.8	22.2	26.4	31.0
- return on equity	5.4	9.0	4.1	4.6	14.4
- forex loans to total loans	0.5	0.4	0.2	0.2	0.2

Sources: National Central Bank.

3. PUBLIC FINANCE

The 2022 budget deficit was contained at 4.8% of GDP which is better than envisaged in the revised 2022 budget. The initial budget set the general government deficit target at 5% of GDP, significantly higher than the 2021 outcome of 1.9%. This was mainly due to the expected 3 pps fall in the revenue-to-GDP ratio stemming from abolishing mandatory health contributions and introducing a non-taxable part of wage income. Following the amendment of the 2022 budget in October to accommodate a number of mostly permanent increases in mandatory spending (including additional allowances for all children and for mothers of three and more children, large increases in minimum pensions, wage increases in the public sector and additional financing for the health insurance fund) the overall deficit target was raised significantly to 8.3% of GDP. The deficit outcome was significantly lower at an estimated 4.8% of GDP due to a combination of higher-than-projected revenue, mainly from VAT; lower-than-expected spending, mainly on investment and wages as there were delays in planned employment; as well as higher nominal GDP than previously projected. Public revenue growth was supported by high inflation, a successful tourism season, high consumer spending and improved tax discipline, while the temporary reduction of excise taxes on fuel and the reduction of VAT rates on basic foodstuff and pellets for heating had the opposite effect. A further increase in government revenue was thanks to the implementation of the economic citizenship programme. Overall, nominal revenues increased by 3.3% compared to 2021 but declined by 4.5 pps as a share of GDP. Overall budget spending increased by 11% as compared to 2021 but fell by 1.7 pps as a percentage of GDP.

Current expenditure increased by 9.8% y-o-y, driven by an increase in social security transfers (17.8%) due to higher child allowances and pensions and a rise in transfers to institutions and individuals (29.3%), the latter made necessary by shortfalls in the Health Insurance Fund and the Pension and Disability Fund. Capital spending increased by 22%.

The ERP recognises the need for fiscal consolidation, but its fiscal path assumes a further rise in the budget deficit and public debt ratios. Recent permanent measures weaken revenues and lead to an elevated level of public spending in 2023-2025 due to higher mandatory allocations for public wages, social transfers, pensions and the Health Insurance Fund. Interest costs as a share of GDP are set to rise by 0.9 pps between 2023 and 2025, while capital spending is expected to remain at close to 5% of GDP in this period, with construction of an additional section of the Bar-Boljare highway not expected to start before 2025. Public revenue is set to decline from 39.8% of GDP in 2022 to 37.8% in 2025 while public spending is projected to decrease only slightly, from 44.5% to 44% of GDP over this period. This projected path would result in large budget deficits in the medium term, rising from 5.9% of GDP in 2023 to 6.2% in 2025. The primary deficit would also remain sizeable at close to 4% of GDP on average. The projected fiscal position is much weaker than last year's prediction, which assumed a headline deficit close to zero in 2024. High public deficit and debt are set to exceed the limits prescribed by the rules of fiscal responsibility[3]. After falling in 2023, the debt ratio is projected to increase to close to 75% in 2024 (5 pps higher than expected in last year's ERP) and remain at this level in 2025.

Table 3

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

	2021	2022	2023	2024	2025	Change: 2022-25
Revenues	44.3	39.8	39.3	38.0	37.8	-2.0
- Taxes and social security contributions	36.2	33.3	32.8	33.0	33.0	-0.2
- Other (residual)	8.1	6.5	6.5	5.0	4.8	-1.8
Expenditure	46.2	44.5	45.2	44.2	44.0	-0.6
- Primary expenditure	43.8	42.9	43.4	42.0	41.3	-1.6
of which:						
Gross fixed capital formation	4.7	5.0	4.6	4.8	4.8	-0.2
Consumption	18.2	16.7	17.7	16.5	15.9	-0.8
Transfers & subsidies	12.5	13.0	13.7	13.8	14.1	1.1
Other (residual)	8.5	8.2	7.4	6.8	6.5	-1.7
- Interest payments	2.3	1.6	1.8	2.2	2.7	1.0
Budget balance	-1.9	-4.8	-5.9	-6.2	-6.2	-1.4
- Cyclically adjusted	0.3	-5.9	-7.5	-8.1	-8.2	-2.3
Primary balance	0.5	-3.1	-4.1	-4.0	-3.5	-0.4
- Cyclically adjusted	2.5	-4.9	-5.7	-5.9	-5.5	-0.6
Gross debt level	84.0	76.1	73.6	74.8	74.8	-1.4

Sources: Economic Reform Programme (ERP) 2023, Commission calculations.

(3) Numerical fiscal rules limit the general government deficit and debt to below 3% and 60% of GDP, respectively.

The expected increase in the budget deficit in 2023 results from recently adopted measures affecting both sides of the budget. At the end of December 2022, the parliament of Montenegro adopted the 2023 budget law, which targets a deficit of 5.9% of projected GDP, assuming real growth of 4.4% and inflation levelling out to 5%. Compared to the 2022 result, government revenue is set to decline by 0.5 pps of GDP. Revenues from labour and corporate income taxation are projected to rise by 3.5% and 26% respectively as compared to 2022, in line with economic trends, the introduction of progressive taxation of corporate income and expected repayments of tax debt in compliance with the Law on tax debt rescheduling. The projected revenue from labour income is roughly unchanged at 2.4% of GDP, while the revenue from corporate income is projected to increase to 2% of GDP, up from 1.6% in 2022. Increases are expected for VAT revenues (5.3%) and excise duties (9.4%), the latter partially supported by the gradual restoration of the excise tax on fuel. The revenue from VAT is projected to decline by 0.4 pps to 15.5% of GDP, while excise revenue is set to rise slightly to 4.4%. Social security contributions are planned to decline considerably to 7.7% of GDP from 8.1% in 2022. As the economic citizenship programme comes to an end, less revenue will be generated in related fees[4]. However, there is a substantial one-off increase in the 'other revenue' category, as special funds accumulated under the economic citizenship programme in previous years will be allocated to the 2023 budget. In contrast, public spending is projected to increase by 0.7 pps of GDP, mainly driven by the increase in current spending. Social spending is planned to increase by 17.5% y-o-y, or by 1 pp to 12.7% of GDP, reflecting the full-year effect of social transfer rises introduced during 2022. The gross wage bill is planned to rise by 0.7 pps to 11.1% of GDP reflecting public wage increases. The capital budget is set at 4.6% of GDP, somewhat lower than in 2022. Debt repayment is estimated at 5.7% of GDP which is 0.4 pps higher than in 2022.

The budget for 2023

* On 28 December, the parliament of Montenegro adopted the 2023 budget law, targeting a deficit of 5.9% of projected GDP.
* Draft laws, which were submitted for parliamentary approval in early 2023 and aim to strengthen the revenue side, are not included in the budgetary projections.

Table: Main measures in the budget for 2023

Revenue measures*	Expenditure measures**
• Reducing the excise duty on sale of unleaded gasoline and gas oils *(Estimated impact: -0.4% of GDP)* • Implementing the Law on tax debt rescheduling *(Estimated impact: 0.2% of GDP)* • Introduction of progressive taxation on profits generated by legal entities	• Implementing the Law on public wages and branch collective agreement for healthcare workers *(Estimated impact: 0.11% of GDP)* • Implementing the Law on public wages and branch collective agreement for the workers of the University of Montenegro

(4) The window of applications for the economic citizenship programme was closed by end-2022, but a number of applications will be processed during 2023.

(Estimated impact: 0.4% of GDP) • One-off change in non-tax revenue due the implementation of the economic citizenship programme *(Estimated impact: 0.4% of GDP)* • Full year effect due to abolishing contributions to health insurance *(Estimated impact: -0.4% of GDP)*	*(Estimated impact: 0.08% of GDP)* • Implementing the Law on public wages and branch collective agreement for the public workers (deletion of former 'job group D') *(Estimated impact: 1.08% of GDP)* • Benefit for newborns *(Estimated impact: 0.11% of GDP)* • Benefit for all children under 18 *(Estimated impact: 0.41% of GDP)* • Benefit for mothers of three or more children *(Estimated impact: 0.22% of GDP)* • Increasing the minimum pension and adjusting pensions in line with inflation *(Estimated impact: 0.9% of GDP)*

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

Source: ERP

In the medium term, the ERP projects elevated deficits due to high current spending, while the capital budget is set to remain stable. Fiscal consolidation is not envisaged. Public revenues are set to grow in nominal terms, but their ratio to GDP is projected to decline. While tax revenue is set to remain stable, the decline is driven by other revenue in 2024-2025, related to the economic citizenship programme coming to an end. On the spending side, legislation adopted in recent years has led to high current spending (nearly 40% of GDP) from 2023 onwards. Responsible factors include higher allocations for social benefits, public wages, the Health Insurance Fund, child benefits and subsidies for agriculture. The capital budget is projected at 4.8% of GDP in 2024-2025.

