

LABOR MARKET OUTCOMES IN MONTENEGRO: CHALLENGES AND POLICY OPTIONS¹

This study provides a set of explanations to understand the observed labor market outcomes in Montenegro, which are weak by European standards. After providing stylized facts for the inactivity rate, (long-term) unemployment rate, and informal employment, this study presents a discussion covering the following dimensions: (i) level of employment protection; (ii) level of labor taxation; (iii) pace of wage growth, including the minimum wage; and (iv) non-employment income support and activation policies. The main conclusions are the following. First, there is still room to improve the current draft Labor Law to increase flexibility, formalization of work, and labor participation by modifying current proposals related to the establishment of the employment relationship, the internal organization and systematization act, and termination of employment. Second, reform options on labor taxation need to consider a reduction of the tax wedge, especially on low income earners, and a gradual withdrawal of social assistance and family benefits rather than a sudden decline after reaching a certain level of net income. Third, while active labor market policies (ALMPs) can contribute to reduce the labor market mismatch in the short to medium term, the education system is the key element for the reduction of labor market mismatches in the medium to long term.

A. Labor Market Outcomes: Stylized Facts

Inactivity Rate

1. Despite an improvement in recent years, participation in the labor market is low in Montenegro. The inactivity rate² is about 37 percent, which is lower than the average for Western Balkan countries (excluding Montenegro), but much higher than the average for EU member countries and New Member States. The inactivity rate is prevalent among both men and women. However, the gap is larger in the case of women, where its difference with the EU average is nearly 14 percentage points. Moreover, the inactivity rate is more critical among the youth (between 15 and 24 years) and people with low education attainment (see Figure 1a and Figure 1b).

Unemployment Rate

2. The unemployment rate is high by European standards. While declining in recent years (see Figure 1b), the current rate, at about 16.1 percent, is significant and higher than the average rate observed in EU and New Member State countries (see Figure 1a).³ The unemployment rate is more critical for less educated people and the youth. By group age, people between 15 and 24 years

¹ Prepared by Marco Arena and Morgan Maneely.

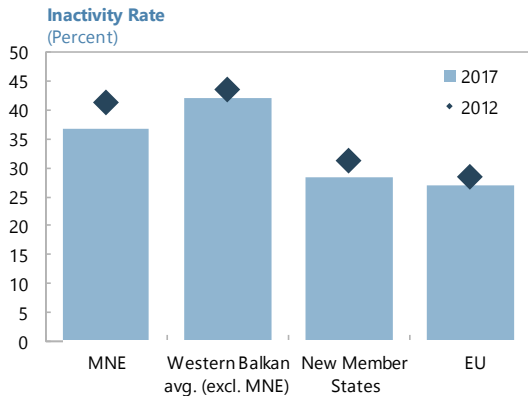
² The activity rate is defined as the proportion of the working age population that is not in the labor force. When added together, the inactivity rate and the labor force participation rate will sum to 100 percent.

³ The unemployment data is taken from the Labor Force Survey (LFS), which also allow us to do a cross-country comparison. However, the number of unemployed people released by the Employment Office is different than the number presented by the LFS because unemployed people for the Employment Office equals the number of persons who are considered as registered unemployed by the Health Fund.

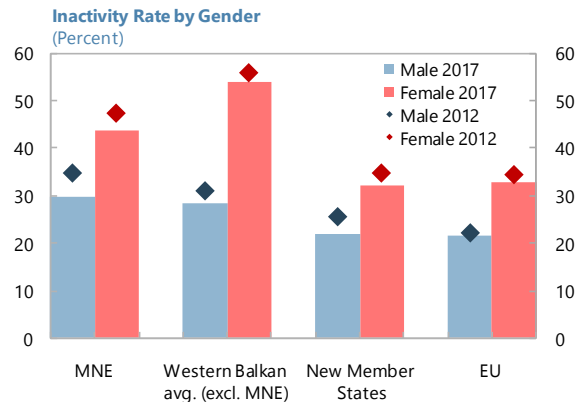
show the highest unemployment rate at 32 percent. Montenegrin youth are much more likely to be unemployed than their EU and New Member States counterparts but also much less likely to be economically active.

Figure 1a. Labor Market Developments Compared to Peers

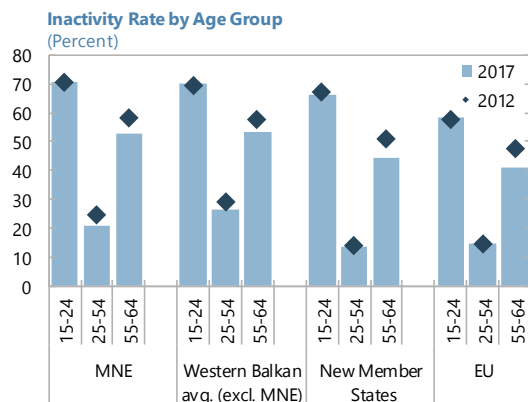
Despite an improvement in recent years, the inactivity rate is high by European standards.



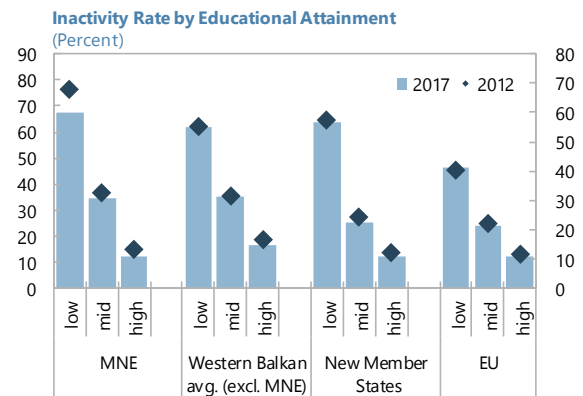
...and is higher among women...



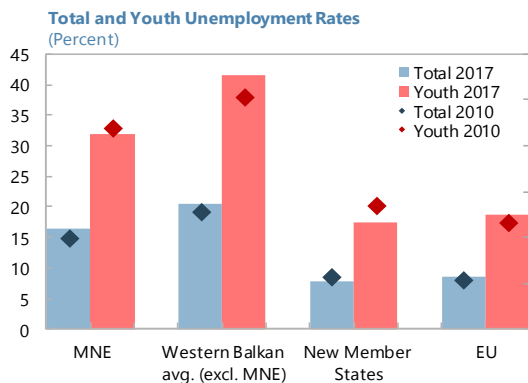
...youth (between 15 and 24 years) ...



