Analysis on Public Debt

Montenegro

CSOs as equal partners in monitoring public finances

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BALKAN MONITORING PUBLIC FINANCES

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CREDITS

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This document has been produced as a part of the project "CSOs as equal partners in the monitoring of public finance", which started beginning of 2016 and is implemented by a consortium of 10 organizations from 7 countries and will last for four years.

The aim of the project is to improve the transparency and accountability of policy and decision making in the area of public finances through strengthening the role and voice of NGOs in monitoring the institutions that operate in the area of public finances. In this way, the project will strengthen CSO knowledge of public finance and IFIs and improve CSO capacities for monitoring. Additionally, it will help advocate for transparency, accountability and effectiveness from public institutions in public finance. Moreover, this project will build know-how in advocating for sustainability, transparency and accountability of public finance and IFIs. This project will also increase networking and cooperation of CSOs on monitoring of public finance at regional and EU level. Lastly, it will increase the understanding of the media and wider public of the challenges in public finance and the impacts of IFIs.

Key project activities are research and monitoring, advocacy, capacity building and transfer of knowledge/practices and networking in the field of the 4 specific topics: public debt, public-private partnerships, tax justice and public infrastructure.

More information about the project can be found on http://wings-of-hope.ba/balkan-monitoring-public-finance/ and on the Facebook Page Balkan Monitoring Public Finances

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CONTENT

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

INTRODUCTION

Montenegro is highly-indebted country. Its public debt increased three times over the last decade and reached 2.5 billion Euros at the end of 2016 or 68% of the GDP. Main burdens to the budget include construction of the highway, interest rates for previous loans, state guarantees for private companies and salaries for oversized public administration. The Parliament did not conduct oversight in this area, while the Government frequently ignores findings of the State Audit Institution. The Government does not provide clear public debt prognosis, only measures for its management - rationalisation of the public sector wages, harmonisation of tax policies and improvements in tax collection. However, international financial institutions estimate that the public debt might reach 3 billion Euro or nearly 90% of the GDP in the following three years.

In the first years after independence in 2006, public debt of Montenegro was at a reasonable level, and from 2008 onwards its increase significantly progressed. Global financial crisis in 2009 hit Montenegrin economy, as it hit the rest of the World, but this was not the only problem Montenegro faced. Irresponsible economic and financial policy of the Government, especially in the area of privatisation and state aid to new owners, led to heavy increase of the public debt.

Various subsidies and guarantees to privatised companies, together with new loans for long-term infrastructure projects, such as the highway Bar-Boljare are main reasons for the increase of the public debt. Legal solutions, which increased salaries in the over-crowded public sector and lifetime benefits for certain categories of population put additional pressure at public finances.

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1. LEGAL FRAMEWORK ON PUBLIC DEBT

Montenegro does not have a special act regulating public debt. Thus, public debt is addressed by the Law on Budget and Fiscal Responsibility. Other laws and policies are Law on State Aid Control and strategic framework for debt management.

Law on Budget and Fiscal Responsibility stipulates that "**public debt"** is the debt of the "General Government" [i] which include National Government and governments of all 23 Montenegrin municipalities. The Law also recognises the „**state debt**", which is a debt of the National Government only.[ii] Furthermore, the Law stipulates that the State may take borrowings during the fiscal year up to the level established by the annual State Budget Law (SBL).[iii] The borrowing, in this sense, refers to undertaking financial obligations with regard to loan agreements, issue of debt securities and issue of guarantees.[iv] Borrowing is defined as short-term or long-term depending if the repayment period is below or above 12 months.[v] The Law also recognises the possibiliy of debt assumption from other subjects, but the State may only do so by adopting of a special law or prescribing it into the annual SBL.[vi]

The State may borrow funds in order to:

- finance expenditures of the State Budget in accordance with the annual SBL;
- redeem and refinance the State Debt;
- maintain the budget liquidity;
- hedge against risks by entering into swap contracts[vii] and derivative purchase contracts[viii];
- finance other needs in accordance with law.[ix]

In order to establish management of the debt, the Law prescribes that the Government, with the opinion of the Central Bank, adopts the **Debt Management Strategy**, which defines a framework borrowing program for a three-year period, guidelines for risk assessment for taking borrowings, guidelines for management of debt, cash, guarantees, and borrowings, and other matters significant for debt management.[x] However, inputs from the Central Bank are not obligatory. [xi] All these categories are incorporated into the current Strategy which refers to the 2015 – 2018 period[xii].