Despite elevated deficits, the ERP projects public debt to stabilise at close to 75% of GDP in 2024-2025. In the first three quarters of 2022, Montenegro continued with regular debt repayments without undertaking new borrowing, which together with strong nominal GDP growth resulted in a significant decrease in the public debt ratio by end-September 2022 - to 71.4% of GDP from 84.7% at end-2021. The ERP estimates total public debt at 76.1% of GDP at end-2022. Total financing needs amounted to 10.6% of GDP, which was covered by government deposits (7.6% of GDP), new loans (2.4%) and privatisation revenues (0.5%). Despite the projected increase in the primary deficit in 2023, the ERP expects the public debt ratio to fall to 73.6% of GDP, helped by nominal GDP growth and negative stock-flow adjustments, the latter partly related to the continued use of government deposits to meet financing needs. In 2024-2025, rising interest expenditure, high primary deficits and stabilising nominal GDP growth create headwinds for debt reduction, and the increase in the debt ratio is only contained by negative stock-flow adjustments, which are however not further explained in the ERP. Government deposits are not expected to be used for debt repayments in 2024 and only minimally in 2025. The maturity profile of public debt constitutes a risk in the context of tighter global financial conditions. Debt repayment needs will rise sharply, from 5.7% of

GDP in 2023 to 6.6% in 2024 and 11.1% of GDP in 2025, bringing gross public financing needs to 17.4% of GDP in 2025. Debt management efforts, including a hedging arrangement concluded in 2021 with four private banks to reduce currency risk for a loan from China, have reduced some vulnerabilities linked to the high debt burden and its composition. Currently, around 95% of the public debt is held in euro while a further 2.7% and 2.3% are held in USD and in other currencies. While 77% of all debt carries fixed interest rates, the ERP assumes a large increase in borrowing costs due to tightening global financial conditions.

Montenegro

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

	2021	2022	2023	2024	2025
Gross debt ratio [1]	**84.0**	**76.1**	**73.6**	**74.8**	**74.8**
Change in the ratio	-21.3	-7.8	-2.6	1.2	0.0
Contributions [2]:					
1. Primary balance	**-0.5**	**3.1**	**4.1**	**4.0**	**3.5**
2. "Snowball" effect	**-13.5**	**-9.0**	**-3.9**	**-2.0**	**-1.0**
Of which:					
Interest expenditure	2.3	1.6	1.8	2.2	2.7
Growth effect	-11.6	-5.6	-3.1	-2.7	-2.5
Inflation effect	-4.2	-5.0	-2.7	-1.4	-1.2
3. Stock-flow adjustment	**-7.4**	**-2.0**	**-2.7**	**-0.9**	**-2.5**

[1] End of period.

[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).
The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

Source: Economic Reform Programme (ERP) 2023, Commission calculations.

Debt dynamics

Large primary deficits together with growing interest expenditure are set to push up the public debt-to-GDP ratio. Using government cash deposits to repay public debt is projected to generate some downward stock-flow adjustments in 2023. The very favourable snowball effect seen in recent years is set to gradually diminish, as nominal GDP growth slows and interest costs rise.

The ERP identifies positive and negative risks to the baseline fiscal scenario. The main risks relate to political instability and populist policies which could result in new spending pressures, undermining the sustainability of public finance and credit conditions for future borrowing at a time of rising debt repayment obligations. Revenue projections are conservative and could be higher if amendments to certain tax laws that aim to broaden the tax base, are adopted. Positive revenue risks also relate to the reform of the Revenue and Customs Administration, strengthened measures against the informal economy and the concession of Montenegro's airports. Projections for public spending are set at the maximum and may contain some buffers. There is also a specific issue concerning the revision of future statistical data, namely that alignment with the European System of Accounts (ESA 2010) methodology would require reclassifying some operations of public companies into the general government sector, potentially increasing deficit and debt levels.

Sensitivity analysis

The ERP includes a detailed analysis of the deficit, with a comparison between the various scenarios as well as with the previous ERP. The comparison of scenarios includes a detailed risk matrix identifying potential positive and negative events (see above). However, a detailed impact of each single risk is not quantified; only their total effect on the budget balance, as reflected in the alternative scenario. Under the low growth scenario, the general government deficit would widen from 6.5% of GDP in 2023 to 7.3% in 2025. In addition, the public debt-to-GDP ratio would reach 79.5% of GDP by 2025 implying higher fiscal sustainability risks.

The current composition of public finance results in large structural deficits and leaves little space for investment. Following initiatives adopted over 2021-2022, high public spending is mainly driven by current expenditure (88% of the total) while resources for productive investment are set below 5% of GDP. Several social transfer initiatives, e.g. child-related benefits, were adopted without a proper needs and cost assessment. Abolishing mandatory health contributions and introducing a non-taxable part of wages benefited those citizens with lower incomes and helped reduce unemployment. However, these and other measures substantially weakened the tax base, while corrective measures to strengthen public revenue and limit government spending, in particular on the chronically deficit-prone health and pension funds have not yet been adopted.

Numerical fiscal rules are not respected but plans to set up an independent fiscal council have advanced. The current medium-term fiscal planning breaches fiscal rules, as numerous fiscal initiatives were introduced without proper fiscal costing, resulting in high structural deficits. With a view to setting up an independent fiscal council to strengthen fiscal oversight and budgetary discipline, Montenegro has prepared amendments to the draft Law on budget and fiscal responsibility, which received the Commission's comments and should be presented to the parliament in spring. Several measures are being taken to improve the medium-term budgetary framework. These include enhancing the budgetary system, improving the IT system for budget planning and introducing a centralised payroll calculation system to ensure better control and a more efficient management of spending on public wages.

4. Key structural challenges and reform priorities

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

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

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

(ii) strengthening the regulatory environment; and

(iii) reducing informality in the economy.

This assessment therefore focuses on those three key challenges.

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

Furthermore, the country should proactively implement the Energy Community's Decarbonisation Roadmap to achieve the agreed climate and energy targets, and strive towards establishing a carbon pricing instrument compatible with the EU ETS.

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

With the economic recovery from the COVID-19 crisis, labour market indicators also continued to improve, surpassing pre-crisis levels. The unemployment rate in the third quarter of 2022 fell by a further 1.8 pps to 13%, compared to the same period in 2021. The employment rate increased from 46.5% to 52.3% and the activity rate from 54.6% to 60.1%. By way of comparison, in the EU, the unemployment rate (15-74) was 4%, the activity rate (20-64) was 79.4% and the employment rate (20-64) was 74.7% in the Q3-2022. Significant disparities remain between the country's three regions. The unemployment rate in the Northern region remained high at 32.9% in Q3-2022, and was more than three times that of the Coastal region which increased to 10.3%. Long-term unemployment remains a major structural challenge, with 75.6% of unemployed people being out of work for more than 12 months during Q3-2022. The most vulnerable groups on the labour market remain women, young people, Roma and low-skilled workers, with Roma and people with disabilities facing particular challenges in accessing the labour market. While some support is available for these groups by way of employment and education programmes, these do not seem effective in supporting these groups to better prepare for or integrate into the labour market.

The pandemic had a significant negative impact on young people's labour market situation with no evidence of recovery. Youth employment (15-24) fell to 18.4% in Q4-2020, down from 26.9% in Q4-2019. The unemployment rate (15-24) also rose to 42.0% in Q4-2020, up from 27.8% in Q4-2019. In 2021, the proportion of young people (15-29) not in employment, education or training (NEET) stood at 26.5% signifying a 0.1 pps decrease compared to 2020, but still 5.2 pps above the 2019 level and more than double the EU-27 average (13.1% in 2021). This reflects significant difficulties in transitioning from education to employment, and a mismatch between the skills acquired through formal education and the skills in demand on the labour market. It also indicates too few relevant job opportunities available for young people. This is a structural challenge that persists from pre-COVID-19 times. Like in the EU, the phenomenon of platform work is also rising in Montenegro and a legal framework remains to be developed (ETF, 2022). The NEET profile analysis conducted by the International Labour Organization (ILO) (ILO, 2016) points to a high and increasing number of graduates from secondary and higher education who are out of employment. In 2019 the employment rate of recent graduates (within 1-3 years following graduation from ISCED levels 3-8) stood only at 65% in Montenegro, compared to 81% for the EU average (OECD, 2021).

Women's labour market situation is more responsive to economic fluctuations; while the pandemic further widened the gender gap in the labour market, women's labour market indicators also improved more significantly than those of men. The employment gap (20-64) between women and men decreased by 2.0 pps to a 9.5 pps difference, women's unemployment rate decreased by 1.2 pps more than men's, and their activity rate increased by 1.5 pps more than men's in Q3-2022, although women's activity rate remains significantly (14.1 pps) below men's at 53.2%. Regional disparities in the labour market situation of women are significant, with women's activity rate 20 pps below men's at 37.6% and their employment rate 11.4 pps below men's at 26.2% in Q3-2022. Employment gains continue to be larger for men than for women. Data on the gender pay gap is not available, hindering gender-sensitive employment policymaking. Gender-sensitive career counselling, programmes to encourage young women to enrol in non-traditional vocational programmes and studies, and programmes to help women re-enter the labour market after a prolonged absence, for example as a result of childcare, are lacking (OECD, 2021). Montenegro scored 55 points on the 2019 Gender Equality Index, below the EU average of 67.4. In July 2021, the government adopted a new National Strategy for Gender Equality for 2021-2025, setting out clear operational objectives and measures to improve gender equality, however the results are yet to be seen. The government adopted the Strategy and Action Plan for Early and Preschool Education for 2021-2025 in 2021. Enrolment numbers in pre-primary education have also improved, surpassing pre-pandemic levels at 24 663 children enrolled for the year 2022/2023. Regional disparities remain with low take-up in the north.

The highest share of unemployed people continues to be those with a lower level of education. High long-term unemployment persists; 75.6% of unemployed people had been unemployed for more than a year in Q3-2022. Montenegro adopted its National Employment Strategy for 2021-2025 in December 2021. The ambitious Strategy sets out measures to support a sustainable rise in employment, including through strengthening skills development. Montenegro's local employment strategies guide efforts to address regional differences by setting out tailored measures.