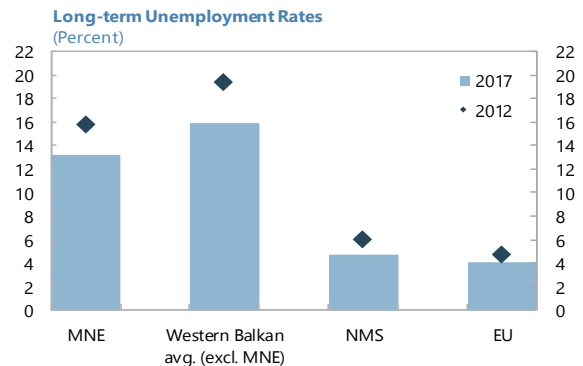
...and especially those with low education.



The unemployment rate is high, especially for youth...

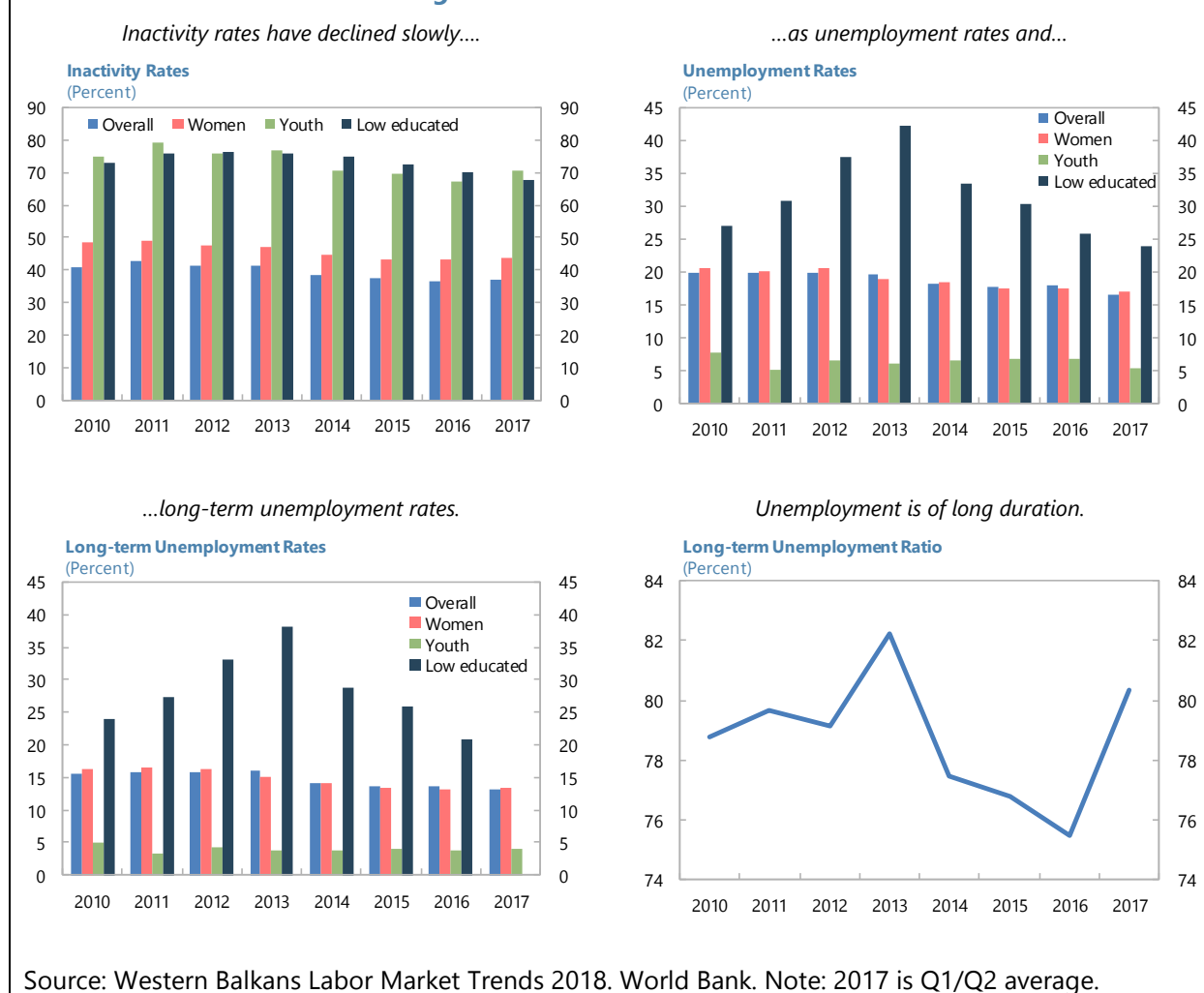


...reflecting more structural rather than cyclical characteristics.



Sources: Eurostat; World Bank; and IMF staff calculations. Data for 2017 is 2017Q1/Q2 average.

