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Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 23-Aug-2024 | Report No: PIDDA00061

Public Disclosure Authorized

BASIC INFORMATION

A. Basic Project Data

Project Beneficiary(ies)	Operation ID	Operation Name	
Montenegro	P178646	Montenegro Resilient Fiscal and Sustainable Development DPF	
Region	Estimated Approval Date	Practice Area (Lead)	Financing Instrument
EUROPE AND CENTRAL ASIA	04-Oct-2024	Macroeconomics, Trade and Investment	Development Policy Financing (DPF)
Borrower(s)	Implementing Agency		
Montenegro	Ministry of Finance		

Proposed Development Objective(s)

The program development objective is to support the Government of Montenegro to: (i) strengthen fiscal sustainability and (ii) enable sustainable development.

Financing (US$, Millions)

Maximizing Finance for Development

Is this an MFD-Enabling Project (MFD-EP)? Yes

Is this project Private Capital Enabling (PCE)? Yes

SUMMARY

Total Financing	**90.00**

DETAILS

Total World Bank Group Financing	**90.00**
World Bank Lending	90.00

Decision

The review did authorize the preparation to continue

Explanation

B. Introduction and Context

Country Context

1. **As a small and euroized economy, Montenegro is particularly affected by external shocks, best evidenced during the pandemic, when the country suffered one of the sharpest recessions in the world.** Montenegro's economy grew 3.4 percent on average over the last decade which helped reduce poverty from 23.3 percent in 2013 to an estimated 9.4 percent in 2023. Growth was driven largely by public and private investments on the back of highway construction and high net foreign direct investment (FDI) of 10 percent of GDP on average over the past five years. These investments, however, had limited productivity spillovers and increased fiscal vulnerabilities as they necessitated large deficits and external imbalances due to their high import dependence, leaving the economy more vulnerable to external shocks. The COVID-19 pandemic exposed these vulnerabilities, as the tourism-dependent economy suffered a sharp recession. GDP declined by 15.3 percent in 2020, while public debt peaked at 103.5 percent.

2. **Despite a robust recovery, volatile economic activity and susceptibility to external shocks hinder stronger and more inclusive growth in Montenegro.** The economy recovered strongly in 2021-23, averaging 8.5 percent growth per annum, driven by a rebound in tourism and private consumption, underpinned by employment gains, higher wages, but also an influx of foreigners, particularly Russians and Ukrainians. Strong economic activity also led to better fiscal outcomes - in 2023 Montenegro recorded a fiscal surplus, though largely supported by one-off revenues, while public debt declined from its peak of 103.5 percent in 2020 to 60.3 percent of GDP. With these developments, and the current policy stance of the Government, the macroeconomic framework is adequate for this operation. But, if GDP continued growing at a trend average rate of 3.4[1] percent, it would take as much as 35 years for incomes to converge to average EU levels. At the same time, public debt remains a vulnerability because of an uneven debt amortization profile with large Eurobond refinancing needs in the years ahead. Additionally, global headwinds such as geopolitical tensions, tightening financial markets, food price inflation, and climate change underscore the need for greater economic resilience.

Relationship to CPF

3. **The proposed DPL is aligned with the World Bank's forthcoming Country Partnership Framework (CPF) for Montenegro FY25-29[2].** In particular, the DPL is strongly linked to the first and second proposed Higher-Level Outcomes (HLOs) of the CPF on *Better economic opportunities* and *Improved environmental outcomes,* given the fiscal sustainability measures supported by the operation and its focus on enhancing green and climate resilient development, while also enabling private sector resource mobilization and a green transition. Measures supported by the DPL would also contribute to the CPF's cross-cutting focus on institutional development. The program of policy and institutional reforms

[1] Average real GDP growth rate between 2013 and 2022
[2] The CPF is expected to be discussed by the World Bank Group (WBG) Board in September 2024.

is informed by the findings of the World Bank 2022 Montenegro Country Economic Memorandum and builds on the programmatic Policy-Based Guarantee operations, approved in 2017 and 2020. The DPL benefits from and links directly to the World Bank's extensive technical assistance support in energy, forestry, climate, and fiscal management. The design of the operation has been informed by the Regional Country Climate and Development Report for the Western Balkans. The proposed DPL is also Paris Aligned.

C. Proposed Development Objective(s)

The project development objective is to support the Government of Montenegro to: (i) strengthen fiscal sustainability; and (ii) enable sustainable development.