The Public Employment Service's (Employment Agency of Montenegro (EAM)) capacity for job mediation remains weak and lacks a continuous monitoring of active labour market policies (ALMPs), which in turn prevents the design of quality, targeted and effective employment activation measures. The EAM's reform and readiness remains a key challenge and is especially important for implementing the Youth Guarantee. The government, together with the multi-stakeholder working group, advanced on the drafting of the Youth Guarantee Implementation Plan which is expected to be adopted in 2023, with the pilot starting in 2025. It will be crucial that the EAM's capacities and organisational structures are modernised and adapted before the Youth Guarantee is rolled out. Other active labour market measures (ALMMs) targeting young people and women have shown mixed results at best. While the self-employed programme seems to have been effective and other long-running programmes such as the graduate programme have been found ineffective (ILO, 2022), the overall picture is unclear as the effectiveness of ALMMs is analysed in several separate studies. The country lacks a comprehensive monitoring and impact assessment of the effectiveness of ALMPs, including following up on the number of beneficiaries who remain employed in the long-term following their participation in activation programmes. This means that continuous policy adjustments to ensure that policies remain fit for purpose are not made. Efforts are ongoing to improve the currently ineffective institutional set-up and functioning of Montenegro's public employment service, the EAM.

Reform Measures 1 and 2 aim to address shortcomings in the functioning of the EAM and to move towards better job offers for young people by putting in place the Youth Guarantee. *Reform measure 1 – Strengthening operational capacities of the Employment Agency for carrying out services and measures via digitalisation*, is a continuation of a measure from the 2022-2024 ERP. It continues to be an important and adequate measure to tackle some of the shortcomings faced by the EAM. However, other organisational and operational reforms besides digitalisation will also be needed. *Reform measure 2 – Introducing the Youth Guarantee Programme in Montenegro* continues to be in line with Montenegro's commitment to improve labour market opportunities for young people and responds to Policy Guidance 6 from the Joint Conclusions of 2022. It is encouraging that some activities under the measure also focus on improving the capacities of EAM.

A mismatch of skills remains a significant challenge, particularly for graduates of vocational education and training or higher education, despite some recent efforts to improve the transition from education and training to the labour market. The quality and relevance of the entire education system and the lack of practical experience of graduates from vocational and higher education are long-standing challenges. The situation was aggravated by the COVID-19 pandemic and continues to be a reform priority under the Osnabrück and Bologna Declarations (ETF, 2022). A high share of people transitioning from vocational education and training programmes to higher education and other programmes are less suited to market needs. Occupational mismatches (i.e. over-qualification) are highest for people with a tertiary education (around 14%). Although tertiary educational attainment is still lower than the EU average, the labour market cannot absorb the numbers of tertiary graduates in certain areas, such as business and humanities. However, there is still a shortage of medical and STEM graduates (ETF, 2019), demonstrating the need to step up the smart specialisation strategy. The OECD's report on Labour Migration in the Western Balkans found that, in Montenegro, 28% of respondents disagree with the claim that skills learned in the education system meet the needs of their job and 51% of surveyed firms identify applicants' lack of skills as a reason for unfilled vacancies (OECD, 2022). Montenegro's Entrepreneurial Lifelong Learning Strategy for 2020-2024, the National Partnership and the Innovation Fund are expected to help address these skills shortages. Furthermore, the Strategy for the Development of Vocational Education in Montenegro (2020-2024), along with its action plans, outlines measures to overcome workforce skills shortages and to improve the efficiency and the effectiveness of the VET system and lifelong learning. Reform of career guidance services at all levels leave further space for development (ETF, 2022). Montenegro has committed to the Western Balkans agenda on innovation, research, education, culture, youth and sport, which is expected to guide its reform efforts. Lifelong learning and adult education with up- and re-skilling has not yet played a sufficiently prominent role, including in facilitating the green and digital transitions. Given the very high share of long-term unemployment, developing and implementing these measures remains essential.

The quality and inclusiveness of the education system remains limited, as the Education Sector Analysis 2015-2020 (ESA) (UNICEF and Ministry of Education, 2022) conducted by the Ministry of Education and UNICEF points out. According to the 2020 Human Capital Index issued by the World Bank, 'a child born in Montenegro today will be 63% as productive when they grow up as they could be if they enjoyed complete education and full health'. During the 2018 PISA test, 44% of Montenegrin pupils (15 years old) scored below level 2 in reading, 46% below level 2 in mathematics and 48% below level 2 in science. In comparison, the OECD average for these is 14%, 13% and 16% respectively. The ESA's recommendations include improving the curriculum, making teaching interactive and more engaging - which would require adequate teacher training, increasing enrolment rates, providing support to the most vulnerable groups, improving the adequacy of school infrastructure including by making sufficient places available across the country, as reduced hours due to a shifts system can be detrimental to children's learning in many of the country's more populated municipalities. Finally, the ESA recommends that a coordinated, funded, well-prioritised and cost-effective strategic plan is put in place for a future sector wide education reform.

Following up on these recommendations, *Reform measure 3 – Developing an integrated approach to improving education quality and inclusivity* is a new measure aimed at preparing an overarching, long-term Education Sector Strategy (2024-2030) to tackle the above-mentioned shortcomings in a coordinated and properly budgeted way. This Strategy will not, however, address the higher education sector, the new strategy for which is pending adoption since 2020. *Reform measure 4 – Digitalisation of the education and development of digital skills* is a continuation of a measure from the 2022-2024 ERP. It remains relevant and justified both in the context of EU accession and in line with national priorities.

Montenegro has adopted several reform measures since 2020 to improve its social protection system, however the effectiveness and sustainability of this system continues to raise concerns. With the publication of the Roadmap for the reform of the social and child protection system in July 2021 it was expected that social protection would become better adapted to vulnerable members of society, while also contributing to labour activation and the sustainability of public finances. However, no further steps were taken in 2021-2022 on a costed analysis and timeframe for implementing priority reforms in line with the Roadmap. Coordination between employment and social services, the interoperability of relevant databases and the expansion of the Social Welfare Information System (SWIS) have not progressed. Therefore, disincentives to formal work persist (see key challenge 2 below for further details). In 2021, the amendment to the Law on Social and Child Protection granted universal benefits to all households with children under the age of six, although they are not automatically distributed due to a lack of interoperability between databases. In addition, the mothers' benefit was reinstated for previous beneficiaries, but fails to target child poverty as it is distributed to women who became mothers decades ago. While the universal child allowance is expected to help reduce child poverty, there is a lack of targeted measures. Most notably, poverty-targeted material support services have been reduced, reducing the impact of social transfers. As also indicated by the World Bank's and UNICEF's Social Protection Situational Analysis (World Bank and UNICEF, 2022), reform priorities include improving social assistance, reassessing the adequacy of combined benefits, finalising the move to a centralised disability assessment , improving the monitoring and evaluation capacities of social services and their coordination with each other, improving employment services and tax authorities, making the relevant databases interoperable, expanding the SWIS and strengthening the adequacy and sustainability of the pension system through a long-awaited pension reform.

Reform Measure 5 – Reform of the social and child protection system based on the Road Map is a continuation of a measure from the 2022-2024 ERP. It responds to the strong need to establish a well-coordinated and better-targeted social protection system that provides adequate support to the most vulnerable while also supporting labour market policies. The government announced that instead of the Roadmap, they plan to develop a National Social and Child Protection Strategy that would integrate all existing social protection strategies, prioritise reforms and budget them, which is expected lead to an overall better coordinated social protection system reform.

Key Challenge #2: Strengthening the regulatory environment, including reforms relevant to digital transition, green transition and climate change

A better and more business-oriented institutional and regulatory environment would contribute to a dynamic development of Montenegrin companies and facilitate investment. The regulatory environment hinders the dynamic development of local companies and foreign investors' activities, as analysed in detail in the Commission's ERP assessments of recent years. This translates into lost opportunities in terms of jobs (with an impact on key Challenge 1) and provides incentives, specifically to micro and small enterprises, to carry out undeclared work and transactions (thus fuelling the issues described under key Challenge 3). Substantial improvements are needed to remedy the inefficiencies and delays of dealings with the administration, excessive complexity of the legal framework and the administrative burden from local taxation and para-fiscal charges. Transparency in decision-making, arbitrary interpretation and law enforcement by public authorities, and access to finance for SMEs are also among the main issues for improvement.

A recent analysis of the regulatory environment, financed by Norway and implemented by the UNDP, pointed out that there are around 280 different legal acts, as well as their implementing acts, that regulate the SME sector alone. Insufficient communication and information exchange between the state and local authorities, and between the local authorities themselves, was singled out as one of the chief obstacles to improving the regulatory environment. The limited participation of municipalities in the drafting and implementation of the state laws and economic policy strategies is another concern that needs to be addressed as soon as possible, possibly in the Competitiveness Council.

The major avenues to consider when addressing this key challenge include: (i) the digitalisation of public administration and deployment of digital technologies in support of businesses; (ii) a continuous, structured dialogue between authorities and the business world; (iii) transparent and inclusive legislative and regulatory processes, involving the relevant state and local authorities; (iv) reconsidering the role of the state exercised via state-owned enterprises (SOEs), their management and financial performance; (v) enabling state-backed green transition; and (vi) ensuring the resilience of the regulatory ecosystem and critical infrastructures in times of crises.

Structured dialogue between authorities and the business world continued but the level of activity decreased due to lack of support and political uncertainty. In recent years, the involvement of businesses in the regulatory processes improved in a number of key areas, including in the design of ERP structural reforms and support to economic operators, with the COVID-19 mitigation measures for example. The Competitiveness Council, which gained momentum in 2021 as a promising forum for dialogue between businesses, municipalities and the government, continued its work on identifying barriers to business and maintained technical level of cooperation with the state administration. The updated document produced by the Council in 2022 identified 98 different barriers. However, due to the lack of political support and interest, the outcome of this work did not lead to any concrete deliverables from the government's side, apart from some partial, technical level replies and statements from the responsible ministries and public institutions. At the same time, the involvement of business partners in designing, drafting and implementing measures affecting businesses practically came to a standstill, as few legislative proposals were adopted by the government or discussed by the parliament.