Figure 1b. Labor Market Trends



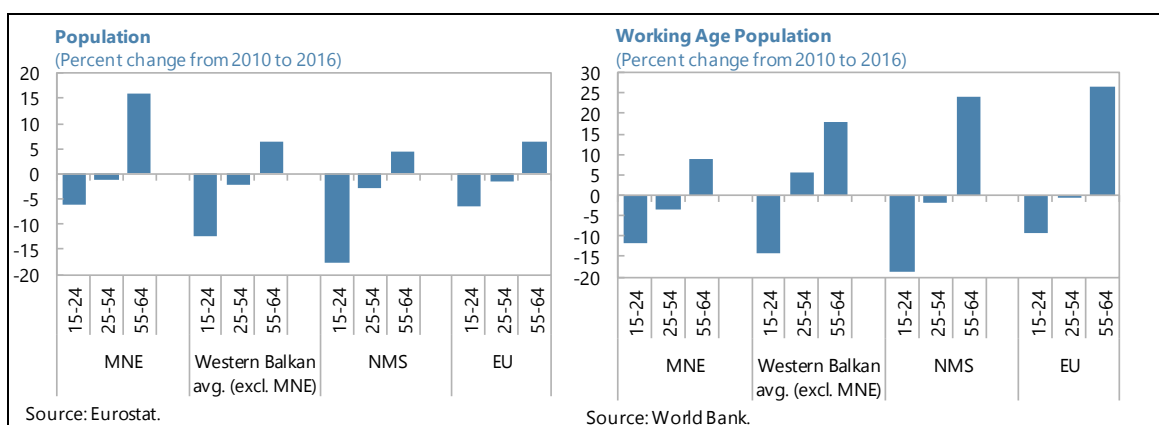
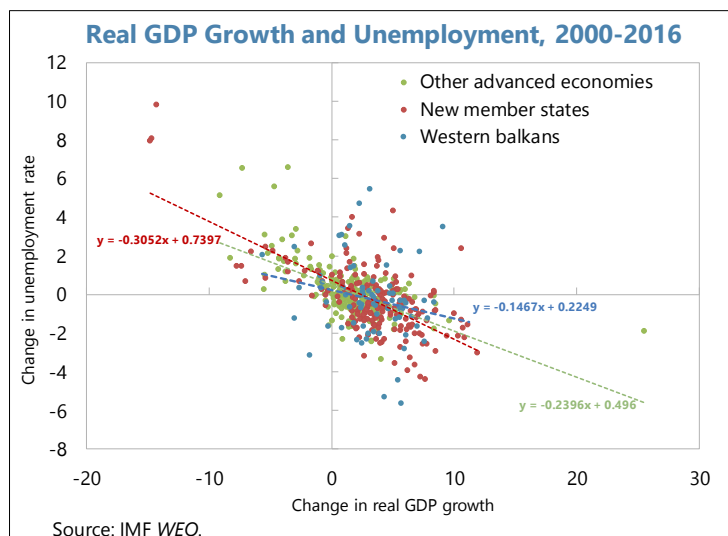
3. Unemployment is of long duration. About 80 percent of the unemployed in Montenegro were out of work for more than a year on average (see Figure 1b), reflecting more structural than cyclical characteristics. On one side, the degree of responsiveness of unemployment to GDP growth is lower in the Western Balkans than in New Member States of the European Union and advanced European countries. On the other side, the share of long-term unemployment reveals that low outflows from unemployment are the main source of high joblessness. This fact would reveal a difficult labor market entry in Montenegro, which is associated with labor market rigidities, labor market frictions, and education and training. The consequences of long-term unemployment are critical, including an erosion of human capital, decline of productivity, and an increase in the risk of social exclusion.⁴

⁴ Youth unemployment rates fell faster than the overall unemployment rate, reflecting more responsiveness to the business cycle (World Bank, 2017). Another World Bank study explains that labor market outcomes of youth are linked to the business cycle, with higher job losses during downturns, but more new employment during economic recoveries/booms. The latter would be partially explained by the fact that youth employment represents a more flexible segment of the labor market (World Bank, 2016).

4. Negative demographic trends underlie these labor outcomes.

Most Western Balkan countries are facing a demographic contraction or stagnation driven by outward migration and declining birth rates (World Bank, 2017). As in other Western Balkan countries, these developments are compounded by population aging, as the decline has been more pronounced in the under 25 age group, while the number of those aged 55-64 increased significantly. In addition, the working age population has also declined in recent years,

especially for the age groups between 15 and 24 and between 25 and 54 years old (the decline in total population, 4.3 percent, was larger than the one in working age population, 4.0 percent, between 2010 and 2016). These trends are expected to continue (see SIP on long-term growth) and will pose further challenges.



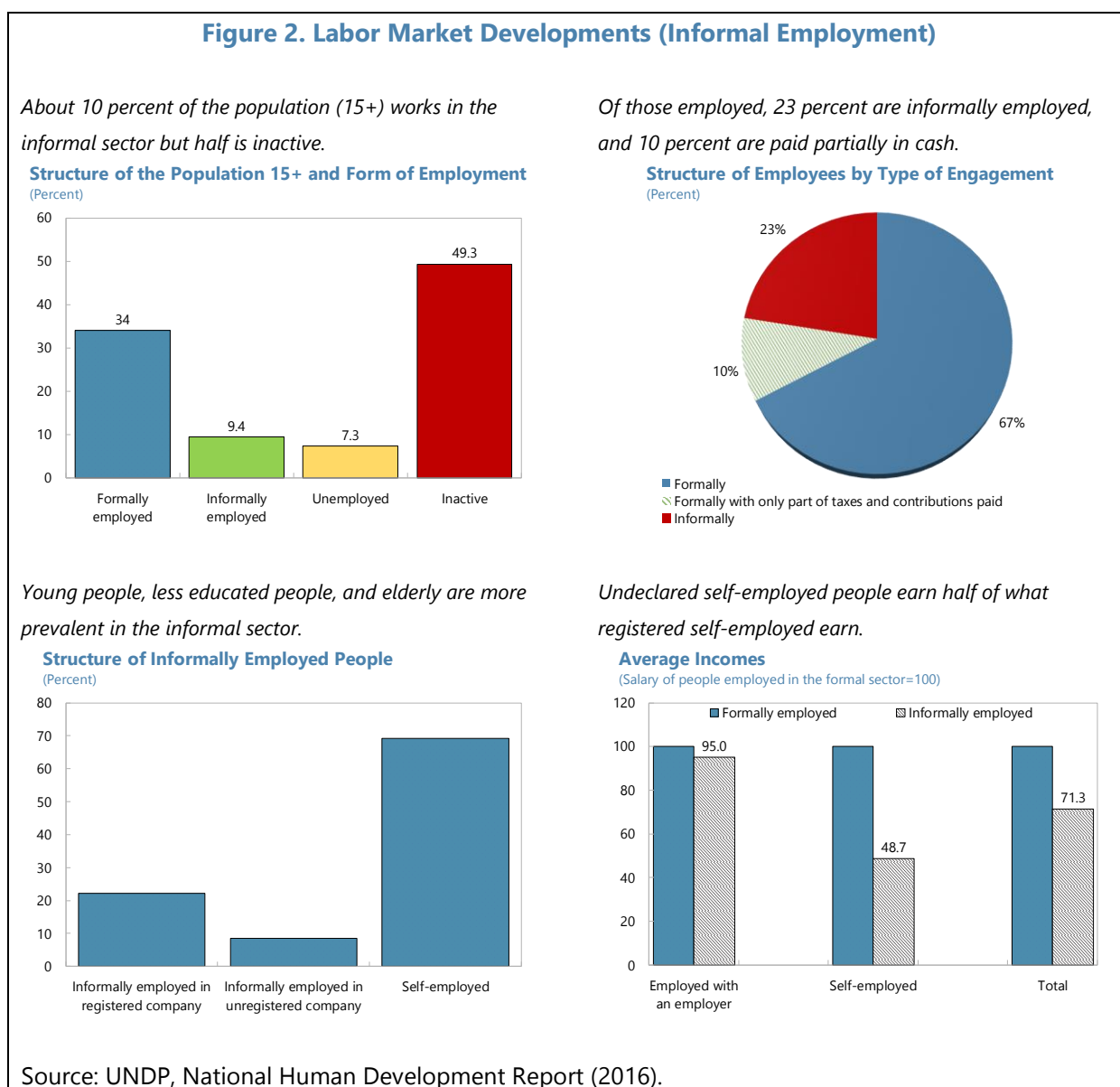
Informal Employment in Montenegro

5. In 2016, the United Nations Development Programme (UNDP) published the report “National Human Development Report- Informal Work: From Challenges to Solutions,” which was prepared after the research institution IPSOS conducted a survey commissioned by UNDP. The report tackles the topic of informal work in Montenegro, which is a critical topic given that a third of employed people are fully or partially informally hired, which put them at risk of inadequate social and health protection.⁴ Below, we present and summarize of some of the report’s main highlights.