The Ministry of Finance keeps the records of the public debt – it manages and keeps data on the state debt, while municipalities inform it on their debt on a quarterly base.[xiii] All are obliged to publish quarterly records on their websites.[xiv]

The Ministry of Finance provides a record of domestic and foreign debts and is responsible for the debt management.[xv] Director General of the State Treasury is in charge of keeping records of the State debt.[xvi]

Law on State Aid Control stipulates that a state aid may be granted in the form of: subsidies, fiscal reliefs (taxes, contributions and other public revenues), state or municipal guarantee and interest rate subsidy for loans. It also enables state aid in the form of giving gain and/or dividends of the State or municipality for grantor's development projects to economic entities, discharge of debt, sale of immovable property by the State or municipality at a price lower than the market price or purchase at a price higher than the market price or other aid in accordance with law.[xvii]

The European Union emphasize Montenegro should pay particular attention to stabilising and reducing public debt, including by adopting measures to restrain current spending and improve revenue collection and developing a comprehensive strategy to further foster the disposal of non-performing loans.[xviii] It also points out the need for Montenegro to develop stronger medium-term budget framework, improve programme budgeting, better planning of capital projects and enhanced debt management.[xix] Similar to EC findings, key recommendations of the IMF are that the Government need to develop sound macroeconomic policies to address risks of large infrastructure projects' impact on fiscal and external sustainability. Also, they recommend "containing public sector wage bill, improvements of the sustainability of the pension system and strengthen revenue collection to reduce public debt ratio to 60% of the GDP over the medium term."[xx]

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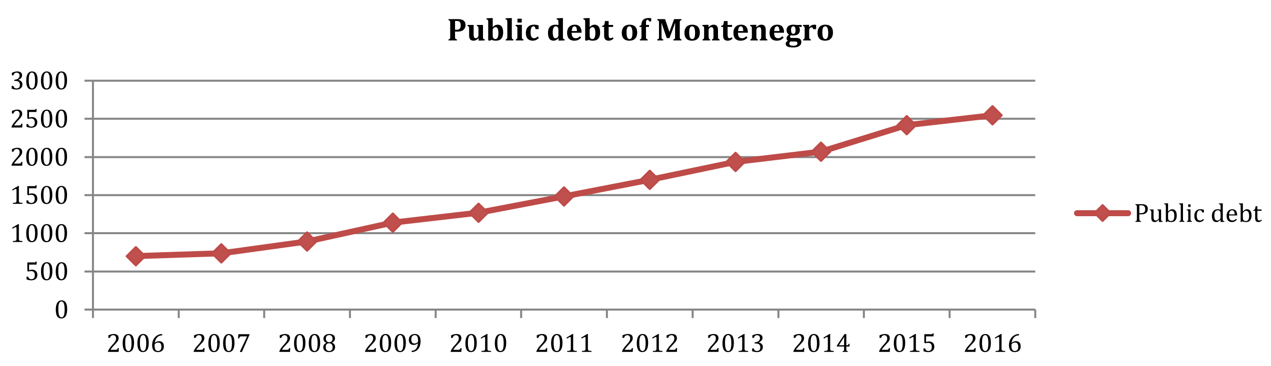
2. PUBLIC DEBT

Montenegro is highly-indebted country, whose public debt increased three times over the last 10 years, since it gained independence[xxi]. Key reasons for a significant increase of the debt are related to increase of the public sector expenditures - overemployment and increase in salaries and pensions, extensive provisions of the state guarantees and subsidies to the privately owned, privatized companies and large infrastructure project which were not supported with an equal growth of the economy.

At the end of 2016 the public debt of Montenegro was over 2,5 billion EUR, or 68.27% of GDP.[xxii] According to some analysis, public debt might reach 3 billion EUR by the end of 2017.[xxiii] Last, more extensive increase of the public debt is related to the **highway project financed from the Chinese loan, with an** estimated cost of just the first out of three phases of the project exceeding one billion EUR (higher than initially expected due to exchange rate effects).[xxiv]



Graph 1: Public debt of Montenegro since independence in 2006 until 2016 expressed in millions of EUR (sources: Central Bank of Montenegro; Debt Management Strategy for the period 2015 – 2018; Reports on the Public Debt)

At the end of 2016, Montenegro has 20 foreign and nine domestic groups of creditors for the state debt only. At the same time, there is no information on creditors of municipalities, just information on the level of the debt.