Work on digitalisation continued in 2022, albeit at a slower pace. In the previous years, and despite a largely adverse economic situation (COVID-19 crisis) Montenegro showed steady progress in the area of digitalisation. The switch to an entirely electronic procurement environment (in the course of 2021) marked a major milestone in addressing the shortcomings of the previous paper-based procurement system. Several structural reforms were launched to improve the business and regulatory environment by developing electronic government services, including for online company registration, a 'single access point' portal for SMEs and broadband infrastructure.

However, the pace of digital transformation reforms slowed down in 2022, due to both internal and external factors. Protracted political uncertainty had a negative impact on the work of the administration and led to general delays or a standstill in the decision-making process. Furthermore, a series of large-scale cyberattacks on the state IT infrastructure in the second half of 2022 interrupted the timeline of the digital transformation reforms. These cyberattacks spurred Montenegro's government to focus one of the new reforms on cybersecurity. The government also proposed a new structural reform to improve the digital skills of public administration employees.

The proposed *Reform Measure 7 – 'Establishing a full electronic registration of enterprises'* is a continuation of the reform initiated in the 2022-2024 ERP and is credible and well developed. It should streamline the procedure of setting up and registering a company. The measure would nonetheless benefit from exploring synergies and complementarity with the new cybersecurity reform measure (Reform Measure 10).

Reform measure 9 – 'Improving digitalisation of the public administration by developing and improving digital skills' aims to develop and continuously improve the digital skills of public administration employees, thanks to the new Digital Academy. The measure appears very relevant, with a mostly clear scope and details provided on the various activities, though the fact that both physical and online courses will be offered merits a clearer explanation. Costing appears underestimated and synergies with the cybersecurity reform measure (Reform Measure 10) should be explored, e.g. on the ICT experts' network.

Reform measure 10 – 'Strengthening cyber resilience' is very relevant in the context of the cyberattacks on the government servers in the course of 2022 and responds to the Commission's recommendations for previous ERP cycles. The measure combines legislative actions and institutional building. The description and planned activities are clear and understandable, the timeline appears feasible and the identified risks are well defined. To ensure maximum benefits and synergies and to avoid duplication of efforts (e.g. when setting up CERT teams, data centres and the Cybersecurity Agency), the reform measure should be include all government institutions.

Reform measure 11 – 'Improving infrastructure for the broadband internet access and introducing next-generation networks' continues from 2022-2024 ERP and supports the development of digital services at national and local level. The measure is well justified and relevant and will undoubtedly contribute to developing a competitive and modern economy. A more detailed description of expected impacts on competitiveness, society and labour is needed.

Planned reforms for SOEs were downscaled by the government and their implementation is now highly uncertain. The caretaker government led by prime minister Abazović stepped back from both the reforms announced in the 2022-2024 ERP and the implementation of the 2022 Joint Conclusions of the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye in the area of SOEs. The ambition of 2022-2024 ERP reforms was to formulate the ownership strategy of the state and define a portfolio of key companies that should remain in state possession, transform the management structures and practices of the SOEs and ultimately improve their financial performance. However, there was no political agreement on the direction and scope of such reforms among the political parties supporting the caretaker government. Consequently, the government rolled back its previous plans for a holding company to manage and reform SOEs, and limited the scope of its 2022 actions to setting up a small unit in the Ministry of Finance whose role is to monitor fiscal risks related to SOEs.

Reform measure 12 – 'Improving management of state-owned enterprises' continues from the 2022-2024 ERP in terms of its title, but is completely redesigned. Its stated objective is to improve the corporate governance of SOEs and the monitoring of the financial and fiscal risks of their operations. However, the political and administrative risks of the reforms are high. While the planned activities and aims are clearly described, more concrete reform steps focus mostly on uncontroversial monitoring activities. The initiative, which aims to curb the purely political appointments in SOE management bodies and to ensure that only individuals with the required qualifications are appointed, seems to lack the necessary safeguards. The draft envisages a possible new selection procedure to be set up by the government decision, thus making it subject to easy changes for every successive political party in power. Actions (yet to be determined) to improve the regulatory framework of SOEs, their financial control and to reduce fiscal risks of SOEs are planned only for 2024-2025, at least partially in expectation of a better political climate. The EU Reform Facility should be mobilised to provide relevant reform expertise and support.

Trade facilitation measures and support for innovation and research complement the list of regulatory environment reforms. Montenegro's 2023-2025 ERP adds trade facilitation measures in the context of CEFTA cooperation as a new area of structural reforms under the regulatory environment challenge. The reform measure aimed at fostering innovation and providing support for research and development continues from the last year and is progressing well. In contrast, a reform measure aimed at facilitating access to finance for SMEs by setting up a Credit Guarantee Fund, initiated last year, has been discontinued. No significant progress was made on the project following the incomprehensible idea of granting the task to the Investment and Development Fund.

Reform measure 8 – 'Strengthening the national innovation and research ecosystem' continues from the 2022-2024 ERP. The focus of the reform is on the consolidation of the institutional framework for innovation and research and on improving the institutional support provided to scientists and researchers. The reform is relevant and aligned with the EU strategies. Ensuring appropriate administrative capacity in the Montenegrin Innovation Fund and the Council for Innovation and Specialisation is key to the success of this reform. Stable and progressively increasing funding from the state budget is another critical factor.

Reform measure 13 – 'Facilitation of trade in goods and services through implementation of CEFTA Additional Protocols 5, 6 and 7' comes back to the ERP after a one-year absence. The measure is relevant, with a clear impact on competitiveness and reducing regulatory burden. The activities are clear, but the implementation of some actions depends on regional developments. Risks associated with the delayed or partial deployment of the New Computerised Transit System (NCTS) should be recognised in the text.

Montenegro's green transition regulatory environment remains at an early stage of development. The National Energy and Climate Plan, which should be also aligned with 2030 energy and climate targets, adopted by the Energy Community Ministerial Council in 2022, and 'Clean Energy Package' legislation, is under development and is expected to be adopted in early 2024. As EU Member States move towards greener economies, it is important that Montenegro also moves in the same direction in order to strengthen its competitiveness during the accession process (for example on the Carbon Border Adjustment Mechanism), and ultimately to cope with increased market pressures. Consequently, it should proactively implement the Energy Community's Decarbonisation Roadmap and strive towards establishing a carbon pricing instrument compatible with the EU ETS, including a reliable and transparent framework for the monitoring, reporting and verification of greenhouse gas emissions. While the use of renewable energy sources is high (some 43% of the electricity production in 2020 came from renewable sources, mostly hydropower and biomass) the country needs to address significant energy-related challenges, including energy efficiency. In particular, it must take a strategic decision on how to replace the thermal (lignite) power plant in Plevlja, which currently produces approximately 50% of Montenegro's electricity, to further reduce CO_2 emissions without exacerbating energy costs for the local economy. The EU Energy Support Package and Montenegro's association action plan identify a set of reforms to be implemented in 2023.

In summary, Montenegro's efforts to improve the regulatory and institutional environment slowed down significantly in 2022, due mainly to the political situation in the country. Efforts must focus on reinvigorating the country's digitalisation ambition, the reform of state-owned enterprises and structured dialogue with socio-economic actors, given the protracted political uncertainty and external challenges (i.e. Russian war of aggression against Ukraine, energy crisis and cyberattacks on the state IT infrastructure) that challenge the smooth functioning and resilience of state institutions and public administration. The proposed reforms have the potential to improve the efficiency and transparency of the regulatory environment, reduce costs and limit the scope for corruption, but they need to be implemented in a timely and steadfast manner. Working towards an inclusive, business-oriented regulatory environment and the adoption of a business-centric culture by the central and local public administrations should remain the authorities' focus in the coming years.

Key Challenge #3: Formalisation of the economy

The informal economy constitutes a major obstacle to the inclusive, sustainable growth and the competitiveness of Montenegro. The informal sector is fuelled by deficiencies in the institutional and regulatory environment, weaknesses on the labour market, insufficient enforcement capacity of the public authorities, corruption and tax non-compliance. The impact of the informal economy is particularly harmful for the SMEs operating legally and microenterprises in the services sector, which dominate the economy. These smallest companies perceive informal competition as the most costly obstacle to doing business. The costs of the informal economy and corruption are also higher for innovative companies, which particularly hinders the development of sectors of the economy that are based on knowledge and skills.

Policies that aim to reduce the size of informal economy need to be broad and comprehensive due to the diverse causes of the phenomenon and the complex relationship between labour market structures, the institutional and regulatory environment, taxation, social policies and cultural factors. They need to create incentives and conditions for the formalisation of informal economy, apply strong disincentives and penalties to businesses and individuals that continue operating in the informal sector and unfairly compete with legitimate businesses. Public authorities also need to take decisive actions to close gaps in the legal and institutional system that are subject to abuse. The authorities need to draw on a wide spectrum of measures to combat the problem of informal economy effectively.

A 2022 survey provides fresh insights on the country's informal economy. A survey conducted in 2022 by IPSOS for the Ministry of Finance and Social Welfare, estimates the size of Montenegro's informal economy at 20.6% of GDP for businesses and employees operating in the formal sector (a drop of 3.9 pps since the 2014 IPSOS survey), and at 37.5% of GDP for a fully informal sector (IMF MIMIC methodology). The averages for the entire EU are estimated at 4.2% and 16.8% of GDP respectively (ILO, 2016). The methodology used in the IPSOS survey differs from the ILO methodology, so a fully equivalent comparison cannot be made. Nevertheless, the IPSOS survey provides useful information on the relative size of the challenge. Informality figures based on IMF methodology can however be compared with 47 European countries. In this context, Montenegro features among the three European economies with most widespread informality, along with Kosovo and North Macedonia.

