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The 2022 Tax Reform in Montenegro – Facts, Misconceptions, and Lessons for Serbia

Nikola Altiparmakov, Snežana Ugrinov, Ivan Lakićević

FISCAL COUNCIL – REPUBLIC OF SERBIA

Nikola Altiparmakov[1]

E-mail: nikola.altiparmakov@ekof.bg.ac.rs

Snežana Ugrinov[2]

E-mail: snezana.ugrinov@fiskalnisavet.rs

Ivan Lakićević[3]

E-mail: ivan.lakicevic@fiskalnisavet.rs

THE 2022 TAX REFORM IN MONTENEGRO – FACTS, MISCONCEPTIONS AND LESSONS FOR SERBIA

Abstract: The elimination of health insurance contributions requires a tangible increase in the rate of value added tax (VAT) to offset the shortfall in budget revenues. Due to the lack of political support for raising the VAT rate, Serbia did not implement such a reform in 2010. Montenegro however took the plunge in 2022 and eliminated health insurance contributions without simultaneously increasing the VAT rate, despite the risk of a widening budget deficit. As it turned out, the strong tax revenue collection in 2023 has largely offset the loss of revenue incurred due to the elimination of healthcare contributions. However, we argue that the strong tax collection is predominantly the result of external factors, primarily the huge inflow of financially sound citizens of Russia and Ukraine. The temporary nature of this immigration will constitute a risk for the public finances of Montenegro over the coming period. We conclude that there is no compelling evidence to establish the causality between the higher tax revenues in 2023 and the elimination of health insurance contributions a year before. It would be particularly risky and unfounded to extrapolate the strong 2023 tax collection to the potential elimination of pension insurance contributions, which is currently under consideration in Montenegro. The elimination of pension contributions would not only destabilize the state budget but also inevitably lead to the collapse of the public pension system which is one of the pillars of modern societies in Europe over the past century.

KEYWORDS: TAX REFORM, LAFFER CURVE, PENSION PRIVATIZATION, MONTENEGRO, SERBIA

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[1] Faculty of Economics and Business, Belgrade University; Fiscal Council of the Republic of Serbia
[2] Fiscal Council of the Republic of Serbia
[3] Fiscal Council of the Republic of Serbia

1. Introduction

In 2010, more than a decade ago, the Ministry of Finance of the Republic of Serbia initiated a public debate on the possibilities for implementing a systemic tax reform to reduce the tax wedge on labor through the elimination of health insurance contributions (Arsić et al., 2010). Since health insurance contributions constitute an important budget revenue source, their elimination required an increase in the value added tax rate by four percentage points. This step turned out to be politically unacceptable, so the reform was abandoned.

In 2022, the Government of Montenegro took a bold step to eliminate health insurance contributions, without a concurrent increase in the value added tax rate. Although expert institutions such as the International Monetary Fund (IMF, 2021) warned that this approach could be very risky for increasing the budget deficit, the strong collection of tax revenues in 2023 largely compensated for the loss of revenue incurred by the elimination of healthcare contributions. These seemingly favorable fiscal developments have resulted in similar reform initiatives being considered by business communities in Serbia. Moreover, encouraged by the developments so far, the Government of Montenegro is announcing an even more radical reform for 2025 in the form of eliminating contributions for pension insurance.

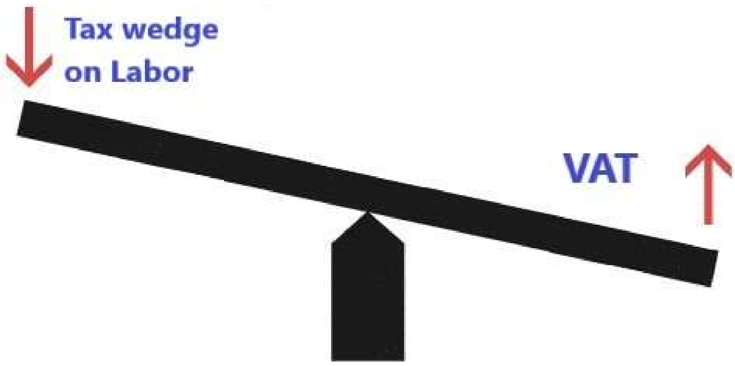
This paper offers a critical analysis of the strong trend of tax revenue collection in Montenegro in 2023 and concludes that there is no compelling evidence it has been caused by the 2022 tax reform. On the contrary, it seems that the strong tax collection was predominantly caused by external factors - primarily the huge influx of financially sound working age population from Russia and Ukraine, as well as the autonomous continuation of the economic recovery from the deep COVID crisis of 2020. Attributing the strong tax collection in 2023 to the elimination of health contributions a year earlier, and especially extrapolating these results to the potential elimination of pension contributions - would be extremely risky and unfounded. On top of the risk to the state budget, the potential elimination of pension contributions would definitely undermine the public pension system, as seen in the draconian Chilean privatization of the pension system in 1981. This controversial approach, which was rejected in all Western European countries, yielded unsatisfactory results and failed to increase pension benefits in other Eastern European countries which have been abandoning it one after the other over the previous years.

This paper is organized in the following manner: the second part presents the *ex-ante* tax reform plans in Montenegro and compares them with the earlier draft reform plans in Serbia. The third part analyzes the *ex-post* trend of strong tax collection in Montenegro in 2023 and demonstrates that it is not in line with the initial plans and that there is no evidence that it was caused by the tax reform. The fourth part points out that the possible elimination of pension contributions and the consequent privatization of the public pension system would undermine the foundations of the social system that had been established one hundred years ago. Concluding considerations are presented in the fifth part.