Table 1: Breakdown of the Montenegrin public debt (source:Report on the Public Debt for 2016)

Type of debt	**In million EUR**	**% of the GDP)**
State debt to foreign creditors	2,002.76	53.7
State debt to domestic creditors	400.20	10.73
Debt of municipalities	143.09	3.84
Total public debt	**2,546.05**	**68.27**

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Key Montenegrin foreign creditors were holders of our EUROBONDs worth over one billion EUR, European Bank for Reconstruction and Development (EBRD) with over 210 million, Chinese EXIM Bank with over 189 million, Credit Suisse Bank with over 128 million and European Investment Bank with over 105 million EUR of loans.

However, debt to the Chinese EXIM Bank is to be significantly increased in the several upcoming years, since its current amount depends on the implementation of the Highway Project, while overall value for the first phase is to exceed one billion EUR, as previously mentioned.

2.1. Availability of information and transparency of data

Ministry of Finance, in accordance with the Law, publishes quarterly reports on the State debt on its website.[xxv] However, when it comes to overall public debt, these reports are being published on an annual basis, at the website of the Ministry. Nevertheless, this information is not being published in open data format, but is given in PDF.

On the other hand, municipalities do not publish reports on their debt at a quarterly base at their websites, as prescribed by the law.

Furthermore, information about expenditures for certain guarantees, subsidies and other forms of state aid are also not timely disclosed, while many info related to the state aid for construction of the highway are not available to the public.

2.2. Consistency of official data with fiscal framework policies

Government has not managed so far to be fully consistent with the legislative and strategic framework on management of the public debt. The Law stipulates that in order to remove risks of the public finances instability, the Government will, in the event that the public debt reaches 60% of GDP, adopt a proposal of the law amending and supplementing the State Budget Law to ensure maintaining the debt within 60% of GDP.[xxvi] However, this did not occur so far, although public debt exceeded prescribed percentage of the GDP by the end of 2014.

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As recognised by the Debt Management Strategy, the main challenge for the sustainability of state budget is a loan taken for construction of highway Bar-Boljare. Therefore, instead of reducing public debt, it envisaged its further increase. Public debt will trend upwards in the coming years as the Government continues disbursing the highway construction loan, according to the World Bank projections.

"Even under the government medium-term fiscal scenario, public debt will grow to 79 percent of GDP by 2019. Under the current policies scenario, public debt is estimated to peak in 2018 at close to 80 percent of GDP, before stabilizing. However, this is based on the assumption that the highway construction would end by 2018 and that deficit will be around 8 percent of GDP in the 2016-18 period. There are number of additional risks to this scenario. The largest comes from a potential growth shock. If growth stagnates in the 2016-2020 period instead of expected over 3.5 percent average growth per year, public debt to GDP ratio would surge even further to close to 90 percent of GDP."[xxvii]

2.3. Key milestones for the increase of the public debt

During last 10 years, since Montenegrin independence, several issues critically contributed to the increase of the public debt, as shown in the table below:

Year	***Description***	***Amount (in million €)***
2006	*Restitution*	*125*
2008	*Compensations to pensioners, owners of deposits in former Yugoslavia and support to private banks*	*195*
2009	*Compensations to pensioners*	*32*
2010	*Payment of interest rates and subsidies to private sector*	*69*
2011	*Payment of guarantees*	*56*
2012	*Payment of interest rates, subsidies and guarantee*	*102*
2013	*Repayment of previous loans and securities and subsidies to KAP*	*322*
2014	*Loan from EXIM bank for the highway*	*809**
2016	*Additional social giving and increase of salaries in the public sector*	*87*