The most common practices of the informal economy in Montenegro are reportedly informal employment and other forms of informal contracts (particularly in the services sector), unregistered sales of goods and services, tax avoidance on sales of excisable goods and pursuing economic activity without registration or the required license. According to the survey, every fourth employee (26.4%) works either without paying taxes and contributions or with only partially paid taxes and contributions, and every third company is involved in informal economic activities. Lack of capacity of state inspection services (such as labour inspection, Revenue and Customs Administration and market inspection), infrequent or even sporadic sanctions against the informal businesses, together with corruption among the inspectors and political protection are considered to be key elements for the continuous and successful operation of informal businesses, and responsible for a general failure of the control and restrictive policy measures.

Lack of political support and consistency, in addition to erratic implementation, undermine efforts to reduce informality. While the goal of reducing informality started featuring more prominently among the government's priorities back in 2017 when an action plan was developed for this purpose, the bulk of activities, reported under the successive ERPs, have focused on internal reorganisations, reshuffling responsibilities between different administrative bodies and working groups, and internal reporting, rather than on taking concrete actions to reduce informality. Limited actions undertaken by 2021 focused on detecting and penalising some informal activities in the services sector, notably activities that could provide a quick revenue to the state budget.

The fiscal and tax reform of December 2021, analysed in 2022-2024 ERP assessment, which abolished health contributions paid by both employers and employees on salaries, was the first major initiative in recent years to address the roots of informality. The measure significantly reduced labour costs and, at least in accordance with the economic theory, some of the disincentives for employers to formalise employment. Unfortunately, statistical data were not available to confirm this assumption when the informality survey was conducted (February and March 2022). The tax reform was accompanied by two other initiatives: (i) a still ongoing e-fiscalisation, aimed at registering and supporting proper taxation on all cash transactions at the point of sale; and (ii) new excise duty stamps, backed up by a smartphone application that enables users to check the authenticity and legality of excise goods. Both measures were primarily designed to increase the tax revenue of the state, but they are nonetheless much needed steps to address some of the gaps that allow the informal economy to flourish.

Further reforms and actions to reduce informality are yet to be determined. The 2022 survey report on the informal economy in Montenegro provided some specific recommendations on follow-up actions. However, despite these recommendations, Montenegro did not produce a new action plan on the informal economy, promised already in four consecutive ERPs, leaving the commitments made in 2022 Joint Conclusions of the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye unfulfilled. Once again, this was due to political instability and the damaging impact it has on the work of the state administration and on decision-making. According to the government, follow-up actions are expected to be determined in 2023, with an implementation timeline starting only from 2024.

At the beginning of 2023 the government set up a working group to develop a comprehensive action plan on informality to guide the actions of the entire public administration. However, the working group appears be purely technical in character. With such a low-key approach and without clear political willingness to identify and implement the necessary reforms, the action plan risks being focused not on necessary, even if difficult, decisions and concrete deliverables, but on mostly administrative outputs and increased internal reporting. Furthermore, a political lead should be complemented by work processes and implementation mechanisms involving all relevant actors, akin to the process devised for the ERP conceptual work and consultations.

Reform Measure 14 – 'Strengthening mechanisms for the formalisation of informal economy' continues from a 2022-2024 ERP tax administration reform and follows up on the informality survey. The aim is to develop a central, crosscutting action plan encompassing all measures to reduce informality in the economy. Although the reform is very relevant and appropriate, it provides little to no information on component 1 (scope and substance of the action plan). Reform activities beyond 2023 are not defined and depend on the development and adoption of the action plan. In contrast, the activities related to the new integrated IT system for the revenue management (component 2) are well defined and clear.

A clear vision, political leadership, consistency and steadfast implementation are required to achieve more results. The yet-to-be prepared government plan to reduce the size of the informal economy would benefit from an approach combining targeted, dissuasive and control measures with further incentives to legalise informal businesses and informal employment. As evidenced by the findings of the informality survey, a deep reform of inspection bodies and their digitalisation is necessary, together with action to develop the capacities of inspections and tax authorities. Obvious gaps and inconsistencies in legislation that allow informal businesses to operate need to be closed. Continuous coordination of action between different public institutions, businesses and other civil society actors, and a structured dialogue involving both central and local authorities are key for the successful and timely implementation of any measures. Digitalising the public administration and public services is a good way to reduce the scope and size of the informal economy. The determination of the public authorities to enforce rules through administrative and judicial means will play an equally important role in the process.

Box: Monitoring performance in light of the European Pillar of Social Rights[5]

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion for the benefit of citizens in the EU. The European Pillar of Social Rights Action Plan, adopted on 4 March 2021, aims at rallying all relevant forces to turn the principles into actions. Since the 20 principles provide direction on how to achieve upward convergence and better working and living conditions in the EU, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes a sharper focus on employment and social reforms through greater monitoring of policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar of Social Rights to guide the alignment of their labour markets and welfare systems with those of the EU.

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

Montenegro is recovering from the COVID-19 pandemic, including its labour market. Nonetheless, structural challenges in the labour market persist. These include high long-term unemployment and continued regional disparities. While the gender employment gap narrowed, figures remain below the EU-27 average. Data is not available on the gender pay gap or on the disability employment gap. However, past years' trends indicate a deteriorating situation on the latter.

MONTENEGRO		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU avg, deteriorating
	Individuals' level of digital skills (basic or above basic)	Worse than EU avg., deteriorating
	Youth NEET (% of total population aged 15-29)	Worse than EU avg., no change
	Gender employment gap	Worse than EU avg., improving
	Income quintile ratio (S80/S20)	Worse than EU avg., improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU avg., deteriorating
	Unemployment rate (% of population aged 15-74)	Worse than EU avg., improving
	Long term unemployment rate (% of population 15-74)	Worse than EU avg., improving
	GDHI per capita growth	Worse than EU avg., improving
Social protection and inclusion	At risk of poverty or social exclusion (in %)	Worse than EU avg., deteriorating
	At risk of poverty or social exclusion rate for children (in %)	Worse than EU avg., deteriorating
	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU avg., deteriorating
	Disability employment gap	Worse than EU avg., deteriorating*
	Housing cost overburden	Better than EU avg., improving
	Children aged less than 3 years in formal childcare	N/A**
	Self-reported unmet need for medical care	Better than EU avg., improving

Skills mismatches and the weak provision of adult learning affect school-to-work transitions and result in workers being insufficiently prepared to find suitable and sustainable employment. The quality and relevance of the entire education system and the lack of practical experience of graduates from VET and higher education are long-term challenges that have been exacerbated by the pandemic. Montenegrins' level of digital skills continues to deteriorate. Montenegro continues to exceed the EU-27 average rate of early leavers from education and training, although the rate has started to decrease in the last year.

Employment remains the best route out of poverty. 38.9% of the population and 45.5% of children were at risk of poverty or social exclusion in 2021, both representing a decrease compared to 2020. The planned National Social and Child Protection Strategy based on the Roadmap of reforms of the social and child protection system is expected to address systemic shortcomings in a prioritised and budgeted way. Montenegro continued to exceed the EU-27 average on the cost of housing, and has now also surpassed the EU-27 average on self-reported unmet medical needs.

The collection of timely and reliable data needs to be sustained and strengthened. The Statistical Office of Montenegro is the main producer of primary data, however it is constrained by limited resources. Efforts should continue to bring the employment and social statistics more in line with EU standards and to send statistics to Eurostat systematically and on time. The lack of interoperability between databases and the lack of official data collection, such as on social welfare and the gender pay gap, makes it difficult to monitor several important indicators, such as children's enrolment rates in education. It is also an added hurdle in designing active labour market policies, developing individual activation plans and distributing social benefits.

(5) The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkan countries and Türkiye. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2021 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: not in employment nor in education and training; GDHI: gross disposable household income.

* No data available for 2021 for Montenegro. The trend is based on 2019-2020 comparison.

** No data on the percentage of children enrolled in formal childcare available. The enrolment numbers have improved from 2020 to 2021.

5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2022

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has adopted targeted policy guidance for all partners in the region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the policy guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the policy guidance is evaluated by the Commission in the following year's ERP assessments. The following table accordingly presents the Commission's assessment of the implementation of the 2022 policy guidance jointly adopted by the EU and the Western Balkans and Türkiye at their Economic and Financial Dialogue at Ministerial level on 24 May 2022.

Overall: limited implementation (33.3%)[6]	
2022 policy guidance (PG)	**Summary assessment**
PG 1: Strengthen fiscal sustainability by reintroducing the initially planned revenue measures of the 2022 budget while providing additional targeted support to vulnerable households and firms if needed to cushion the impact of adverse shocks.	There was **limited implementation** of PG 1: 1) **No implementation** Although the 2022 budget was rebalanced twice, revenue-increasing measures have not been introduced. On the contrary, temporary cuts to excise duties on fuel and VAT on basic food products were adopted[7]. The budget rebalance of September 2022 significantly raised spending on a number of new social benefits (including new allowances for all children and for mothers of three or more children, large increases in minimum pensions) which were generally not well targeted and which increased spending permanently.
Use any excess revenues to contain the 2022 deficit.	2) **Substantial implementation** Strong economic growth led to a surge in revenue, mainly from VAT which, coupled with lower-than-planned expenditure, led to a total budget deficit of 4.8% of GDP, significantly lower than projected in the revised budget and slightly below the original 2022 budget target.
Adopt a new medium-term fiscal strategy with the 2023 budget, including concrete consolidation measures and targeting a primary surplus as of 2024 and continued public debt reduction over the	3) **No implementation** After two governments lost a vote of no confidence in the parliament (in April and August 2022), resulting in a government in a caretaker role, a comprehensive fiscal strategy was not prepared.