2. *Ex-ante* Plans for Tax Reforms in Serbia and Montenegro

The 2008 global financial crisis hit the Serbian economy hard, exposing the weaknesses and the uncompetitiveness of the economic model in the pre-crisis period, when high trade deficit rates of over 20% of GDP were persistently recorded. After the outbreak of the global financial crisis and the loss of a large number of jobs, the unemployment rate spiked to over 20%, which further emphasized the problem of economic inequality in society. The high level of the budget deficit made it practically impossible to pursue a countercyclical fiscal policy. Against this backdrop, in a desire to reduce acute macroeconomic imbalances, the Ministry of Finance put forward a proposal to implement a revenue-neutral tax reform that would shift the burden of taxation from labor to consumption, the so-called *fiscal devaluation*. The idea was to cut taxes and contributions on wages in order to increase the competitiveness of the domestic labor force and create employment incentives, while the shortfall in budget revenues was to be offset by higher taxes on consumption, specifically the value added tax (VAT), which is not levied on exports and investments and therefore does not diminish the local competitiveness.

Chart 1 – Illustration of the proposed reform in Serbia



Under the draft reform plan elaborated in the study *Tax Policy in Serbia – Looking Forward* (Arsić et al., 2010), the cut in the labor tax wedge was to be achieved predominantly by the elimination of health insurance contributions. The decision to eliminate healthcare contributions was made because the income (wage) tax rate was already low, while pension contributions constituted a key source of funding for the public pension insurance system. On the other hand, the healthcare system in Serbia essentially does not function according to the (Bismarck) insurance principles because the payment of health insurance contributions does not give contributors the possibility to be treated in private institutions, but only in public ones. At the same time, close to 98% of citizens have the right to use the public health care system (by paying contributions, or through the social protection system), so the system in practice corresponds more to the (Beveridge) model of public health care, where financing can be organized directly through taxes instead of through separate contributions for healthcare.

The proposed reform included three key measures:

1) Elimination of health insurance contributions, which amounted to 12.3% of gross wages, in order to reduce the tax burden on wages and incentivize employment, while making a shift towards financing the public health sector directly from the budget
2) More progressive taxation of wages and salaries by sharply increasing the amount of tax-free allowance with a view to securing the steepest tax wedge cut for low wages and thus boosting social coherence and reducing inequality
3) A rise in the VAT rate (both standard and reduced) by four percentage points in order to offset the loss of budget revenues incurred due to the cut in the labor tax wedge.

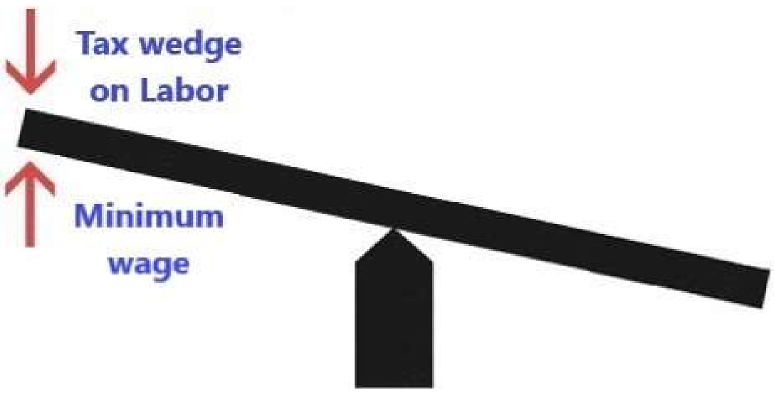
The then studies of the Organization for Economic Cooperation and Development (OECD, 2007; OECD, 2010) generally suggested that shifting the tax burden from wages to consumption should have a positive effect on the economic growth rate in the long run. European Commission simulations also confirmed the improvement in economic performance, at least in the short and medium term (European Commission, 2006) [4]. However, the requested increase in the VAT rate by four percentage points turned out to be too bitter a pill for which there was not enough political support, and the reform was abandoned.

The *Europe Now* reform program implemented by the Government of Montenegro in 2022 is also characterized by three key measures:

1) Elimination of health insurance contributions, which amounted to 10.8% of gross wages, in order to reduce the tax burden on wages and incentivize employment, while making a shift to financing the public health sector directly from the budget
2) More progressive labor taxation by introducing a high tax-free allowance of EUR 700 per month with a view to securing the steepest tax wedge cut for low and below-average wages (while maintaining the wage tax rate of 9% and introducing a second progressive rate of 15% for gross wages above EUR 1000 per month)[5]
3) A large increase in the statutory minimum wage, from EUR 250 net on a monthly basis to EUR 450.

We can see that the first two points of the Montenegrin *Europe Now* program are basically identical to the corresponding measures in the study *Tax Policy in Serbia – Looking Forward*. Instead of the politically unpopular increase in the VAT rate by four percentage points, which previously precluded the reform implementation in Serbia, the Montenegrin reform included a sharp increase in the statutory minimum wage. However, the anticipated economic benefits of the thus conceived tax reform are not entirely clear.