⁴ Based on the Labor Force Survey data, staff calculations suggest that the ratio of informal employment to the labor force is around 33 percent since 2009, showing a slight increase in recent years (just above 35 percent in 2016).

6. About 10 percent of the population (15+) works in the informal sector and half is inactive. According to the report, observing the structure of employees by status, about 78 percent of employees are formally employed (67 percent with their full salary declared and 10 percent with only part of their salary declared) and 22 percent of employees are informally employed.

7. About 70 percent of informally employed people are self-employed. According to the report, by age, the dominant group is made up of informally employed people aged between 46 and 64, and 37 percent of self-employed are people without any education or primary school education only, while 6 percent have a college degree. The probability of engagement in the informal economy is higher for young people, less educated people, and the elderly. Women are less engaged in informal activities than men. The largest volume of informal employment was recorded in agriculture and in households as employers.



8. Income of informally employed people is, on average, almost 30 percent lower than the incomes of formally employed individuals. People employed informally with an employer earn 5 percent less than formally employed people, while undeclared self-employed people earn half of what registered self-employed earn. In addition, by income deciles, according to the report, it appears that a high degree of inequality exists within the lower-income deciles, where the income of informally employed people in the first decile would be equivalent to 36 percent of the income of formally employed in the first decile. However, the difference decreases for higher deciles.

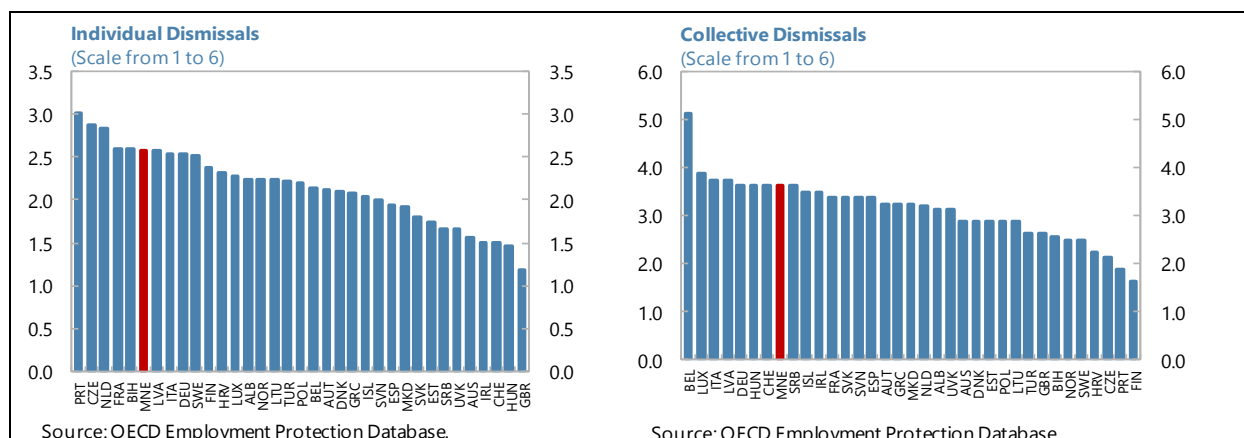
B. How to Explain These Labor Outcomes in Montenegro?

9. As discussed in the OECD jobs strategy (OECD, 2006), the analysis of employment policies needs to include the following elements: (i) level of employment protection; (ii) level of labor taxation; (iii) pace of wage growth, including the minimum wage; and (iv) non-employment income support, activation policies, education, and training.

Labor Market Regulations

10. A key dimension of labor market regulations is the employment protection legislation (EPL), which reflects the level of flexibility/rigidity of regulations related to permanent and temporary labor contracts as well as those related to collective dismissals. Evidence for OECD countries (OECD 2001, 2004) shows that strict EPL reduces both inflows into unemployment and outflows from it, contributes to long-term unemployment, affects the employment prospects of the youth and women, and stimulates the use of fixed-term or temporary contracts. In addition, empirical evidence shows that countries with stricter EPL tend to have a larger informal sector (Johnson, Kaufmann, and Zoido-Lobaton, 1998; Loayza, Oviedo, and Servén, 2005; and Fialova and Schneider, 2011). Also, strict EPL appears to undermine productivity growth (Scarpetta and Tresselt, 2004; Micco and Pages, 2006; and Bassanini and Venn, 2007).

11. EPL in Montenegro is above the average of OECD countries. According to the UNDP report, the reform of labor legislation in 2008 increased flexibility, primarily through regulations related to the use of fixed-term contracts. However, the reform legislation of 2011 led to a decline in flexibility due to a limitation on the use of fixed-term contracts, even though there was an improvement in certain aspects such as severance payments. Based on the latest OECD's EPL rigidity index, the individual and collective strictness indicators are higher than the average for OECD and European countries.