(6) For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes. This is available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en

(7) After reducing the amount of excise duty for the sale of unleaded fuel and gas oils by 50% in June 2022, the government extended this decision, but kept decreasing the percentage of reduction (40%, 25% and 15%) mirroring the stabilisation in the prices of oil derivatives on the international market. The latest decision envisages a 15% reduction and is valid until 27 February 2023. The decision to reduce the VAT rate on the sale and import of basic foodstuff (flour, sunflower oil and salt) expired at the end of 2022, while the decision to reduce the VAT rate on bread (0%) and heating pellets (from 21% to 7%) is valid until the end of 2023.

medium-term, should the recovery be firmly entrenched.	
PG 2: Implement the public investment management assessment (PIMA) recommendations, prioritising key public infrastructure works within the available fiscal space while avoiding exceptions regarding project selection. Adopt amendments to the Law on Budget and Fiscal Responsibility and take concrete steps towards setting up a fiscal council. Based on an analysis of the economic and fiscal impact of all tax expenditures, prepare concrete budgetary recommendations to reduce tax expenditure (like exemptions, deductions, credits, deferrals, etc.) and share this analysis with the Commission	There was **limited implementation of PG2**. 1) **No implementation** After the IMF prepared the PIMA report in mid-2021, a PIMA action plan was included in the PFM reform strategy for 2022-2026. However, no concrete activities were undertaken to implement its recommendations aimed at improving public investment management. 2) **Partial implementation** Amendments to the Law on budget and fiscal responsibility were prepared and shared with the Commission for comments in January 2023. The government aims to finalise the consultations and send the draft amendments to the parliamentary procedure. 3) **No implementation** With technical support from the IMF, a review of Montenegro's tax exemptions was carried out in 2021. However, no concrete steps were taken on preparing an economic impact analysis/quantification of the scale of tax exemptions.
PG 3: Carefully assess and analyse price developments and stand ready to use the limited tools available under the chosen monetary framework to ensure price stability. Ensure a transparent and accurate reporting of asset quality and adequate provisioning as well as a timely follow up on findings from the Asset Quality Review, and continue to reduce data gaps in particular as regards the real estate sector. Continue to improve and implement legislations to further align with the EU framework on regulation and supervision, including on deposit insurance, and accelerate efforts to provide viable and timely	There was **substantial implementation of PG 3**: 1) **Partial implementation**: The central bank carefully monitored the evolution of price dynamics and observed some increases in lending rates arising from euro area monetary tightening. Fiscal policy that led to large net wage increases also added to underlying inflationary pressures, while the central bank did not use macroprudential tools to curb strong credit growth to help contain the excess demand pressures also contributing to the higher inflation, given the unilaterally euroised regime. 2) **Substantial implementation**: Non-performing loans (NPLs) have been on a declining trend after a rise following the 2021 Asset Quality Review (AQR), and all AQR follow-ups have been completed. NPL provisioning has been adequate. On the real estate sector, the central bank has asked banks to calculate loan-to-value and debt related to income ratios when providing loans, but data gaps remain for the real estate sector more broadly. 3) **Substantial implementation**: Progress was made with key legislation that further aligned Montenegro's regulation and supervision with the current EU framework, including amendments to the

solutions for swift and effective NPL resolution.	Law on the resolution of credit institutions. An EBRD credit line with the Deposit Protection Fund remains in place, which has incrementally raised the coverage ratio of insured deposits. The central bank has set up a Resolution Department, and all banks have submitted resolution plans. However, progress has been limited on legislation and on actions to strengthen the broad institutional framework for efficient insolvency. In a renewed attempt, the central bank is setting up a working group of key stakeholders to address shortcomings in the judicial process and the legal framework on the collection of receivables.
PG 4: Finalise an analysis of barriers to businesses at the local administration, propose improvements to the institutional and regulatory environment on this basis and start to implement them. Continue implementing digital services for micro, small and medium enterprises and prioritise the development and implementation of interactive e-government platform for transactional electronic services. Adopt a strategic plan for "Montenegro Works" and perform an analysis of Montenegrin state-owned enterprises to prepare a proposal for the optimal portfolio of state ownership.	There was **limited implementation** of PG 4. 1) **Partial implementation:** An analysis of support for the development of micro, small and medium enterprises (MSMEs) that focused on cooperation between local self-governments and national authorities, was published in April 2022. The analysis provided recommendations to improve the overall administrative and legislative framework for MSMEs and communication between municipalities and government, which are however not implemented. In parallel, the Competitiveness Council continued its work on identifying barriers to business and maintained a technical level of cooperation with the state administration. The document produced by the Council in 2022 identified 98 barriers, but did not lead to any concrete deliverables by the government. 2) **Limited implementation**: In the first half of 2022, the government offered e-payment opportunities and electronic identification (digital ID cards) for a selected number of services. The government also improved the user experience and the scope of the open data portal (data.gov.me). However, political instability and cyber attacks in the second half of 2022 stalled efforts to further develop interactive e-government platform and to make progress on the related ERP reforms. 3) **Limited implementation**: In July 2022, the government decided to overhaul its strategic approach to the reform of state-owned enterprises (SOEs) and closed down 'Montenegro Works', set up by the previous government. A small department in the Ministry of Finance was set up to monitor the fiscal risks of SOEs instead, while plans for the yet-to-be determined SOE reforms are to be prepared based on further analyses to be made in 2023. Current plans do not address the ownership strategy of the state and do not determine a portfolio of key companies that should remain in the state's possession.

PG 5: Complete the survey on informality and assess the short-term effects of the "Europe Now" programme. Analyse the results and feed them into a comprehensive action plan to tackle informality and start its implementation. Ensure structural cooperation between central and local authorities in the development and implementation of the plan, including on preventing measures and incentives to legalise informal businesses and employees.	There was **limited implementation** of PG 5. 1) **Substantial implementation:** A comprehensive survey on informality was completed in July 2022, but the analysis of the December 2021 tax reforms ('Europe Now' programme) on informality has not been finalised yet. 2) **No implementation:** The results of the informality survey have not been analysed yet. A working group to draft an action plan was set up in February 2023 but the timeline for adopting the document is the end of 2023, with the possible implementation starting only in 2024. 3) **No implementation:** As the drafting and implementation of the action plan has not yet started, the degree of cooperation cannot be assessed.
PG 6: Finalise, in co-operation with all relevant ministries, their agencies and stakeholders, a Youth Guarantee Implementation Plan, adopt it and initiate its implementation. Based on the Roadmap of Reforms on Social assistance and social and child protection services in Montenegro, establish a clear timeline and financial planning for its implementation and continue implementing the reforms. Continue efforts to reform the provision of active labour market policy measures with an emphasis on their labour market relevance, including work-based learning, and establish a continuous monitoring mechanism.	There was **limited implementation** of PG6. 1) **Partial implementation** The multi-stakeholder working group prepared a first draft of the Youth Guarantee implementation plan in mid-2022 and is currently working on finalising it following comments received. The Plan is expected to be adopted in 2023 and implementation to start in 2025. 2) **Limited implementation** The terms of reference for the analysis of costs and the preparation of a financial plan for the social and child protection system reform was prepared, but not submitted due to the no-confidence vote of the previous government in Q2-2022. This work is expected to be integrated into the preparation of the new national strategy for social and child protection, expected to be prepared in 2023. 3) **Limited implementation** Monitoring the implementation of the national strategy for employment remains a challenge, as with the previous strategy, because of the scarcity of data. Although studies were conducted on certain active labour market measures, a continuous monitoring mechanism of active labour market measures is still lacking. The effectiveness, cost-efficiency and coverage of active labour market policies thus remains insufficient.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2023-2025 ERP

Public financial management

Reforms of public financial management (PFM) over the last 2 years led to the introduction of programme-based budgeting, including the first elements of performance budgeting. Additional legislative changes are needed to complete these reforms, such as setting up a Fiscal Council and switching to accrual accounting. A new PFM strategy for 2022-2026 was adopted in December 2022. Capital budgeting, debt management and asset management require further reforms. The lack of interoperability of the various IT systems remains an obstacle to some reforms. Some progress was made in 2021 on budget transparency. However, the monitoring and reporting framework is still not operational, due to IT issues. Finally, civil society is not systematically involved in monitoring the implementation of the PFM reforms.

Reform measure 12 – 'Improving management of state-owned enterprises' is analysed under the key challenge on strengthening the regulatory environment.

Green transition

Montenegro committed to the Green Agenda for the Western Balkans and to achieving carbon neutrality by 2050. It is in the process of drawing up a national energy and climate plan, due in 2024. The country needs to address significant challenges in the areas of energy, transport and Trans-European Networks, and in particular the future of the coal power plant in Plevlja, which produces approximately 50% of the country's electricity.

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

Reform Measure 18 - 'Reducing release into circulation of lightweight carrier plastic bags and single-use plastic products' continues on from the 2022-2024 ERP and remains relevant, given Montenegro's numerous environmental concerns. Activities planned for 2022 were postponed to 2023. The timely implementation of the reform depends on the adoption of the Law on waste management and of the related secondary legislation, which would e.g. target plastic producers. The impacts of the reform may be difficult to measure in the short term, as statistical data on plastic waste and its recycling are not available.