Chart 2 – Illustration of the reform implemented in Montenegro



The elimination of healthcare contributions and the introduction of a high tax-free allowance reduce the cost of labor for employers, but the rise in the minimum wage increases it. If we look at the total labor costs for employers in Table 1, which in addition to net wages include taxes and contributions on the behalf of the employee and employer (the so-called gross-2 wages), we can see that total labor costs at all levels of wages have gone up in nominal

[4] Back in 2007, Germany implemented a cut in healthcare contributions and an increase in the VAT rate, albeit on a much smaller scale, while Croatia implemented a similar measure in 2012.
[5] Tax on wages and other types of income from work have a dominant share in the total income for the purposes of the personal income tax, for which reason we use the terms wage/payroll tax and personal income tax interchangeably in the text.

terms after the 2022 reform.[6] The cost increase is the highest in the case of minimum wages, where it amounts to about 35% in nominal terms. Furthermore, a tangible cost increase is observed in the case of average and above-average wages as well, where employers' costs have gone up by about 8% on average in nominal terms. Taking into account the annual inflation rate, which averaged 13% in 2022, we can conclude that total labor costs have been reduced by about 4% in real terms in the case of average and above-average wages, but the labor costs for minimum wage had gone up by more than 20% in real terms. The high increase of minimum wage labor costs was rationalized by the existence of a common practice of employers declaring workers to receive the statutory minimum wage and topping up their actual remuneration with undeclared "envelope" payments. Although this practice indeed is widespread in Montenegro and in Serbia, it is by no means universal as there are many employers, especially in less developed sectors and regions, that could not afford to make any additional payments on top of statutory minimum wages and have suffered a significant real increase in their actual labor costs.

Table 1 - Net wages and total labor costs, for different wage levels in Montenegro, in EUR

	2021		2022		Nominal growth 2022/2021		Real growth 2022/2021	
	Net	Gross II	Net	Gross II	Net	Gross II	Net	Gross II
Minimum wage	251	412	450	565	79.6	37.2	58.9	21.4
Average wage	531	873	730	943	37.3	7.9	21.5	-4.5
2x Average wage	1063	1747	1346	1895	26.7	8.5	12.1	-4.0
3x Average wage	1594	2620	1964	2862	23.2	9.2	9.0	-3.3

Source: Authors' calculations based on official Monstat data.

Accordingly, the Montenegrin reform has not resulted in tangibly lower labor costs or improved competitiveness. Quite the opposite, the IMF (2021) warned that the steep rise in the statutory minimum wage would bring the nominal value of Montenegrin minimum wages up to the level of minimum wages in neighboring Croatia, thereby undermining domestic competitiveness because labor productivity in Croatia is 25% higher. Hence, the improvement in the standard of living through the nominal increase in the net wages of (current) workers is the main result of the 2022 reform. Yet, the fiscal issue of reduced budget revenues after the elimination of healthcare contributions remains open.

[6] The increase in the minimum wage results in an increase of other "higher" levels of wages on the labor market, thus pushing the entire wage distribution up to a higher level. Also, it was implicitly expected that employers would use the elimination of health insurance contributions to increase the net wages of their (current) employees,

Table 2 – *Ex-ante* planned reform costs, in millions of EUR, Program *Europe Now*

Impact on revenue	**2022**	**2023**
Increasing the minimum wage, reducing the tax burden on labour and introducing progressive PIT	-125.0	
Change in excise policy	23.0	
Reprogramming of tax claims	15.0	
Progressive profit taxation	0.0	28.0
Fuel marking	14.0	
Taxation of undeclared income	20.0	
Revenues from the new gambling law	15.0	
Reducing the "shadow" economy	10.0	
Cash withdrawal tax for companies	5.0	
Total	-23.0	28.0

Source: *Europe Now* program, page 25, Government of Montenegro (2021)

In Table 2, which is taken over from the *Europe Now* program, we can see how the Government of Montenegro planned to cover the loss of revenue caused by the elimination of healthcare contributions and the introduction of a tax-free allowance amounting to EUR 700 per month. In our assessment, the reform plan lacked transparency, consistency and credibility:

- *Lack of transparency* is reflected in the fact that the reform proponents failed to clearly present the individual costs of the three key reform measures (the elimination of healthcare contributions, the introduction of the tax-free allowance, the raising of the minimum wage); instead, they only presented the aggregate net revenue shortfall (combined with the anticipated increase in revenue generated by the introduction of the second personal income tax rate of 15% and the minimum wage increase) which according to them is supposed to yield a reduction in budget revenues by EUR 125 million. However, this aggregated result prevents independent assessment of each individual reform measure, raising doubts that the actual revenue losses might have been underestimated since health contribution revenues alone stood at 180 million EUR in 2021.
- *Lack of consistency* is reflected in the attempt to partially offset the permanent loss of tax revenues with the planned revenues from the tax debt rescheduling. However, tax rescheduling schemes constitute (at best) a one-off source of revenue and cannot be used to cover permanent tax cuts.
- *Lack of credibility* of the reform plan is reflected in the absence of the so-called *firm policy measures* in the form of increases in relevant tax rates. In the absence of an increase in the VAT rate, which is the only sufficiently generous revenue source, the Government of Montenegro was left with a limited range of options, to raise excise taxes and introduce progressive corporate income taxation of large companies. Other measures are in fact optimistic expectations from a more effective suppression of the shadow economy. Such declaratively listed measures like "Fuel marking", "Taxation of undeclared income", "Reduction of the informal economy" and "Taxation of cash withdrawals" are actually all synonyms for a more efficient combating of the shadow economy.

Table 2 shows that under the *Europe Now* program the reform package was supposed to generate a small initial tax revenue loss of EUR 23 million, or 0.4% of GDP in 2022, only to completely eliminate the revenue loss in 2023, owing to the introduction of a progressive corporate income taxation for large companies. In the next section, we analyze the *ex-post* implementation of this plan.