12. The new Labor Law should provide a balance between the protection of work and job security. The Social Partners have finalized a draft of the new Labor Law following a three-year process and the authorities will send it to the European Commission for its opinion. Among other elements, the new Law introduces a simplification of procedures for dismissal of employees, an extension of the duration of fixed-term contracts to 36 months (calculated in a cumulative way), the adoption of a legal Act for the internal organization and classification of jobs, and the introduction of a mechanism for an amicable resolution of employment. Some elements of the current draft Law could be further discussed and revised to increase incentives for more flexibility, declaration of work, and labor participation:

- *Establishing employment relationships:* An employee should be allowed to work for more than one employer even if the additional work is full time. Registration limitations under the Labor Law appear to hamper additional self-employment activity, thus providing “incentives” to under-report self-employment.
- *Internal organization and systematization act:* The requirement that all firms need to have a Rulebook regarding the internal organization and classification of jobs could imply a potential burden for SMEs, particularly for small firms. For these firms, it would be sufficient to include a brief description and/or specification of the work in the employment contract.
- *Termination of employment:* According to the draft Law, “Employment shall terminate by virtue of law when the employee reaches the age of 67 and minimum 15 years of pension insurance...” This eliminates the possibility to extend a contract even if the employer and employee agree. This provision appears counterproductive in an economy with a declining and aging population, where the focus should be on extending working lives.
- *Addressing informal employment:* In the new draft Law, if a job inspector finds a worker without a formal employment contract, the worker automatically receives an open-ended contract. Compliance with the Law and enforcement is a necessary but not a sufficient condition to reduce informal employment, and it is questionable whether this penalty alone will provide the right incentives to comply with the law. Instead, the authorities should devise a system of

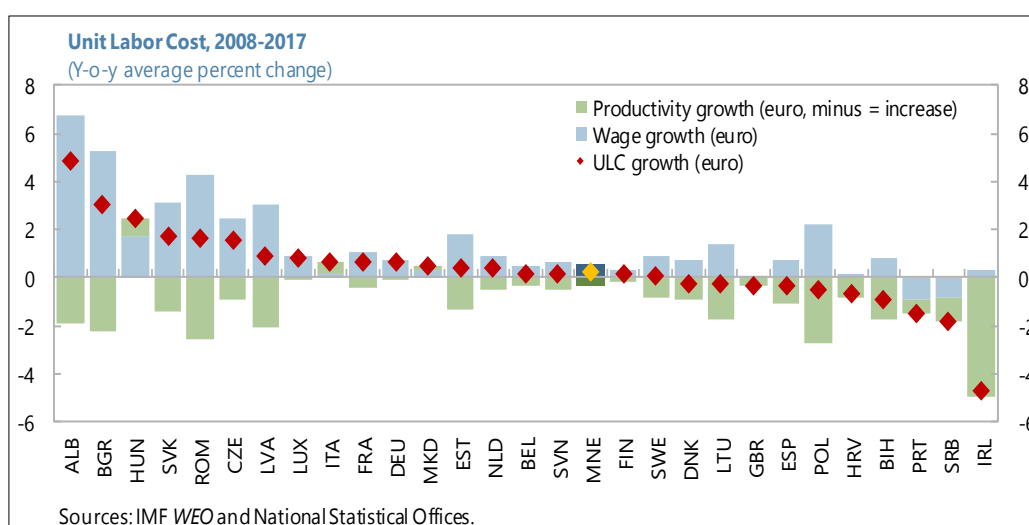
incentives focused on the formalization of economic activities, which also involve employment and tax policies (comprehensive strategy).

13. Labor regulations would also benefit from revisions to the General Collective Agreement (GCA). Under the GCA, negotiated provisions cover all workers in the economy. However, it is generally considered best practice that collective agreements shall apply only to employers and employees who agree to be bound by such collective agreements. It is also recommended that collective agreements be time bound, with a possibility of extension, with the consent of parties. Labor regulations need to provide some flexibility to employers to adjust to different economic situations, especially during recessions. In addition, under the GCA, the minimum wage recognized under the Labor Law is to be multiplied by a set of coefficients depending on the education level of an employee. This seems to imply that there are potentially multiple minimum wages in the economy and that the minimum wage could be modified by changing the basic amount or changing the set of coefficients.

Wage Costs

Wage Costs and Labor Productivity

14. After accounting for productivity and inflation, Montenegro's real unit labor costs would have shown a decline in the post Global Financial Crisis period. According to the World Bank (2018), measured in purchasing power parities (PPP) which accounts for price level differences among countries in 2016, the highest wage levels were found in Montenegro and in Bosnia and Herzegovina. However, while real unit labor costs (ULCs) increased by 3 percent over the last 10 years (2008-17), they have declined in recent years. The average wage, in real terms, has declined by 5 percent between 2010 and 2017 and labor productivity increased 4 percent during the same period.⁵ While labor productivity did increase in recent years, its increase is modest from a medium-

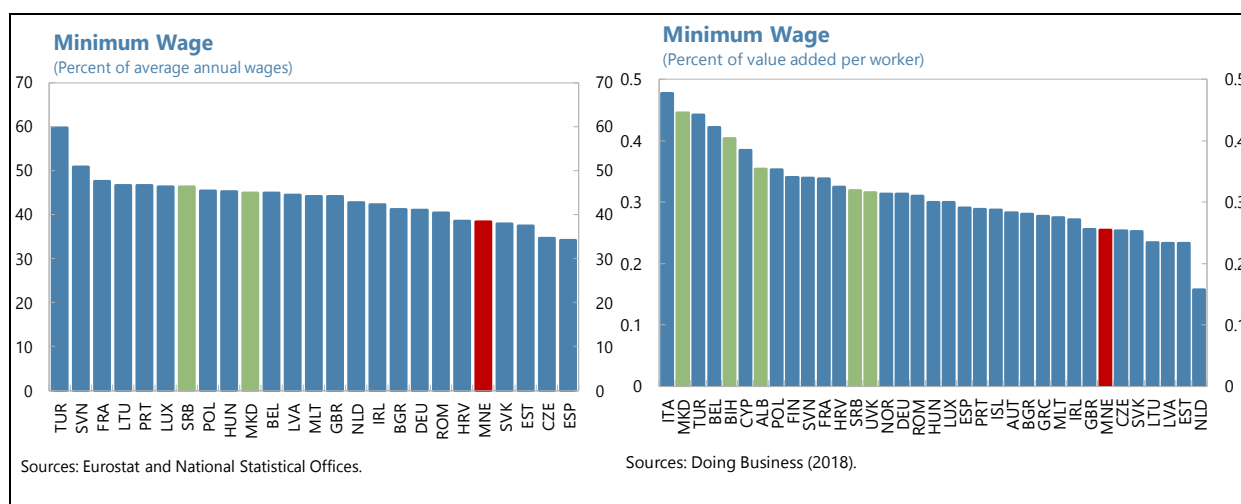


⁵ Information on average wages is obtained through both surveys to employers of enterprises with more than 10 employees and data collection from the tax administration office.

to long-term perspective (since 2008), and it lags the growth rate observed in other Western Balkan countries such as Albania and Bosnia and Herzegovina.