**Actual costs for the highway will occur in following years*

Table 2: Key milestones for increase of the public debt

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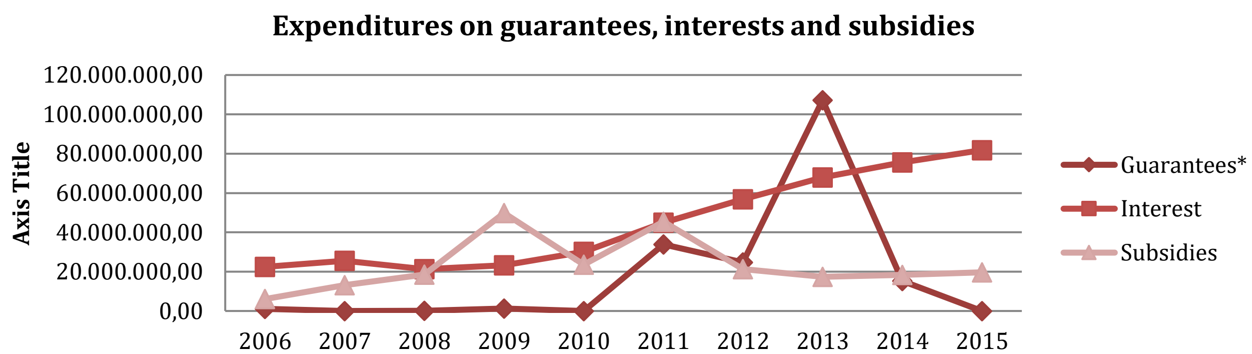
In 2006 first key increase of the public debt occurred. Due to the previous adoption of the Law on Restitution of Property Rights and Compensation, debt for this purpose was for the first time compressively calculated and estimated at over 125 million EUR.

During 2008 there has been a second large increase of the public debt. Montenegro adopted the Law on Compensation of Pension and Disability Insurance. This Law envisaged payment of pension arrears in the total amount of 105 million EUR. This was also followed by obligations from adoption of the Law on Payment of Foreign Currency Savings Deposited with Authorized Banks Headquartered Outside the Republic of Montenegro, increasing debt in this area for over 20 million.

In addition, The Government also approved loan assistance to the “First Bank of Montenegro” (Prva Banka Crne Gore)[xxviii], owned by the Prime Minister Milo Đukanović and his family, in the amount of 44 million EUR and bought commercial loans in the amount of 26 million EUR from private banks, thus making the first major "hole" in the budget.[xxix]

In 2009, Montenegro spent over 32 additional million EUR for compensation to pensioners.[xxx] Also in this year started significant increase for payments for guarantees, interest rates and subsidies.



*There is no information on guarantees in 2007

Graph 2: Expenditures on payment of guarantees, loan interest and subsidies since independence in 2006 until 2015 (source: State Audit Institution’s reports on final budget account of Montenegro 2006-2015)

In 2010, in addition to expenditures for salaries of employees in public administration, the Government allocated large amounts of budget for payment of subsidies (38.7 million EUR) and loan interests (30.7

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million EUR). During the same year, Montenegro adopted a Decision on Loans and Issuance of Guarantees, giving guarantees in the amount of 140 million EUR for support to the economy. The largest guarantees were given for loan arrangements of the Aluminium Plant, in the amount of 82 million EUR, as well as the Iron Factory in Nikšić in the amount of 27.3 million EUR. Although there were no payments in 2010 based on these decisions, it heavily impacted increase of public debt in the following years.

A year later, Montenegro had to pay the 33.9 million EUR, out of which 26.3 million EUR for guarantees given to Iron Factory.

In 2012 Montenegro had expenditures in the amount of 56.9 million EUR for loan interest, 21.3 million EUR for subsidies and 24.7 million EUR for guarantees.

During 2013, public debt increased due to repayment of loan principal in the amount of 132.8 million EUR. Public debt dizzily jumped due to payment of guarantees for the Aluminium Plant in the amount of over 102 million EUR. Additionally, Montenegro allocated 87.5 million EUR for repayment of securities and credits to residents and non-residents.

Case Study 1: Aluminium Plant Podgorica (KAP) causes enormous debt

Montenegro has lost over several hundred million of EUR due to the murky privatisation of KAP, which was brought by the Central European Aluminium Company (CEAC) of the Russian oligarch Oleg Deripaska.

At the beginning of 2009, after several months of crisis and fail of market price of aluminium, KAP was about to collapse. On 16 November 2009, the Government signed a settlement agreement with CEAC, where the Government has committed itself to issue state guarantees for KAP loans in the amount of 135 million, which was done in several phases. First guarantees have been issued with the OTP Bank in the amount of 49.7 million EUR on 19 November 2009. In June 2010 the Government issued new state guarantees for repayment of KAP loan at Deutche Bank in the amount of 22 million EUR. In October the same year, the Government issued additional guarantees for the KAP loan with the Russian VTB bank in the amount of 40 million EUR.