3. Tax Revenue Collection in Montenegro Following the 2022 Reform

In order to analyze the relevant macro-fiscal developments, we will only focus on the trends in the collection of (core) tax revenues in Montenegro. Despite the fact that, after the reform, examples have reached the general public showing a lack of medical supplies in healthcare institutions, or a shortfall in projected personal income tax revenues of local self-governments, we will not analyze the overall budget deficit, since the expenditure side of the budget is the result of political economy. Naturally, it is not possible to absolutely clearly delineate a macro-fiscal analysis from political economy because, for instance, (politically motivated) steep public sector salary hike of 30% in 2023 will have a positive effect on tax collection, regardless of the implementation of the tax reform in 2022. In our work, we use this approximation for research purposes, aware of the fact that by doing so we can also potentially attribute to the tax reform partial effects of other macro-fiscal developments during the reference period. We will analyze tax revenues in their relative amounts, as a percentage of GDP, in order to exclude the effects of inflation and economic growth and focus on the structural nature of tax revenues.[7] Table 3 shows the annual data on the core tax revenues in Montenegro since 2018, for the purpose of identifying the collection trends prior to the 2022 reform, as well as prior to the 2020 COVID crisis.

Table 3 – Tax revenue collection in Montenegro, % of GDP, 2018-2023

	2018	2019	2020	2021	2022	2023*	2022	2023*
	in % of GDP						*Change compared to 2021(in %)*	
Total, main tax categories	**34.2**	**35.0**	**36.1**	**35.4**	**31.1**	**34.3**	**-4.3**	**-1.1**
Personal income tax	3.5	3.6	4.0	3.7	2.3	2.0	-1.4	**-1.7**
Corporate income tax	1.5	1.5	1.9	1.5	1.5	2.3	+0.0	**+0.8**
Value added tax	13.2	14.1	12.7	14.0	15.3	16.3	+1.4	**+2.3**
Excises	4.7	4.8	4.9	5.0	4.2	4.9	-0.9	-0.1
Social insurance contributions	11.2	11.0	12.7	11.2	7.8	8.7	-3.4	-2.5
Pension and disability	6.8	6.6	7.9	6.9	6.9	8.0	-0.1	**+1.1**
Healthcare	3.9	3.8	4.1	3.6	0.4	0.1	-3.2	**-3.5**
Unemployment	0.3	0.3	0.4	0.3	0.3	0.4	-0.0	+0.1
Other	0.3	0.3	0.3	0.3	0.2	0.3	-0.1	+0.0

Source: Authors' calculations based on official data of the Montenegrin Ministry of Finance.
* The data for 2023 is the authors' projections based on the outturn in the first 10 months.

The cumulative net loss of revenue from the three key reform measures (the removal of healthcare contributions, progressive taxation of wages and the increase in the minimum wage) amounts to about 5% of GDP. Roughly one-third of the revenue shortfall is due to the reduction of personal income taxation via the introduction of significant tax-exempt allowance, while

[7] Steep (predominantly external) increase in inflation in 2022 tangibly attenuated the budget problems caused by the imprudent ex-ante tax reform plans.

two-thirds of net revenues losses are due to the elimination of health insurance contributions.[8] Despite the initial underestimation of the tax reform costs, an extremely strong trend in the collection of value added tax (+2.3% of GDP), pension and disability insurance contributions (+1.1% of GDP) and corporate income tax (+0 .8% of GDP), made it possible in 2023 to compensate for most of the tax revenues lost due to the 2022 reform (we estimate the total tax revenue reduction in 2023 at a "tolerable" 1% of GDP).

At first glance, the results of the tax reform appear to be very positive. It seems that the lower tax burden on wages has led to an increase in employment and consequently higher revenues from pension insurance contributions, while the raising of net wages increased consumption and consequently resulted in a strong surge in VAT revenue. The trend of tax revenue collection in Montenegro seems impressive and at first glance could resemble the Laffer curve concept, which suggests that tax rate cuts can lead to a (partial) increase in tax revenues. However, bearing in mind that the empirical literature for the most part rejects the existence of the Laffer curve on a statistically significant scale, a more detailed analysis is necessary to examine the existence of the causality between the tax reform in 2022 and the impressive tax collection in 2023.

If we assumed that employers shifted the entire labor tax wedge cut to their workers, in the form of higher net wages, this would mean a rise in the disposable income of workers by approximately 5% of GDP. If we further assumed that the workers spent the entire increase in their disposable incomes, and that the consumption was fully tax-registered, this could explain the rise in VAT revenue by a maximum of 1% of GDP, since the statutory value added tax rate is 21% (the reduced rate is 7%). Therefore, it remains unclear how VAT revenues have gone up by as much as 2.3% of GDP in 2023.[9]

It is important to note that Montenegro has been the European record holder for years when it comes to the share of VAT revenue in GDP, which amounted to about 14% of GDP. Only Croatia's VAT revenue, accounting for 13.3% of GDP, was even remotely comparable to Montenegro, though the statutory VAT rate in Croatia is significantly higher and stands at 25%. The unusually high share of VAT revenue in Montenegro and Croatia could be explained primarily by the large share of tourism in the economies of both countries, as well as by the chronically high trade deficit in the trade of goods (subject to VAT), which in Montenegro has stood at over 40% of GDP for many years (Annex). However, the exceptionally high share of VAT revenue in Montenegrin GDP of over 16% in 2023 cannot be explained by either the hitherto macroeconomic trends or the tax reform in 2022.

The only remaining explanation is the arrival of a large number of financially sound citizens of Russia and Ukraine after the outbreak of war in Ukraine in February 2022. According to the estimates, around 100,000 foreign citizens, primarily from Ukraine and Russia, took up residence in Montenegro in the past year and a half.[10] Compared to the official data on the population of Montenegro of 620,000, it is an increase in the number of residents by nearly 20%, with the increase in purchasing power being significantly higher, bearing in mind that these are highly affluent foreign citizens. This hypothesis is also supported by the research carried out by Vuković (2023), which shows, based on autoregressive analyses of monthly tax revenue collections, that the break in time series and the higher collection of VAT revenues closely correspond to the period of immigration of Russian and Ukrainian citizens.