Key Results

4. **Results supported by this operation would contribute to several results outlined in the World Bank Corporate Scorecard, including increased GW of renewable energy capacity enabled and reduced net GHG emissions.** Higher excises on tobacco, sugary products, higher fees on games of chance, and reduced tax expenditures are expected to bring additional revenue to the budget and mitigate negative health outcomes of these products. The proposed pharmaceutical reforms are expected to help contain public pharmaceutical spending by allowing for stronger penetration of generics into the market. The establishment of the Fiscal Council is expected to enhance transparency, accountability, and credibility of fiscal policy, providing objective analysis and early warnings to ensure responsible and effective fiscal management. The creation of a register of State-Owned Enterprises (SOEs) and an improved regulatory framework is expected to enhance their transparency, accountability, and efficient management, reducing fiscal risks, and promoting better governance and financial performance. The new law on waste management is expected to improve waste management practices and help to enforce EU standards on circularity and recycling thereby reducing GHG emissions associated with the sector. The law also provides for a ban on selected single-use plastic products, benefiting tourism and other key economic sectors. The new law on forests is expected to enhance monitoring and sustainable forest management practices, create an enabling environment for increasing the wood industry's value and state revenues, improve climate change resilience and reduce GHG emissions associated with deforestation. The reforms in the energy sector are expected to bring private investment to support generation of renewable energy (offshore wind, green hydrogen, and others), supporting decarbonization objectives and increasing the energy sector's resilience to the impacts of climate change. The new law on climate change is expected to align national legislation with EU standards and create a more robust carbon pricing mechanism through an expanded emissions trading system coverage or a potential carbon tax.

D. Project Description

5. **The proposed DPL supports Montenegro to strengthen its fiscal sustainability and enable sustainable development.** The operation would be the first in a programmatic series of two DPFs and is financed in parallel by the French Development Agency (Agence Française de Développement, AFD) and the OPEC Development Fund. The proposed DPL is organized under two pillars: (i) strengthening fiscal sustainability; and (ii) enabling sustainable development. These pillars closely complement each other reinforcing the impact of the reform program. These reforms are consistent with the government's Economic Reform Program for 2024-26 and have benefited from the coordinated support and targeted technical assistance from development partners, including the World Bank, AFD, European Commission, and the IMF.

6. **Pillar 1 aims to strengthen the sustainability of Montenegro's public finances by supporting revenue measures reducing inefficiencies, improving the oversight of fiscal rules, and reducing fiscal risks from SOEs.** Measures under *Pillar I: Strengthening Fiscal Sustainability* support fiscal sustainability through increased domestic revenue mobilization by increasing the excises on sugary products and tobacco and increasing the government fees from online games of chance; containing very high pharmaceutical spending, establishing an independent Fiscal Council to improve fiscal oversight and to hold government accountable for responsible budgetary and fiscal policies; and publishing a registry of SOEs and improving their governance that enhances their transparency and accountability, while reducing fiscal costs.

7. **Pillar 2 aims to enable sustainable development by reducing the economy's environmental and GHG emissions footprint to preserve key natural resources that are growth drivers.** To this end, the new Waste Management Law strengthens the enforcement and institutional arrangements to better manage solid waste which is critical to sustain economic growth linked to tourism and adapt to climate change risks such as more intensive flooding. The new Forestry Law aims to implement sustainable management practices in the sector through significant institutional and management reforms. Additionally, it creates an enabling environment for the growth of the wood industry, directly enhancing sector sustainability and fostering economic growth through exports. Lastly, the new Renewable Energy Law allows Montenegro to better harness its comparative advantage in clean energy exports and move toward decarbonizing the tourism sector and its economy overall. By focusing on Montenegro's key sectors in terms of both environmental degradation and economic growth potential (including through their links to timber and wood exports and tourism) and climate change vulnerability and mitigation potential, Pillar 2 reforms are seen as critical for facilitating Montenegro's green transition and sustainable development overall. The policy reforms supported under pillar 2 are aligned with EU requirements.

E. Implementation

Institutional and Implementation Arrangements

The Ministry of Finance is responsible for the overall coordination of the proposed operation. While the Ministry of Finance is the main policy counterpart for the World Bank team for the first pillar, line ministries play an important role in the implementation of policy actions set forth in the policy matrix, particularly in the second pillar, and have been coordinating the technical support requirements with development partners. The results indicators for each prior action will be used to monitor the implementation of the operation. The World Bank team will continue to provide support to the Government in monitoring the reform progress and results. The monitoring of the results will be led by the Ministry of Finance, in coordination with the Ministry of Ecology, Sustainable Development and Development of the North, Ministry of Energy, Ministry of Agriculture, Forestry, and Water Management, and other relevant ministries and agencies.

F. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

8. **The proposed operation is expected to have overall neutral poverty and social impacts.** Some of the prior actions are expected to have distributional and social impacts, and measures are in place to mitigate potential adverse effects. The overall short-run poverty impact is expected to be limited, while the indirect effects of restoring fiscal and financial stability—through economic growth, investment, and job creation—are expected to lead to significant welfare

improvements in the future. The reforms supported by the DPL on increasing excises on tobacco and sugar products could have limited immediate adverse but positive medium- to long-term distributional and social impacts. Unhealthy habits aggravate poverty conditions and put a larger burden on health systems. Consumption of tobacco and high-carbohydrate foods is linked to an elevated risk of diseases and preventable deaths. The economic cost of smoking includes direct health expenditures, lower investment in human capital, as well as a reduction in years of work. Recent studies show that taxation is an effective method to decrease consumption, and the overall distributional effect is progressive. Reducing direct medical expenditures related to smoking and lowering years of working life lost will have a positive poverty effect in the medium and long term. This is particularly the case for women in Montenegro, who on average smoke more than men. Households in Montenegro spent on average 2-3 percent of their budget on tobacco products in 2021 and this share was uniform across income deciles. The share of household spending on sugar, cocoa, ice cream, and other related products varied between 5 percent for the poorest decile to 3.5 percent for the richest decile. Like above, there is no detectable impact on poverty levels, even assuming maximum spending shares, and assigning the full price increase to the actions of this reform. In contrast, positive social impacts include job creation in waste management, forestry, and energy, and better health outcomes from reduced plastic pollution and improved forest management.

Environmental, Forests, and Other Natural Resource Aspects

9. **Prior Actions supported through this DPL are likely to have mostly positive or neutral effects on the environment, forests, and natural resources.** Actions under Pillar 1 have no significant negative effects on environmental resources while those under Pillar 2 are likely to have mostly positive impacts, with some manageable adverse impact that could be associated with renewable energy source installation, over the longer term. The improved legislative framework on waste management and on forests is likely to have positive environmental effects as the new provisions take effect. Banning selected single-use plastics should reduce the introduction of persistent pollutants into the environment, mitigating risks from plastic pollution, including microplastics. It will also extend the lifespan of waste management facilities by decreasing waste volume. Additionally, stringent Extended Producer Responsibility requirements will help minimize the adverse impacts of products with larger environmental footprints. New provisions of the Forest Law will foster sustainable forest management and remove distortions that allow unhindered exploitation of forest products, which will improve forest and ecosystem health and service provision. Introduction of auctions as a market mechanism for supply of renewable energy sources will reduce the use of fossil fuels and consequent emissions of Green House Gases, as well as local pollutants and is likely to have largely positive environmental effects. Some negative impacts could be associated with the mechanism of supply of renewable energy if it results in increased installation of solar or wind plants and needed transmission infrastructure. These include the changes to land use at plant sites, threats to wildlife movement, such as birds and bats, generation of wastes, including hazardous waste, noise, etc. These potential impacts can be assessed and suitably managed in line with Montenegrin law during the environmental impact assessment process, which is closely aligned with the EU EIA directive.

G. Risks and Mitigation

10. **The overall risk rating for this operation is Substantial.** Among the risk categories, macroeconomic risks and political and governance risks are deemed to be substantial; all other risk categories are rated as moderate except for environmental and social risks, which are rated low. Macroeconomic risks are substantial due to the implementation challenges of the fiscal reforms announced in the Fiscal Strategy 2024-27, particularly the implementation of the compensatory measures to offset the loss in revenues due to cuts to pension contributions. Success will also depend on

stronger enforcement of current policies and efforts to reduce the informal economy. Other macroeconomic risks include heightened geopolitical tensions and related adverse trade and inflationary developments, as well as high cost of financing in the light of large debt repayments over the medium-term. Since the August 2020 Parliamentary elections, when the ruling party changed for the first time in 30 years, Montenegro's political environment has been complex. Two coalition governments collapsed in 2022, leading to snap elections on June 11, 2023. A new government was formed on October 31, 2024, and reshuffled on July 23, 2024 and is now supported by a coalition of 54 out of 81 MPs. Despite differences, the coalition is unified by a commitment to the EU accession agenda. Montenegro's turbulent politics over the last four years have seen significant policy continuity due to its EU accession process. Mitigating macroeconomic risks requires a firm commitment to fiscal rules and deeper structural reforms, supported under this operation, which is expected to reinforce sustainable growth and help mitigate the risks. Furthermore, considering the government's significant financing needs, this operation will help mitigate financing pressures in the short run and provide a positive signal to the markets that Montenegro remains committed to reforms in the medium term**.** The reforms supported under this operation are also part of the overall reform agenda within the EU accession process, which is mitigating political and governance risks.

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