Due to increase of state debts, the Parliament requested from the Government to terminate the contract with the CEAC in 2012, but the Government refused to do so. Therefore, citizens payed additional

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23.4 million EUR of loan to the Deutche Bank. In the beginning of 2013, the Parliament again adopted conclusions requesting the Government to terminate the contract, but it was again refused. In June 2013 the VTB and OTP banks activated guarantees, withdrawing 102 million EUR from the state budget.[xxxi] Finally, the contract was terminated following over 125 million EUR spent for guarantees.

In October 2014, the Government and Chinese Exim Bank signed the financing contract for the first phase of the highway construction in the amount of over 800 million EUR.[xxxii] The contract is related to only one section of the highway which is 41 km long. The overall cost of that section is 809.6 million EUR, of which 85 percent will be covered by the Exim Bank loan, while the remaining 120 million EUR will be provided through the budget over the four years, which is the expected period of construction. However, since the loan is indexed in US Dollars although Montenegro uses Euro as currency, and the Government did not purchase insurance for the currency rate fluctuation, current worth of the loan was increased to over one billion EUR, due to the increase of the US Dollar vs. Euro.

In 2015 Montenegro adopted amendments to the Law on Social and Child Protection, which introduced lifetime benefits to mothers with three or more children from the beginning of 2016. This right was used by over 18 thousand persons and for this purpose, Montenegro had to allocate over 67 additional million EUR, thus creating new pressure at the budget.[xxxiii] However, this Law was ruled unconstitutional in April 2017 by the Constitution Court, and at the moment it is not clear will mothers continue to receive these benefits and in which amount.

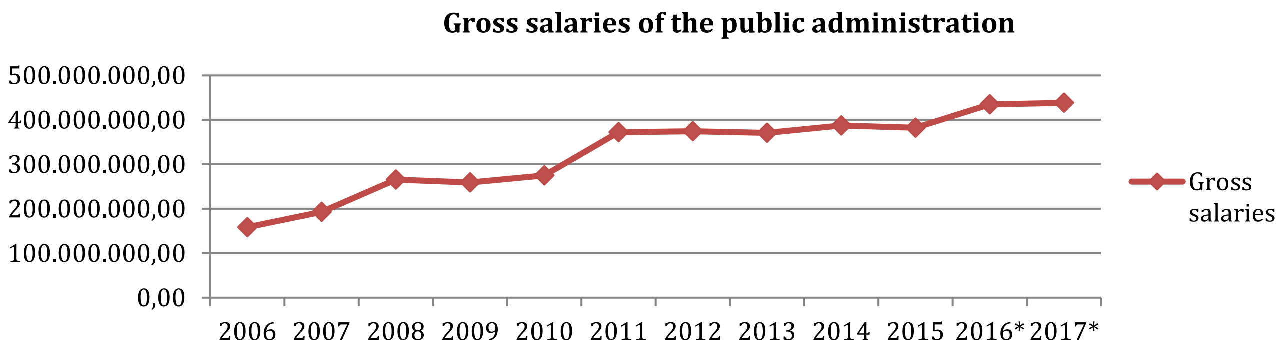
Although the Government raised concern about lifetime benefits for mothers being one of key reasons for the debt increase, official data show that so far expenditures for this purpose participate with 2,63% in the current public debt.

Also, by adopting the Law on Earnings in the Public Sector at the end of 2015, increase of salaries of public servants and officials in 2016 worth almost 20 million EUR additionally burdened the budget. Local NGOs and media argue that public administration is oversized for political purposes and number of employees is increased prior to every election. [xxxiv]

Case Study 2: Salaries of the Public Administration

One of the main items burdening the budget of Montenegro is salaries of public sector employees. In 2015 the Parliament adopted the act on increase of salaries in public sector.

According to available information, the public sector in Montenegro has around 30,000 employees, which represents around 17% of the total number of employees in Montenegro.[xxxv] Expenditures for salaries of employees in public sector seriously are constantly increasing. According to the Budget of Montenegro, expenditures for gross salaries of employees in public sector amounted to 438.2 million EUR in 2017.