Minimum Wage

15. The minimum wage in Montenegro appears to be moderate by some measures. The purpose of the minimum wage is not only distributional to ensure that low-skill workers receive a payment that would be sufficient to live (Blanchard, Jaumotte, and Loungani, 2013) but also to avoid exploitation by local monopolies. As mentioned by Krsmanović (2004, page 2), “The minimum wage regulation was introduced as a social policy measure aimed at protecting the most vulnerable portion of the labor force, especially workers with low qualifications.” Relative to the average wage and to value added per worker, the minimum wage in Montenegro ranks low across the sample of European countries.⁶ However, an increase in the minimum wage could have additional consequences by potentially affecting the wage distribution in the formal (and potentially the informal) sector.



16. Different levels of the minimum wage, based on the level of education, may have an adverse impact on hiring decisions, especially for new workers in the labor market with higher education levels. Under the country’s General Collective Agreement (GCA), the minimum wage differs depending on the educational level of an employee. The GCA provides the set of coefficients, which determine by how much the minimum wage will be multiplied by depending on the education level (the coefficients range from 1.00, unqualified labor, to 4.12, Ph.D. education level). This differentiation could have the unintended consequence of having multiple minimum wages.

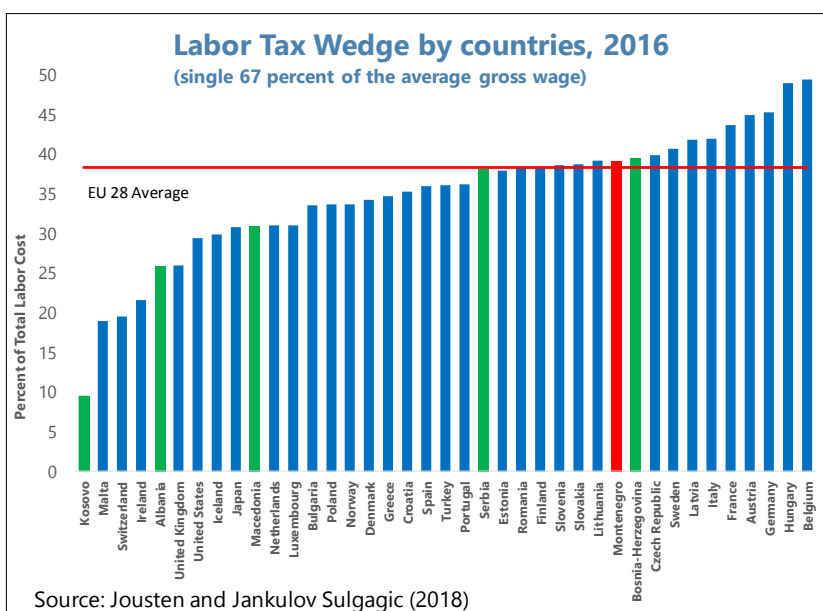
⁶ Currently, the minimum wage is just below 40 percent of the average wage in Montenegro. A joint ILO, OECD, IMF, and World Bank report concludes that a minimum wage of 30-40 percent of the median wage would strike a suitable balance, which corresponds to a range of 25-35 percent below the average wage, i.e. the minimum wage is slightly below this range (IMF, 2016). Relative to GDP per capita, Montenegro’s minimum wage ranks high across European countries. However, the denominator is affected by the large proportion of inactivity (lack of labor force participation) in the labor market.

17. Increases in the minimum wage would not necessarily affect the wage distribution in the private sector. The minimum wage in Montenegro does not seem to be binding across the whole formal sector. As discussed by Krsmanović and Walewski (2006, page 11), while the minimum wage should be binding for all companies in the economy, it would be the case in Montenegro that the minimum wage mainly influences workers in the public services sector given that wages in this sector are linked to the national minimum wage. In the private sector, “while the minimum wage would not be binding for a small portion of employees working in big companies, it influences the effective tax burden on wages” (Krsmanović and Walewski, 2006, page 11). Evidence refers to some employers’ practice of paying the minimum wage along with an additional undeclared amount on which no wage-related taxes are paid. In such situations, an increase in the minimum wage would result in a higher tax burden for employers and in a potential reshuffling between official and unofficial payment, without affecting the actual remuneration.⁷

18. Workers in the informal sector, at the lower income deciles, would not be protected by the minimum wage. As discussed by the UNDP report, there is a large gap between formal and informal income at the lower-income deciles, between 50 and 65 percent difference for the lowest three income deciles.⁸ Also, most informal sector workers at the lower-income deciles would have less educational attainment and/or are involved in low-productivity activities. In this context, the minimum wage might price them out of the market rather than protecting this particular group of workers (UNDP, 2016, page 69).

Taxes on labor

19. At around 40 percent, the tax wedge on labor is relatively high in Montenegro and largely independent of the income level (lack of progressivity) despite a low personal income tax rate. The personal income tax is flat at 9 percent with no personal allowance and only a marginal degree of progressivity. Social security contributions are also flat, adding to a combined tax burden of 33.8 percent of gross wages (there are virtually no deductions



⁷ The unusually high number of workers declaring a wage equal to the minimum wage suggests that this situation is prevalent.

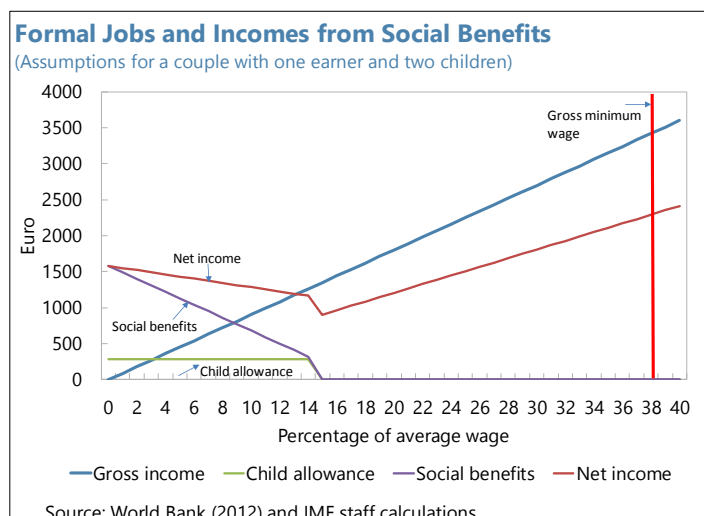
⁸ The report documents that the average net income of informally self-employed people is at the level of the national net minimum wage.

from wage taxes, but certain sources are exempt).⁹ Given the absence of a basic allowance, and the very little progressivity of the PIT on wages, very little variation is observed in the total tax wedge, which stands slightly higher than the EU average.

20. As indicated by the IMF Fiscal Monitor (2017), a relatively high effective tax wedge on labor generally exerts significantly adverse labor market incentives.