Digital transformation

The digitalisation of the public sector and the development of transactional e-government services for the public and businesses has featured prominently among the government's priority reforms in recent years. The process gained additional momentum during the COVID-19 pandemic, but a series of cyberattacks in the second half of 2022 seriously disrupted the government's digital services and brought the issue of cybersecurity, previously somewhat neglected, to the forefront. Access to broadband networks is key to digitalising the economy and public services, and to implementing Montenegro's smart specialisation strategy in the ICT sector. By May 2022, some 82% of Montenegrin households were located in areas with high-speed broadband connection available(defined as 30 Mbit/s), but actual take-up was much lower at only around 48% of households. Meanwhile, 19% of households were still without internet access in 2021, despite it being technically available, with the figure increasing to 37% in rural areas.

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

Business environment and the reduction of the informal economy

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

Research, development and innovation

Public and private investments in research, development and innovation are low. Montenegro is nonetheless considered an emerging innovator in the European Innovation Scoreboard for 2022, with a summary innovation index of 47.5% relative to EU 100%. However, the country's performance gap with the EU is widening. The links between academia, research institutes and business are still weak. Only 2.2% of Montenegrin micro, small and medium enterprises invest in R&D, compared to 22% at regional level. Research staff are employed almost exclusively by the government or in the higher education sector. With a rate of 0.36% of GDP invested in R&D (2019), Montenegro's spending is just over one sixth of the EU-28 average (2.18% of GDP in 2019). The adoption of a smart specialisation strategy (S3) in June 2019 allows Montenegro to concentrate its scarce R&D resources on specific sectors in order to strengthen innovation in key areas such as agriculture and food processing, energy and sustainable environment, sustainable health tourism and ICT.

Reform Measure 8 - *'Strengthening the national innovation and research ecosystem'*, is analysed under the key challenge on strengthening the regulatory environment.

Economic integration reforms

The low level of processing local products and the small size of businesses undermine the country's competitiveness on the export market. Montenegro's largest exports are low value-added bulk products - aluminium, bauxite, metal scraps and electricity. Manufactured goods, construction materials, machinery, transport equipment and food are the main imports. There is significant potential to increase intra-regional trade under the Central European Free Trade Agreement (CEFTA) and with the EU, as trade preferences granting access to the EU market without customs duties apply to 98.6% of Montenegrin products.

In 2021, Montenegro's foreign trade in goods increased by 20.5% compared to the previous year and almost recovered to the pre-pandemic level. The EU remains Montenegro's main foreign trade partner, accounting for 43% of all trade (31.1% of exports and 45.7% of imports of goods). This compares to some 30.5% of trade with CEFTA countries. The EU remains the main source of foreign direct investment inflows for Montenegro.

Reform Measure 13 – *'Facilitation of trade in goods and services through implementation of CEFTA Additional Protocols 5, 6 and 7'* is analysed under the key challenge on strengthening the regulatory environment.

Energy market reforms

Strategic decisions are needed to transform the structure of the energy market and address energy efficiency. Montenegro's energy comes mainly from a coal (lignite) thermal power plant (TPP) in Pljevlja and hydropower. The former provides around 50% of the country's overall energy production and is vital for security of supply and the stability and reliability of the country's power system. However, TPP Plevlja remains the main polluter in Montenegro and operates in breach of the Directive on large combustion plants, having reached its maximum operating hours in November 2020. Finding an alternative solution for energy production or supply is imperative, but any decisions in this regard are not expected until the government has adopted the National Energy and Climate Plan in early 2024. The use of renewable energy is high. In 2020, some 44% of the country's electricity production came from renewable sources, mostly hydropower and biomass. In recent years, investments were made in wind power plants, but the high wind potential is far from fully utilised. Major solar plant projects were also launched, but having encountered initial land ownership and technical problems, most of them are facing significant delays.

Reform Measure 17 - *'Financial assistance to the households with the aim of implementing energy efficiency measures'* continues on from previous ERP cycles. The reform remains relevant and credible, though its impact, given the scale of energy efficiency needs, is limited. The annual activities (cyclical in nature) were implemented on time. However, financing for the programme for the coming years has been significantly reduced.

Transport market reforms

Montenegro would benefit greatly from developing and improving transport infrastructure and from ensuring a good connection with the European transport corridors. The country's geographical situation makes it particularly important to improve transport links with the wider region and with the rest of Europe. However, the strategic steer for developing the sector should be revised to reflect EU development priorities and Transport Community Treaty commitments (sustainable and smart mobility) and move away from the current emphasis on road transport. Montenegro scores very low on connectivity. Progress on improving and modernising short sections of the road and rail networks is slow and mainly thanks to EU funding. The prioritisation of further investments must reflect the available fiscal space and be sustainable. Further action is needed to open the rail market up to competition and to complete regulatory reforms that have been neglected for years. The (currently suspended) tender for a concession to maintain and upgrade the country's two main airports in Podgorica and Tivat could help address the country's limited accessibility by air.

Reform Measure 17 - *'Improving border crossings-opening of the joint railway border station Bijelo Polje'* is new and relevant, but not ambitious enough for a strategic reform in the transport sector. It addresses only a small project in the larger plan (TEN-T network extension in the Western Balkans). The reform appears achievable already in 2024. The main risk – a lack of coordination between the Ministry of Capital

Investments, the Ministry of Finance and the Railway Infrastructure of Montenegro and lack of engagement of the latter in the reform - is not sufficiently addressed and not mitigated.

Agriculture, industry and services

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

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

Services, particularly tourism services, are the country's main export. They accounted for around 80% of total exports in 2019, with the country's tourism revenues recovering to pre-pandemic levels at the end of 2022. The sector provided over 73% of gross value added in 2021 and employed close to three quarters of the workforce. The country's 2019 Smart Specialisation Strategy identified health tourism as an area to develop, which would partially offset the seasonal aspect of tourism. Further diversifying the services sector away from tourism would reduce the economy's vulnerability to external factors, such as the pandemic, geopolitical risks, and climate change.

Reform Measure 16 - 'Investments aimed at the development of agriculture and rural areas' continues on from previous ERP cycles and incorporates elements of the Green Agenda for the Western Balkans. The reform is cyclical in nature, linked to IPARD implementation and dependent on IPARD funding. The measure is relevant, of good quality, and well developed and explained. The timing and planning of activities in 2023-2024 appears somewhat optimistic, given the specifics of EU funding.

Reform Measure 15 - 'Sustainable green tourism' continues on from previous ERP cycles. Activities planned for 2022 were not carried out and have been brought forward to 2023. The measure includes a 'greening' component, focused on developing 'green' accommodation (incorporating environmentally-friendly technologies, emission standards, energy efficiency, renewable energy sources, etc). The measure is relevant and justified, but the description and activities read like a high-level summary of an action plan, given the diversity and broad scope of the various actions. The indicators, funding section and risks therefore remain very generic and do not provide the information needed to verify the credibility and progress of the reform.

Education and skills

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

Employment and the labour market

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

Social dialogue

Montenegro has continued to consult social partners regularly, but further efforts are needed to ensure that consultations are consistent across sectors and institutions. The tripartite Social Council continued its meetings and was regularly consulted on relevant decisions. However, the effectiveness of social dialogue and the mainstreaming of the consultation of social partners across all relevant ministries and departments remains limited. Awareness of the work of and support to the Social Council remains limited and hinders the mainstreaming of consultations of social partners. After some delays, and following the adoption of the new Labour Law in 2019, the updated general collective bargaining agreement came into force on 31 December 2022.

Social protection and inclusion

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

Healthcare

Although the availability of healthcare services is adequate, primary healthcare provision is insufficient. According to the Law on Compulsory Health Insurance every citizen is entitled to healthcare. Although data on real coverage is scarce, with estimates ranging from 99.3% (for people aged 65 and over) to 81.3% (18-24-year-olds) (CeMI, 2017), it is estimated that nearly 100% of the population is covered thanks to the 2017 reform that extended coverage based on residence (WHO, 2022). Nonetheless, out-of-pocket payments are high, accounting for around 39% in 2019 (WHO, 2022), compared to 14.39% in the EU in 2020. The World Health Organization (WHO) found that almost 10% of all households experienced catastrophic health spending in 2017 (WHO, 2022). At the same time, healthcare system financing has increased, reaching 11% of GDP in 2019, which suggests an inefficient use of the funding (WHO, 2022). Montenegro moved to a fully tax-funded health insurance system in 2022, but there are concerns about its long-term financial sustainability (WHO, 2022).

Although the availability of healthcare services (number of hospital beds and medical staff) is comparable to the EU average, primary healthcare provision and prevention measures remain underdeveloped. Self-reported unmet medical needs remain below the EU average. After rising to 3.1% in 2019, the rate dropped to 1.6% in 2020, compared with the EU rate of 4.8% in 2021. Self-reported unmet needs for dental care stood at 3.3% in 2020, compared with the EU rate of 5.0% in 2021. The relatively low rates of unmet needs are likely due to the broad health coverage in the country, while unmet needs are largely due to out-of-pocket costs (WHO, 2022). The government adopted a Strategy for Improving the Quality of Health Care and Patient Safety (2019-2023) in

2019 focused on improving and monitoring the quality of healthcare. However, Montenegro lacks an operational monitoring system which would allow data-based decision-making in healthcare (WHO, 2022).

Reform Measure 6 on 'Digitalisation of the healthcare system in Montenegro' builds on Measure 8 from the previous year, expanding it beyond telemedicine and e-health to encompass a broader digitalisation of the healthcare system. The aim is to improve the existing healthcare services and add new ones to ensure better accessibility, availability and affordability. The activities planned under the measure are ambitious and adequate.