*Gross salaries for 2016 and 2017 are given based on planned amount for salaries since final account has not been developed

Graph 3: Amount from the State Budget Law for gross salaries for public administration for the period 2006 - 2017 (source: Law on State Budget)

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3. INDEPENDENT REGULATORY AND OVERSIGHT BODIES/ ACCOUNTABILITY

The State Audit Institution, which is by Law an independent and supreme state audit body[xxxvi], is in charge for analysing the state budget. According to the Law, audited entities are the authorities and organisations managing the budget or state property and of the local self-government units, the funds and other legal entities being founded by the state or in which the state is a majority shareholder or holds a majority stake.[xxxvii] This institution produces reports on audit of the final accounts of the state budget, containing information on management of budget and state finances by various institutions and provides recommendations for improvements. It has no authority to impose any sanctions for violations of the law or mismanagement of funds.

Public authorities do not always implement recommendations given by the SAI.[xxxviii] In order to increase compliance with recommendations from the SAI, the Parliament adopted the Law on System of Internal Financial Controls in Public Sector, which establishes system of internal audit in public sector. Nevertheless, internal financial control has not yet lived up to its full potential, which was noted by the SAI as well. In the last report on the Final Account of the State Budget, the SAI stated that carrying out activities to establish the function of financial control and internal audit in spending units in accordance with the Law on internal financial control in the public sector should continue.[xxxix]

SAI is not truly independent institution despite such legal requirement. In March 2017 high level official of the ruling party, involved in the vote buying scandal was appointed as member of the SAI's Senate.[xl] Previously, other high-level political officials were also appointed as members of the Senate of SAI.[xli]

The Parliament has authority to control public finances. In the last six years there has been no session of the Committee for Economy, Finance and Budget dedicated to public debt. Several sessions related to specific guarantees, concessions and the final account of Montenegro were held, but none of these were dedicated especially to the public debt or implementation of strategic documents related to the public debt management.

4. PUBLIC DEBT MANAGEMENT

It is expected that Montenegrin public debt will increase in the following years. According to the International Monetary Fund, government debt is projected to increase to 82 percent of GDP by 2019 or 89 percent including all issued guarantees.[xlii] **While the highway will bring some economic benefits, it is provided with significant subsidies and exemption of taxes and customs for goods and services needed for the construction and fees and benefits for employees working on it. Very high costs of that project will limit the Government's ability to undertake other important investments and expose the economy to risks.**

Potential new financing of other large infrastructure projects, such as construction of the second block of the Thermal Plant in Pljevlja or issuing new state guarantees raise concerns about the ability to sustain fiscal discipline in the medium term.

There are further risks for reduce of public debt in the next several years. Firstly, the World Bank believes that fiscal and debt levels are highly sensitive to shocks related to real GDP growth, financing costs, contingent liabilities, primary balance, exchange rate and most notably to an overrun in financing costs associated with the highway, which is why debt levels and financing needs far exceed those assumed by the authorities. Secondly, debt exposure to the US dollar-denominated highway loan and recent social and public wage policy measures place addition burden on public finances and contribute to public debt increase. Finally, historical performance suggests that government deficit targets are typically missed by a large margin (2-3 percentage points of GDP on average per year since 2008) due to over-commitments (public arrears estimated at close to 11 percent of GDP) and contingent liabilities (like guarantees repayment or court suits). [xliii]

Although the Government prepared a medium-term fiscal framework for 2016-18, as noticed by the World Bank, World Bank also suggests further rise in fiscal deficit underpinned by large capital investments and further consolidation of current spending.[xliv] Through this fiscal framework, the Ministry of Finance announced a set of fiscal measures to achieve current spending consolidation: (i) public sector wage system rationalization; (ii) further harmonization of the excise tax on cigarettes; (iii) stricter sanctioning of tax non-payers and fight against informal economy; (iv) new pension indexation and streamlining early retirement options; (v) collection of tax debt through debt-equity swaps and offering a discount for one-time settlement; and (vi) improving the regulatory framework for public procurement.[xlv]

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CONCLUSIONS AND RECOMMENDATIONS