[8] Compared to 2021, when the concept of the reform was developed, 5% of GDP corresponds to a nominal amount of about EUR 220 million, which confirms our previous assessment that the estimate provided in the *Europe Now* program of the total revenue shortfall amounting to EUR 125 million – was an underestimation.
[9] The potential effects of the Keynesian multiplier due to additional consumption would be reflected in a higher gross domestic product but would not be able to further increase the share of VAT revenue in GDP.
[10] Estimates range from over 80,000 based on data from official records, to around 120,000 according to the data of individual researchers, such as Vuković (2023).

As for the increase in revenue from pension contributions of 1.1% of GDP, it is noteworthy that this increase occurs in 2023, while in 2022 there was no increase whatsoever in this revenue category. It is possible that after the implementation of the reform, a period of one year was needed for the dynamic effects to be felt in the labor market and to produce an increase in the collection of pension contributions. However, in Chart 4 we can see that in fact already 2022 saw a big leap in registered employment, but despite this leap in employment no increase in the collection of pension contributions as a share of GDP occurred (up until 2023). Higher pension contribution revenues in 2023 may be due to the Law on tax debt rescheduling which gives precedence to the repayment of debt on pension contributions. If higher pension contribution revenues in 2023 are truly due to the collections on old debts, it would imply only a temporary increase in budget revenues due to disappear in several years after old debts and arrears are repaid. Since the currently available fiscal data is unable to distinguish between payments on current liabilities and repayments of old debts/arrears, a more elaborate analysis of increased revenues from pension contributions in 2023 will have to wait until detailed micro-level data on contribution collections becomes available.

Table 4 – Real growth of tax collection and wage bill, 2018-2023, in %

Year	Registered employment	Gross wage	Total wage bill	Personal income tax revenue	Pension contributions
2018	4.3	-2.4	1.7	9.2	1.9
2019	7.1	0.5	7.6	9.9	3.4
2020	-13.2	1.6	-11.8	-6.4	0.8
2021	6.9	-1.1	5.8	7.3	1.5
2022	18.4	-1.5	16.7	-34.5	4.5
2023	9.4	2.4	12.0	-10.0	21.3

Source: Authors' calculations based on official data of Monstat and Montenegrin Ministry of Finance.

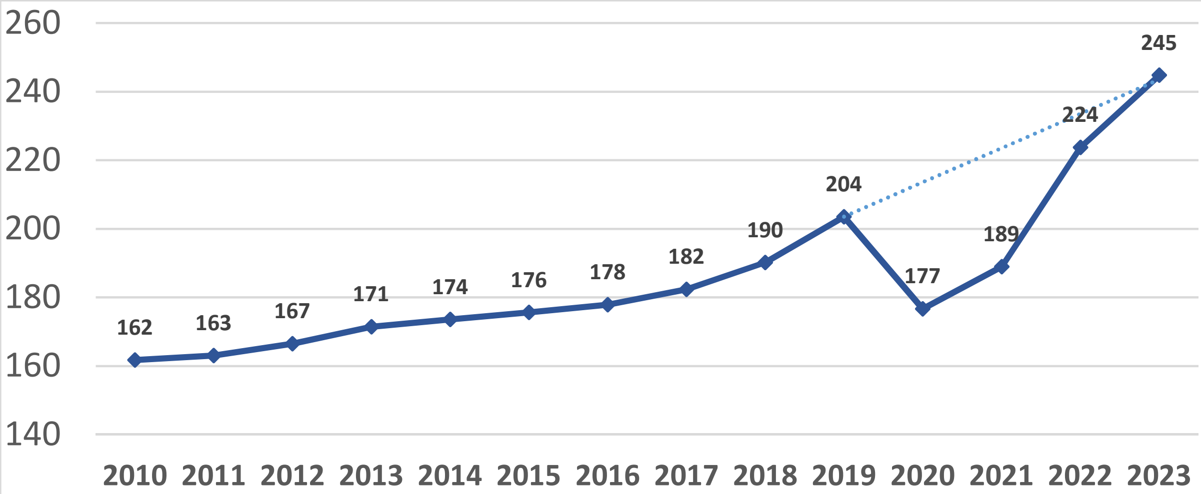
It is also important to note that the wage/personal income tax revenues in 2023 have declined, even in nominal terms, compared to 2022 (Annex).[11] Thus, in Table 4 we have compared the annual growth rates of tax collection in real terms with the real increase in wage bills, as the sum of growth in registered employment and the growth of average wages. Although the wage bill, as a relevant tax base, should correspond to the collection of taxes and pension contributions, we see that this was not always the case in previous years, especially in 2023. The decline in the personal income tax collection in 2023 is surprising, given the high growth of the wage bill in the same year (the drop in personal income tax revenues in 2022 was the result of the tax reform, but in 2023 tax legislation has not been amended).