It discourages formal market labor supply and/or labor demand and contributes to involuntary unemployment and inactivity. The latter is especially important for individuals earning low incomes because social benefits and transfers are often completely foregone or severely taxed away when workers enter the formal

market, implying high effective marginal tax rates. For example, for a family that receives family benefits (e.g. family material support and child allowance) declaring any income of more than around €1,300 annually (around 15 percent of average wage) could result in the complete loss of family benefits (World Bank, 2012) – a loss in net income of about €280 (red line in the graph below).¹⁰ The design of social assistance and family benefits does not provide incentives to declare work, especially for low-income earners, or even to work¹¹ because social assistance benefits are withdrawn at a high rate as formal gross income increases (see purple line in the graph below).



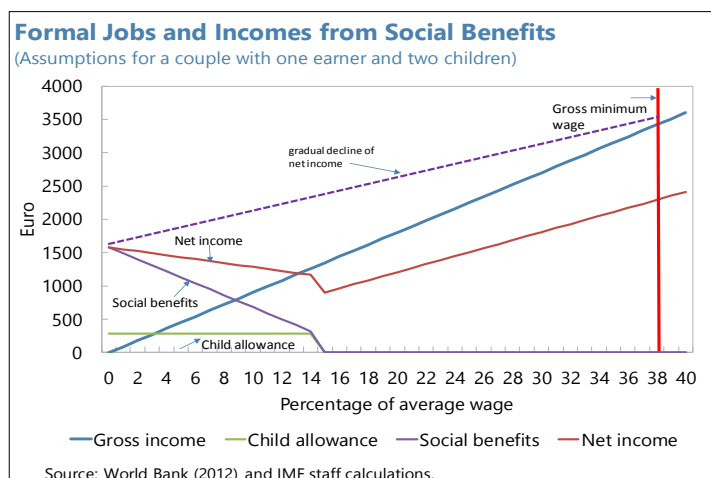
21. Reform options need to consider a reduction of the tax wedge, especially on low income earners, and a gradual withdrawal of social assistance and family benefits. As part of a comprehensive reform, reducing the level of the tax wedge on labor – and possibly increasing progressivity along the income spectrum – will be critical to reducing incentives for under-declaration of income. The latter could be achieved through the re-introduction of a basic allowance for wage income and/or through targeted earned income tax credits or lower employer contributions (e.g. health insurance could be financed through the general budget rather than by

⁹ Para-fiscal and local charges contribute to widening the effective labor tax wedge as perceived by employers (e.g. compulsory levels for the chamber of commerce, the earmarked labor fund for covering severance pay in the case of bankruptcies, and the professional rehabilitation fund). See Jousten and Jankulov Suljagic (2018). Also, health insurance contributions are phased out at certain income levels.

¹⁰ According to the Law of Social and Child Protection, Article 31, “The amount of financial support for a family that earned revenue shall be established in the amount of difference between the amount established by paragraph 1 of this Article and the average monthly revenue of the family from the previous three months.”

¹¹ Both the formalization of the working relationship and the level of declared earnings (under-declaration of earnings for tax purposes).

contributions by employees and employers).¹² In addition, beneficiaries of social assistance and family benefits should not be penalized, especially at low levels of income, when entering the formal labor market. On the contrary, they should gain from joining the formal market; i.e., any additional formal wage should increase their net income including benefits (see purple broken line below (Rutkowski, 2011)).



Activation Policies

Facilitating the Transition to the Labor Market

22. The structure of the Montenegrin economy has experienced significant changes over the fifteen years. As discussed by Barlett et al. (2016, pg.25), “the structure of the economy has gone through profound changes, characterized by a continuous process of deindustrialization and fast expansion of services.”¹³ Due to the structural changes in the economy, there has been a reduction in the demand for occupations related to industry and an extension in the length of job search, particularly in labor intensive sectors. Even though there has been an increase in employment rates in recent years, it does not seem to be the case that a structural change towards higher productivity jobs occurred because the economy relied mainly on labor-intensive activities to achieve growth.

23. The unemployment rate of higher-education graduates is about twice as high as in the EU-28. Barlett et al. (2016) documents that the overall unemployment rate was about twice as high as in the EU-28, as was the unemployment rate of higher-education graduates in 2014. The survey for high education graduates shows that currently unemployed graduates have had a difficult entry into the labor market and have been unemployed on average for over a year (13.5 months). The issue of job matching (e.g., ensuring that the job on offer is well matched to the qualifications held) would be an important part of the explanation of the high unemployment rate among new graduates. According to the survey presented in Barlett et al. (2016), graduates receive little assistance in finding a job other than through family and friends. There is also a prevailing view that graduates do not gain enough relevant work experience during their higher education. To mitigate this mismatch, the Employment Office implemented a program for professional training of university graduates in 2013 involving 4,000 participants (UNDP, 2016). Also, it is necessary to foster the

¹² Budgetary implications of reduced social security contributions could be partially compensated by reducing tax exemptions or relying more on environmental and carbon taxes.

¹³ By 2013, the share of employees in the service sector had reached 77 percent, while the share of employees in the industrial sector had declined to 18 percent.

cooperation between employers and high education institutions to allow employers to be involved in curricula development so they can make explicit what the labor market priorities or needs are.

Reduction of (Long-Term) Unemployment

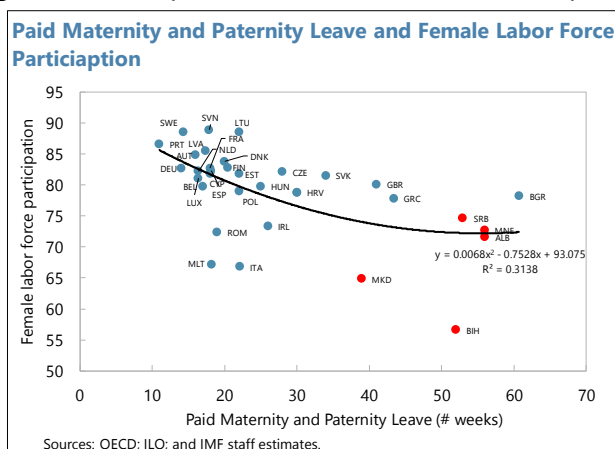
24. The authorities have implemented different programs to improve the knowledge, skills, and competencies of the labor force. Over the last decade, the Employment Office of Montenegro has implemented active labor market policies (ALMPs) with the overarching objective of reducing unemployment and labor market mismatches. These programs include: (i) professional rehabilitation of persons with disabilities and other hard-to-employ persons; (ii) adult education and training; (iii) training programs for independent work; (iv) training programs for work with the employer; (v) public works; (vi) activation of users of family social benefits; (vii) stimulating the first employment of persons with acquired secondary education; and (viii) a project financing/grant scheme. These programs have the objectives of training, employment incentives, supported employment and professional rehabilitation, direct job creation, and start-up incentives. On average, 6 percent of unemployed people have been covered by these programs between 2014 and 2016. According to Drobnič et al. (2017), the percentage of programs' participants that were employed in 2016 ranged from 5 percent to 43 percent.