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[ii] Ibid, article 2, par. 1, item 14.
[iii] Ibid, article 50, par. 1.
[iv] Ibid, article 50, par. 2.
[v] Ibid, article 50, par. 3.
[vi] Ibid, article 51, par. 1.
[vii] Swap contracts is a financial agreement on granting a borrowing for the purpose of risk hedging, under variable conditions in respect of interest and currency. Law on Budget and Fiscal Responsibility, article 2, par. 1, item 24.
[viii] Derivative is a financial security whose value is derived in part from the value and characteristics of another security. Law on Budget and Fiscal Responsibility, article 2, par. 1, item 25.
[ix] Ibid, article 51, par. 2.
[x] Ibid, article 58, par. 1 and 2.
[xi] If the Central Bank fails to submit the opinion within 15 days as of the day the proposal of the Strategy is submitted, the Government will adopt the Strategy without the Central Bank's opinion. Law on Budget and Fiscal Responsibility, article 58, par. 3.
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[xiii] Law on Budget and Fiscal Responsibility, article 59, par. 1, 2 and 3.
[xiv] Ibid, article 59, par. 4.
[xv] Instruction on the Work of the State Treasury, Official Gazette of Montenegro no. 53/14 and 72/15, item 101.
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[xviii] European Commission, *Montenegro 2016 Report,* European Commission, Brussels, November 2016, p. 23.
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[xxv] Reports are being published on the internet page: http://www.mf.gov.me/rubrike/drzavni-dug/.
[xxvi] Law on Budget and Fiscal Responsibility, article 21, par. 2, item 1.
[xxvii] World Bank Group, *Montenegro: Achieving Sustainable and Inclusive Growth Amidst High Volatility, Systematic Country Diagnostic", Washington DC, March 30th, 2016.*
[xxviii] First Bank of Montenegro is owned by Aco Djukanovic, brother of former Prime Minister, Milo Djukanovic.
[xxix] Vijesti online, *MANS: Road to collapse of public finances began with the First Bank,* Vijesti, Podgorica, 27 December 2016. More available on: http://www.vijesti.me/vijesti/mans-put-ka-krahu-javnih-finansija-poceo-je-od-prve-banke-918123.
[xxx] State Audit Institution, *Audit Report on Final Budget Account of Montenegro for 2009,* State Audit Institution, Podgorica, 29 September 2010.
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[xxxv] According to data provided by the Statistical Office of Montenegro (MONSTAT), there have been 177,908 of employees in Montenegro.

[xxxvi] Law on State Audit Institution, Official Gazette of Montenegro no. 28/04, 27/06, 78/06, 17/07, 73/10, 40/11 and 31/14, article 2, par. 1.

[xxxvii] Ibid, article 4, par. 1.

[xxxviii] In the last annual audit report, the SAI concluded that control audit subject that have been given eight recommendations have implemented only one recommendation, four recommendations have been partly implemented, while three have not been implemented at all. State Audit Institution, *Annual Report on Performed Audits and Activities of the State Audit Institution for the Period October 2015 – October 2016,* State Audit Institution, Podgorica, 27 October 2016.

[xxxix] State Audit Institution, *Audit Report on the Final Account of State Budget for 2015,* State Audit Institution, Podgorica, 2016.

[xl] Weekly Monitor, Zoran Jelić, Candidate for the SAI Senator: Four Votes one Senator", Podgorica, February 17th, 2017. More available on: http://www.monitor.co.me/index.php?option=com_content&view=article&id=7452:zoran-jeli-kandidat-za-senatora-dri-etiri-glasa-jedan-senator-&catid=5214:broj-1374&Itemid=6587

[xli] MANS, *Assesment of the National Integrity System of Montenegro,* Podgorica, August 2016. More available on: http://www.mans.co.me/en/wp-content/uploads/2016/09/NISreportEN.pdf

[xlii] International Monetary Fund, *Montenegro: Staff Concluding Statement of the 2017 (Article IV Mission),* International Monetary Fund, 28 February 2017. More available on: http://www.imf.org/en/News/Articles/2017/02/28/ms03012017-Montenegro-Staff-Concluding-Statement-of-the-2017-Article-IV-Mission.

[xliii] World Bank, *Montenegro – Achieving Sustainable and Inclusive Growth Amidst High Volatility – Systematic Country Diagnostic,* World Bank, 30 March 2016.

[xliv] Ibid.

[xlv] Ibid.

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