The divergent trends in the registered wage bill, pension contributions and personal income tax revenues could be an indication of a change in the size of the shadow economy. Indeed, the Government of Montenegro (2023) has concluded that in the 2022-2023 period the shadow economy has shrunk (owing to the implementation of the tax reform). Estimates of the shadow economy used by the Government of Montenegro (2023) are based on surveys measuring the perceptions of the shadow economy among businessmen (Krstić et al., 2022). Although all methods for estimating the shadow economy are inherently unreliable, measuring the shadow economy through the perceptions of businessmen is particularly problematic and unreliable because it is clear that perceptions are not necessarily a credible reflection of economic trends. The application of this controversial method has been contested in Serbia for

[11] This would have been possible had the newly employed workers in 2023 been receiving predominantly below-average wages, on which no wage tax is calculated due to the high tax-free allowance of EUR 700 per month. However, a more detailed sectoral analysis of the rise in employment in 2023 indicates that over a third of new workers have been employed in sectors/industries with above-average wages, such as the IT industry or the sectors of financial intermediation and real estate.

years now, due to the obvious discrepancy between the measured perception of businessmen and the actual trends in tax collection (Arsić et al., 2018). Similarly, in the case of Montenegro, it is difficult to explain the alleged reduction in the shadow economy (measured by the perception of businessmen) on the one hand and the mentioned decline in the personal income tax collection in 2023 on the other hand (despite the high growth of the wage bill).

Chart 4 – Registered number of employees, in thousands, 2010-2023



Source: Authors' presentation based on official Monstat data.

The key issue is the existence of a causal link between the 2022 reform and the mentioned high employment growth recorded in Montenegro in the last two years. In Chart 4, we can notice the secular upward trend in the number of employees from 2010 to 2020, which accelerated over the years. Thus, in the 2018-2019 period, the rise in the number of employees amounted to about 10,000 workers a year. The Montenegrin economy was hit hard by the COVID crisis. In 2020, it recorded the steepest slump in GDP among all European countries amounting to -15.3%, which was consequently reflected in the dwindling number of employees. In 2021, it embarked upon the path of recovery which gained strong momentum, resulting in the rise in the number of employees by 35,000 in 2022 and 20,000 in the course of 2023.[12] This rapid acceleration of employment growth coincides in time with the implementation of the tax reform, but the question of the economic causality between these two phenomena remains open. As we have shown in Tables 1 and 4, the reform has only marginally reduced total labor costs in real terms, and has significantly increased the statutory minimum wage, suggesting absence of tangible employment incentives after the reform.

There is also the question of dynamic timing - was the tax reform able to result in a strong rise in employment as soon as its first year of implementation, or whether a certain period of time is needed for systemic changes in the tax system to be reflected in the economic environment, operation of businesses and the labor market? Bearing in mind the dynamic nature of processes in the labor market, it is quite possible that the accelerated growth of employment during 2022 and 2023 has been a consequence of the recovery from the COVID crisis that hit the Montenegrin economy hard in 2020, because it is well known that, in general, labor markets recover more slowly than GDP growth in the aftermath of crises. On that basis, we have hypothetically extrapolated, as if the COVID crisis had not happened, an average rise in the absolute number of employees of 10,000 per year over the 2018-2019 period during the 2020-2023 period – and we arrived at an identical number of total registered workers in 2023.

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[12] The methodology for registered number of employees has been partially amended over the 2021-2022 period, which potentially undermines the full comparability of data for 2022 and 2023 with earlier years.

Furthermore, our extrapolation of the nominal growth in the number of employees can be considered a relatively conservative approach, bearing in mind the important reforms and improvements that have taken place in Montenegro in the past few years and which, regardless of the tax reform, have the potential to exert a positive influence on the economic environment and employment opportunities. Also, the previously mentioned large-scale immigration of the financially sound working age population from Russia and Ukraine constitutes an important additional growth potential for the economy and employment.

Finally, as far as the corporate income tax collection is concerned, we can see an increase of 0.8% of GDP in 2023, i.e., about EUR 60 million, which is nominally more than the initially planned increase in revenue of EUR 28 million as presented in Table 2. However, based on individual tax returns, the Government of Montenegro (2023) calculated that the additional revenue generated by higher, progressive corporate income tax rates amounted to EUR 16 million in 2023, implying that the initial plan set out in the *Europe Now* program to increase revenue by EUR 28 million – is only partially fulfilled. The remaining increase in the corporate income tax is obviously the result of a rise in the profitability of businesses in 2022, which is a phenomenon recorded in most other European countries due to the acceleration of inflation and the emergence of the "price-profit" spiral (Hansen et al., 2023).

We can conclude that, despite the lack of credible planning and the ex-ante underestimation of the tax reform costs, the tax collection has recovered to a large extent in 2023, and that no uncontrolled ballooning of the budget deficit has occurred. Yet only the higher corporate income tax in 2023 can be said to be (partially) in line with the initial plan. The increase in the collection of value added tax has happened outside the initial *Europe Now* plan and constitutes the result of unrelated, external factors.[13] Some of these factors, such as reforms aimed at joining the European Union, can be considered permanent improvements in the economic environment that will have durable positive effects on economic activity. On the other hand, the immigration of a large number of citizens of Russia and Ukraine is a temporary phenomenon, which can not be realistically expected to be permanently maintained at the current level in the coming years.[14] Hence, a partial reversal of these migration flows in the foreseeable future will pose a risk for tax revenues, especially for atypically high value added tax collections.

4. Plans to Dismantle the Public Pension System

Since no budget crisis occurred after the radical loosening of the tax burden on wages in Montenegro, this initial success enabled the creators of the *Europe Now* program to present it in a positive light to the Serbian business community and to announce an even more radical reform for 2025 - the elimination of pension and disability insurance contributions.[15] Although specific plans for the elimination of pension contributions set out in the so-called *Europe Now 2.0* program have not yet been disclosed, it is obvious that it would be a gigantic blow to the state budget because the revenue from pension contributions is almost twice as high as that from the healthcare contributions and amounts to about 8% of the Montenegrin GDP. In such case, even the presence of a resolute political will to increase the rate of value added tax would not be enough to offset such a massive loss of revenue. Hence, it will be very interesting to see how the creators of the *Europe Now 2.0* program will try to eliminate pension contributions without undermining the very foundations of public finances in Montenegro.