25. The implementation of these programs will benefit from a strengthening of their monitoring and assessment. Careful assessment of the programs' effectiveness is needed to better inform the authorities whether the programs' primary objectives are met or whether better targeting, scope, funding, or coordination with other government departments are needed. Among other recommendations specific to Montenegro, Drobnič et al. (2017) emphasizes that: (i) active labor market measures of training, either on the basis of the criterion of occupation or skills/knowledge/competency should be made on the basis of the mismatch between demand and supply on the labor market; (ii) the analytical reports on the positioning of certain groups on the labor market should be an obligatory element of the designing of active measures; (iii) an ex-ante evaluation is required to establish an adequate scope in the process of creating and designing the measures; (iv) comprehensive evaluations (process, results, preliminary assessments) should be carried out; and (v) there should be indicators for measuring the performance of the results (both quantitative and qualitative) versus the goals of the measures.

Reducing Inactivity Rates: Some Considerations

26. According to the LFS, the main explanations for labor inactivity are retirement and education or training. The inactivity rate of the age group between 55 and 64 years (about 56 percent) is higher than the one observed in other European countries and slightly above the average of other Western Balkan countries (about 54 percent). The authorities need to carefully assess whether there are loopholes in the system that allow people to enter into early retirement as beneficiaries of disability pension schemes (Sanfey et al., 2016). Strict eligibility criteria are important to provide incentives to remain in the labor force.

27. Reforms to family benefit systems could increase female labor force participation. As discussed by IMF (2012, p. 28), publicly financed maternal/parental leave programs can help keep mothers connected to the labor market and increase female employment rates. However, very long paid leave could provide incentives for mothers to take lengthy periods out of the labor market, which could cause skill losses and jeopardize future employment opportunities. Jaumotte (2004) finds that parental leaves (up to a duration of 20 weeks) and child care subsidies are also identified as raising female labor force participation. In most OECD countries, the sum of paid maternity and paternity leave is below 30 weeks. In Montenegro, however, parental leave allows one of the parents to be paid while absent from work for 365 days (52 weeks) from the birth of the child if caring for or nursing a child. In addition, an employed woman may start paid maternity leave 45 days prior to delivery, and 28 days prior to delivery as mandatory leave. As discussed by Atoyán and Rahman (2017, page 8), "...women's successful return to labor force after childbirth and durable stay in the labor force requires family leave policies that (i) do not create incentives for women to stay too long away from work causing skills loss and (ii) ensure the possibility or even mandate for fathers to take leave." In this context, the authorities could consider a reduction of the length of paid parental leave to bring it closer to the one observed in most OECD countries, require a minimum leave period for fathers, and leave it to the discretion of the prospective mother to take part of her maternity leave prior to delivery.



28. At the same time child care should be available to support labor force participation of families. Child care subsidies may be effective together with affordable child care services. In the case of Montenegro, while there has been an increase in public child care units between 2010 and 2017 (from 99 to 122), the significant increase of private child care units during the same period (from 9 to 25) might reflect an increase in demand that is not fully satisfied. Child care options might have to be increased to allow more new parents to participate in the labor market. In practice, since women mostly take parental leave, it would mainly increase female labor market participation.

29. Sizable emigration has had effects on labor force participation. Atoyán et al. (2016) document that during 1995-2010 countries in the Western Balkans have lost up to 18 percent of their population to emigration, mostly men of prime age with average or above average educational levels (brain drain). Remittances could negatively impact employment and labor force participation of both male and female workers who stay behind by increasing the reservation wage, pushing men into informal employment and women into inactivity due to family responsibilities (Atoyán and Rahman, 2017).

C. Conclusions

30. Neither the new Labor Law nor changes labor taxation by themselves would improve current labor market outcomes significantly in Montenegro. A comprehensive and unified strategy is needed to address the country's labor market outcomes related to inactivity, long-term unemployment, and informality given the potential presence of cross-cutting common factors. Especially close coordination is needed between the Ministry of Finance and the Ministry of Labor to address the issue of employment policy, including enforcement of the Labor Code, labor taxes, and social benefits.

31. There is still room to improve the Labor Law. Some elements of the current draft Law could be further discussed to increase flexibility, declaration of work, and labor participation. These include: (i) *establishing an employment relationship by allowing an employee to work for more than one employer even if the additional work is full time*; (ii) *tailoring the internal organization and systematization act for SMEs to reduce potential burdens (particularly for small firms)*; and (iii) *addressing informal employment not only through compliance and enforcement with the Law, which is a necessary but not a sufficient condition to reduce informal employment. The authorities need to work on a system of incentives focused on the formalization of economic activities, which also involves employment and tax policies (comprehensive strategy).*

32. Reform options should reduce the tax wedge, especially on low income earners, with a gradual withdrawal of social assistance and family benefits to avoid poverty traps. As part of a comprehensive reform, reducing the level of the tax wedge on labor – and possibly increasing progressivity along the income spectrum – will be critical to lowering incentives for under-declaration of income. The latter could be achieved through the re-introduction of a basic allowance for wage income and/or through targeted earned income tax credits or lower employer contributions (e.g. health insurance could be financed through the general budget rather than by contributions by employees and employers). In addition, beneficiaries of social assistance and family benefits should not be penalized, especially at low levels of income, when entering the formal labor market.

33. The authorities need to continue implementing labor market reforms aimed to increase employment and reduce the unemployment rate. The National Strategies for Employment and Human Resources Development need to continue providing the overall principles and objectives to increase human capital investment and the level of employment. The strategy should take into account an assessment of the labor market's medium-term needs to better align the education system with future labor demands and avoid simple expensive retraining. In addition, the strategy could provide a useful framework to nurture the cooperation between high education institutions and employers and bring key stakeholders together (e.g. cooperation for curricula design). While active labor market policies (ALMPs) can contribute to reduce labor market mismatches in the short to medium term, the education system is the key element for the reduction of labor market mismatches in the medium to long term. Finally, paid parental leave could be

reduced and child care options increased to increase young parents' labor market participation, particularly that of women.

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