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

Area/Sector	2017	2018	2019	2020	2021	EU-27 Average (2021 or most recent year)
Energy						
Energy imports dependency (%)	40.5%	31.1%	32.9%	27.4%	N/A	55.60%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	263.25	259.50	258.14	280.25	N/A	110.35
Share of renewable energy sources (RES) in final energy consumption (%)	39.69%	38.80%	37.72%	43.77%	39.89%	21.7%
Transport						
Railway Network Density (meters of line per km^2 of land area)	18.1 w	18.1 w	18.1 w	N/A	N/A	N/A
Motorization rate (Passenger cars per 1000 inhabitants)	310.6 w	331.7 w	350.3 w	N/A	356.7 w	N/A
Agriculture						
Share of gross value added (Agriculture, Forestry and Fishing)	8.4%	8.2%	7.9%	9.1%	8.0%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	7.9%	8.0%	7.1%	7.5%	6.4% w	4.3% (2020)
Utilised agricultural area (% of total land area)	18.6% w	18.6% w	18.6% w	18.7% w	18.7% w	40.6% (2020)
Industry						
Share of gross value added (except construction)	11.3%	12.5%	11.9%	13.5%	12.5%	19.9%
Contribution to employment (% of total employment)	9.5%	9.9%	9.5%	10.1%	10.2% w	16.1%
Services						
Share of gross value added	73.4%	72.3%	72.3%	70.1%	73.8%	79.2%
Contribution to employment (% of total employment)	75.0%	73.1%	73.4%	74.1%	76.7% w	70.9%

Research, Development and Innovation						
R&D intensity of GDP (R&D expenditure as % of GDP)	0.35%	0.50%	0.36% [w]	N/A	N/A	2.26%
R&D expenditure – EUR per inhabitant	24.10€	37.7€	28.7€ [w]	N/A	N/A	734.5
Digital Economy						
Percentage of households who have internet access at home	71%	72%	74%	80%	81%	92.5%(2022)
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	71.3%	71.5%	73.5%	78%	82.2%	90%(2022)
Trade						
Export of goods and services (as % of GDP)	41.1%	42.9%	43.8%	26.0%	42.8%	50.4%
Import of goods and services (as % of GDP)	64.5%	66.7%	65.0%	61.0%	62.2%	46.7%
Trade balance (as % of GDP)	-44.9%	-46.2%	-44.1%	-41.5%	-41.7%	N/A

Education and Skills						
Early leavers from education and training (% of population aged 18-24)	5.4%	4.6%	5.0%	3.6%	6.7%	9.7%
Young people neither in employment nor in education and training (NEET) (% of population aged 15-29)	21.4%	21.0%	21.3%	26.6%	26.5%	13.1%
Children aged less than 3 years in formal child care (% of under 3-years-olds)	32.89% [w]	34.13% [w]	37.21% [w]	N/A	N/A	36.2%
Individuals who have basic or above basic overall digital skills (% of population 16-74)	50%	N/A	52.2%	U	47.2%	53.92%
Employment and Labour Market						
Employment Rate (% of population aged 20-64)	58.2%	59.8%	60.8%	55.2%	54.2%	73.1%
Unemployment rate (% of labour force aged 15-74)	16.1%	15.2%	15.2%	17.9%	16.6%	7%
Long term unemployment rate (% of labour force aged 15-74)	12.5%	11.4%	12.0%	13.4%	11.0%	2.8%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	13.8 pps.	13.8 pps.	13.3 pps.	12.9 pps.	11.1pps.	10.8 pps.
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	25.8 pps.	21.2 pps.	18.7 pps.	28.0 pps.	N/A	23.1 pps.
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	4.234	4.241	4.449	4.338	110.27

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

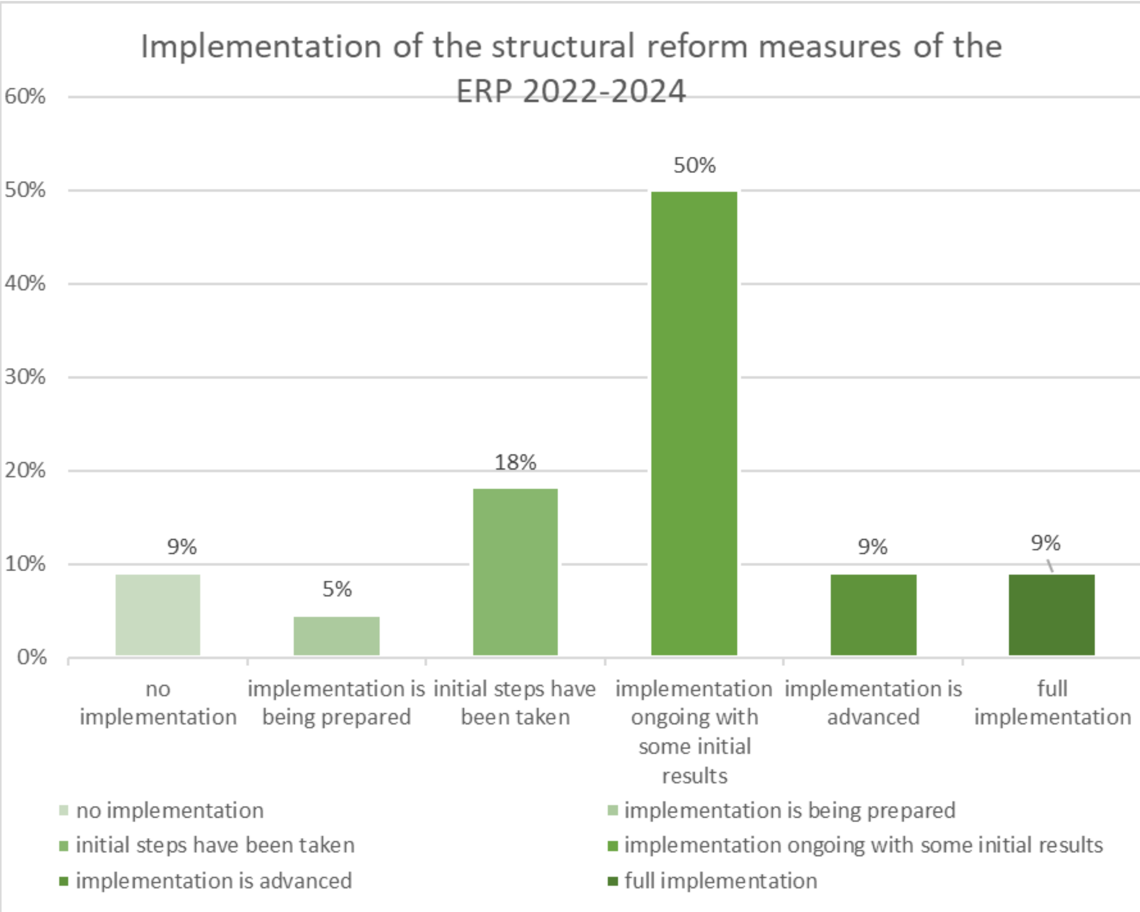
Social Protection System						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	42.2%	41.2%	36.6%	37.8%	38.9%	21.7%
At-risk-of-poverty or social exclusion rate of children (% of population 0-17)	49.0%	48.5%	43.5%	45.0%	45.5%	24.4%
Impact of social transfers (Other than pensions) on poverty reduction	24.84%	23.72%	16.95%	18.71%	27.2%	37.08%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	7.57	7.37	6.72	5.96	5.8	4.97
Housing cost overburden (% of population)	15.1%	14.7%	11.7%	9.4%	8.0%	8.3%
Healthcare						
Self-reported unmet need for medical care (of people over 16)	2.7%	2.3%	3.1%	2.1%	1.6%	4.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	42.17%	39.61%	38.56%	N/A	N/A	14.39%(2020)

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

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM 2022-2024 ERP

Montenegro made limited progress on the measures planned for 2022, with an average score of **2.85** out of 5. Reporting on the 2022 structural reform measures is generally of good quality, with sufficient information provided on the progress of the reforms. An assessment using the performance indicators was provided for almost all reforms.

Implementation was strong for some measures, such as Measure 2 on new work schemes and work-life balance and Measure 20 on financial support to households aimed at applying energy efficiency measures. Implementation was weaker for many other measures, such as Measure 3 on introducing the Youth Guarantee Programme in Montenegro and Measure 9 on establishing a full electronic registration of enterprises. There was no implementation for Measures 4 and 21 – on increasing employability of adults by improving their skills and competences needed at the labour market and on reducing release into circulation of lightweight carrier plastic bags and single-use plastic products.



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government of Montenegro submitted the 2023-2025 Economic Reform Programme to the Commission on 25 January 2023.

Inter-ministerial coordination

The Ministry of Finance and Social Welfare coordinated the work to prepare the 2023 ERP. An inter-ministerial working group involved all relevant ministries.

Stakeholder consultation

The national ERP coordinator organised an initial consultation on the design of the ERP measures in September 2022. Another public consultation on the draft ERPtook place in December 2022, including a round table public discussion.

Macro framework

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

Fiscal framework

The fiscal framework is well detailed, in line with stated policy objectives and consistent with the ERP macroeconomic framework. However, the programme is somewhat vague on medium-term developments, in particular on the impact of one-off measures which were recently adopted. Overall, the factors behind the ERP’s projected revenues and expenditures are based on exting legislative measures, and they are presented clearly. Some revenue measures, which are not included in the ERP’s macro and fiscal scenarios, were adopted after the ERP submission and might improve the budget revenue performance. Montenegro’s fiscal reporting does not follow ESA2010 standards, and therefore does not meet the Commission’s fiscal notification requirements.

Structural reforms

The structural reform parts of the ERP respect the guidance note. A dedicated section provides information on the implementation of the policy guidance for 2022. Reporting on the progress of 2022 structural reform measures is generally of good quality. The 2023-2025 ERP sets out 19 reform measures and structures almost all of them well in terms of scope, timeline and the budget for the planned activities. However, the page limit for structural reforms is significantly exceeded.

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