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[13] Due to the lack of transparency of the *Europe Now* program presented in Table 2, the planned amount of the isolated increase in revenue from pension contributions has remained unknown.

[14] Furthermore, the extent of increased pension contribution revenues in 2023 due to the collection of old debts/arrears is still unknown, which should also be treated as a temporary improvement only.

[15] Address by Milojko Spajić at the 17th Annual NALED Assembly, Belgrade, May 11, 2023.

In the case of a potential elimination of pension contributions, the risk of budget implosion, regardless of its seriousness, will be of secondary importance - compared to the inevitable collapse of the public pension system, which was established more than a century ago in Montenegro. Public pension systems (of the Bismarck type) constitute the largest and longest-lasting public expenditure programs, where the implicit debt towards the current generations of pensioners and workers who have been paying pension contributions – lasts for decades and is several times higher than the explicit public debt in all European countries. Thus, the implicit pension debt in Germany, France, Italy and other euro area countries is estimated at around 300% of GDP (Mink, 2010).[16] Therefore, no developed country in Western Europe or North America has ever seriously considered the dismantling of the public pension system, which is one of the pillars of modern societies.

Still, in 1981, under the dictatorship of Augusto Pinochet, Chile carried out what was considered to be an impossible reform until that point – dismantling the public pension system and substituting it with a statutory system of private pension funds. Motivated by the apparently impressive initial performance of mandatory private funds, the World Bank promoted the Chilean model in Latin America and Eastern Europe, arguing that private pension funds provide not only higher pension benefits compared to public systems but also higher rates of long-term economic growth (World Bank, 1994).[17] These controversial claims were contested from the beginning by relevant institutions such as the International Actuarial Association (Beattie and McGillivray, 1995) and leading experts such as Nobel laureates Joseph Stiglitz or Peter Diamond (Orszag and Stiglitz, 2001; Barr, 2000; Barr and Diamond, 2009).

As mentioned above, the huge implicit pension debt towards the current generations of pensioners and workers mean that the budget costs of the potential abolition of the public pension system, the so-called *transition costs*, last for decades, usually 40 to 50 years (Stanić et al., 2008). Thus, Chile had to run budget surpluses (in the non-pension part of the budget) of over 8% of GDP for decades in order to finance the transition costs of dismantling the public pension system (Arenas De Mesa and Mesa-Lago, 2006). Such great social sacrifices were not realistically feasible in social democracies, so the countries of Eastern Europe only opted for the partial dismantling of their public systems and the establishment of mandatory private funds, the so-called *second pension pillar*, into which they diverted part of the existing pension contributions, thereby creating a large multi-decade deficit in the public pension system.

The transition costs turned out to be socially and politically unacceptably high for most countries in Eastern Europe, even in the case of a partial dismantling of the public pension system. Hence, the advocates of pension privatization often resorted to ignoring, concealing and underestimating the actual transition costs (Drahokoupil and Domonkos, 2012) in order to mitigate socio-political resistance to this controversial reform. A typical example of this practice is the World Bank Working Paper (Anušić et al., 2003, pp. 69-72), which claimed that the transition costs in Croatia will last less than 15 years and cost less than 10% of GDP. Needless to say, these optimistic projections did not materialize because over the 2002-2020 period alone, the transition costs amounted to 24% of GDP, with over 20 years of transition

[16] As for countries in the region, such as Croatia, Hungary or North Macedonia, Holzmann, Palacios and Zviniene (2004) estimate the implicit debt of the public pension systems at around or over 200% of GDP.

[17] Studies that pointed out initial positive economic results in Chile often did not control for the effects of other, in-depth reforms that were implemented at the same time, implicitly attributing all the positive effects to the controversial pension privatization. When the actual effects became visible after a couple of decades, it turned out that private pensions had left a huge number of old people below the poverty line. After massive protests in 2008, the government was forced to react by introducing social pensions and other forms of government aid for vulnerable older persons with insufficient private pensions, which subsequently gave rise to high and permanent budget spending.

period left and about 20% of GDP transition costs remaining since in 2020 alone transition costs amounted to 1.3% of GDP.[18]

Despite high transition costs and social sacrifices, the countries that implemented pension privatization and (partially) dismantled their public pension systems failed to achieve any (statistically significant) acceleration of economic growth relative to comparable peer countries that did not introduce the second pension pillar (Altiparmakov and Nedeljković, 2018). The absence of positive macroeconomic effects, such as accelerated economic growth or higher domestic savings, was also identified by the Independent Evaluation Group of the World Bank (World Bank Independent Evaluation Group, 2006). It turned out that in the vast majority of countries, mandatory private pension funds failed to provide higher pension benefits to their contributors compared to previous public pension systems, causing a wave of political discontent throughout Eastern Europe. Thus, Hungary and Poland decided to completely eliminate the second pension pillar, while countries like Latvia or Slovakia decided to significantly downsize it.[19] The vast majority of countries, including Croatia, North Macedonia, Bulgaria, Slovakia and Romania, have allowed contributors to voluntarily return to the public pension system from the private second pillar in order to receive higher pension benefits (Altiparmakov, 2018). Thus, the option of switching back to the public pension system was utilized by over 90% of new pensioners in Croatia in the course of the previous year.

A more detailed analysis into the causes of the disappointing performance of the second pension pillar is beyond the scope of this paper. We will only mention the issue of inherent market failures in the case of private pension fund industry that clearly prioritized the maximization of their profits over the maximization of their members' pension benefits, as evidenced by examples from a large number of countries, from Australia to Hungary to Croatia. Thus, researchers of the Australian Prudential Regulatory Authority identified rent extracting practices of related-party service providers among financial institutions rendering pension savings services, to the detriment of their contributors (Liu and Arnold, 2010). A similar practice by related financial institutions of extracting profits at the expense of contributors was also identified by World Bank researchers in Hungary (Rocha and Palacios, 2006). The most recent example comes from the neighboring Croatia where some private banks are suspected to have transferred their non-performing loans to the second pillar pension funds in order to avoid shouldering the losses (Wiesner, 2021).

It is therefore not surprising that all the developed countries of Western Europe and North America have resolutely rejected initiatives for pension privatization through (partial) dismantling of the public pension system - because the benefits for contributors from this controversial reform are extremely uncertain (the only certain benefits are those for the involved financial intermediaries). It seems unrealistic that in a mere year, by 2025, Montenegro can develop an adequate model for the dismantling of the public pension system that has existed since 1922, while avoiding extremely negative experiences of other Eastern European countries. However, a more detailed analysis of the political economy from other Eastern European countries (Muller, 1999) suggests that advocates of pension privatization often resorted to hasty reforms, without adequate expert elaboration and with minimal public consultations, even though these are groundbreaking fiscal reforms that last for decades and penetrate deeply into the social fabric of current and future generations.

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[18] Authors' calculations based on official HANFA data on the amounts of pension contributions and payments from the second pension pillar, available at https://www.hanfa.hr/publikacije/godisnje-izvjesce/

[19] In 2009, the Croatian government also tried to dismantle the second pension pillar but was forced to give up after strong resistance put up by the financial sector. Similar organized resistance of the financial sectors was formerly recorded in Bulgaria, Romania, Slovakia, as well as in the Baltic states.

5. Concluding Considerations

Despite the fact that the concept of the 2022 Montenegrin tax reform lacked credibility, the *ex-post* collection of tax revenues largely recovered during 2023 due to a favorable combination of external circumstances, primarily the strong immigration of financially sound working age citizens of Russia and Ukraine. The reversal of migration flows poses a fiscal risk for the tax revenues, but with a relatively benign increase in the VAT rate by a few percent, it is possible to eliminate a potential budget deficit in the future. In this manner, Montenegro would preserve a competitive tax system, and the results of the tax reform could receive a positive evaluation, despite the imprudent *ex-ante* planning.

Hypothetical elimination of pension contributions would constitute a gigantic blow to the public finances of any European country, including Montenegro. An equally important aspect of the potential elimination of pension contributions is the inevitable dismantling of the public pension system, which has been an integral part of modern European societies for the past century. Such radical and controversial reforms have been rejected in all Western European countries, while the experiences of the second pension pillar from Eastern Europe are very negative, prompting more and more contributors, or countries as a whole, to return to the public pension provision.

As for Serbia, the elimination of healthcare contributions was considered in the period of large economic imbalances in 2010, which have since been eliminated for the most part - the unemployment rate has been significantly reduced to around 10% and competitiveness has been tangibly improved, so the trade deficit stands at below 10% of GDP. Therefore, in the current circumstances, it is not necessary to consider the elimination of healthcare contributions. Of course, this reform remains a viable possibility, especially if driven not only by the economic considerations, but also by the desire for a radical reform of the Serbian healthcare system, which is currently a chaotic mixture of insurance elements (from the Bismarck system) and nearly universal access to public healthcare (from the Beveridge system), featuring inefficient coordination of public and private health care providers.

The economic cost of eliminating the healthcare contributions is the increase in the value-added tax rate needed to offset the budget revenue shortfalls. If social and political support for a necessary increase in the VAT rate is lacking, less radical reform approaches can also be considered. For example, instead of completely eliminating healthcare contributions, the application of the tax-free allowance could be extended from the wage tax to healthcare contributions as well, with a view to increasing the tax system progressivity, which should be one of the reform priorities in the coming period (Fiscal Council, 2022).

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ANNEX – Main macro-fiscal data, Montenegro, 2018-2023

	2018	2019	2020	2021	2022	2023*
Macroeconomic indicators						
GDP (mn EUR)	4.663,1	4.950,7	4.185,6	4.955,1	5.924,0	6.629,0
Inflation (period average)	2,6	0,4	-0,3	2,4	13,0	9,0
Inflation (end of period)	1,6	1,0	-0,9	4,6	17,2	
General government revenue (mn EUR)						
Total, main revenue categories	**1.593,9**	**1.730,4**	**1.512,6**	**1.754,5**	**1.843,6**	**2.273,6**
Personal income tax	163,2	180,1	168,0	184,6	136,7	133,9
Corporate income tax	68,2	72,8	78,4	74,7	90,2	153,0
Value added tax	616,9	695,7	529,8	691,9	908,0	1.083,1
Excises	221,2	235,5	205,4	248,7	245,9	323,7
Social insurance contributions	524,4	546,3	531,0	554,5	462,8	579,9
Pension and disability	317,0	329,2	330,8	343,7	405,9	530,5
Healthcare	182,0	187,7	171,6	180,6	25,1	7,2
Unemployment	13,6	15,1	15,4	16,4	18,4	24,3
Other	11,8	14,2	13,2	13,8	13,5	17,9
Current account (% of GDP)						
Balance on goods and services	-23,9	-21,1	-35,0	-19,4	-22,8	-18,2
Balance on goods	-43,9	-41,7	-39,2	-38,7	-45,1	-45,0

Source: Central bank of Montenegro, Monstat, and Montenegrin Ministry of finance