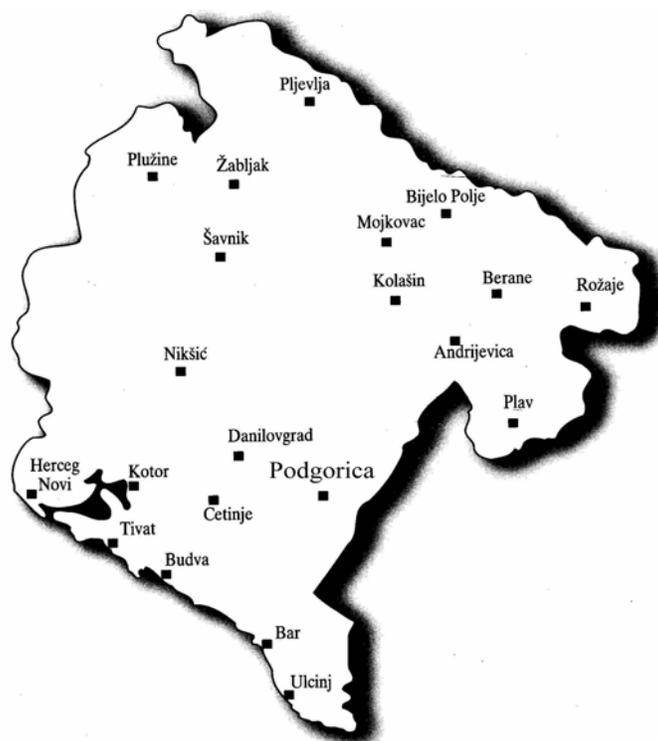


*United States Agency for
International
Development*



*Montenegro Interim Strategy
2002 – 2004*

April 2002

ACRONYMS

ABA/CEELI	American Bar Association/Central and Eastern Europe Law Initiative
ACILS	American Center for International Labor Solidarity
ADP-Zid	Association for Democratic Prosperity
ANTTRC	Albanian National Training and Technical Resource Center
AYJ	Association of Young Journalists
CBM	Central Bank of Montenegro
CDT	Center for Democratic Transition
CEED	Center for Entrepreneurship and Economic Development
CFE	Center for Entrepreneurship
CIPE	Center for International Private Enterprise
CITUM	Confederation of Independent Trade Unions of Montenegro
CoE	Council on Europe
CRDA	Community Revitalization through Democratic Action
CRS	Catholic Relief Services
CY	Calendar Year
DEG	German Development Agency
DEM	Deutschemark (German currency)
DFID	Department for International Development (British Aid)
DG	Democracy and Governance
DOS	Democratic Opposition of Serbia
DPR	Department of Public Revenue
DPS	Democratic Party of Socialists
EAR	European Agency for Reconstruction
EBRD	European Bank for Reconstruction and Development
EPCG	Elektroprivreda Crna Gora (Electricity Company of Montenegro)
EU	European Union
FDDR	Foundation for Development of Democratic Rights (Hungary)
FLAG	Firm Level Assistance Group
FRY	Federal Republic of Yugoslavia
FY	Fiscal Year
GDP	Gross Domestic Product
GNP	Gross National Product
IAS	International Accounting Standards
ICMA	International City/County Managers Association
ICNL	International Center for Not-for-Profit Law
IDA	International Development Association
IMF	International Monetary Fund
IR	Intermediate Result
IREX	International Research and Exchange Board
ISSP	Institute for Strategic Studies and Prognosis
IT	Information Technology
JTC	Judicial Training Center
KAP	Kombinat Aluminijuma Podgorica (Aluminum Manufacturing Company)
LSCG	Liberal Alliance
MAP	Montenegro Advocacy Program
MCM	Micro Credit Montenegro
MISP	Montenegro Infrastructure Support Program

MMI	Montenegro Media Institute
MVP	Mass Voucher Privatization
NATO	North Atlantic Treaty Organization
NBY	National Bank of Yugoslavia
NDI	National Democratic Institute
NEX	Securities Exchange
NGO	Non Governmental Organization
NS	People's Party
OI	Opportunities International
ORT	ORT International (NGO)
OSCE	Organization for Security and Cooperation in Europe
OSI	Open Society Institute
OTI	Office of Transition Initiatives
PAYG	Pay As You Go
ROL	Rule of Law
SDP	Social Democratic Party
SEED	South East Europe Democracy Act
SME	Small and Medium Enterprise
SNP	Socialist People's Party
SO	Strategic Objective
UNDP	United Nations Development Programme
UNEM	Union of Independent Electronic Media in Montenegro
UNICEF	United Nations Children's Fund
USAID	United States Agency for International Development
USG	United States Government
VAT	Value Added Tax
WTO	World Trade Organization
ZOP	Montenegro Payment Bureau

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PART I: OVERVIEW

A. Background

The election of Milo Djukanovic as President in October 1997, and international support for the new regime, laid the foundation for the democratization of Montenegrin society. The new government immediately took actions to put into place a series of potentially far-reaching political and economic reforms. The reform program, and the significant international development assistance program that underpinned it, facilitated the government of Montenegro to distance itself from the Milosevic regime. By 2000, Montenegro had acquired a large degree of self-government and established a good measure of economic autonomy the centerpiece of which was the adoption of the deutsche mark as the official currency. The U.S. and EU strongly supported Montenegro's efforts to democratize its society, and provided considerable, critical budget support and technical assistance to enhance the reform efforts.

The fall of Milosevic in October 2000 significantly changed the political landscape and reinforced the preference of the international community for Serbia and Montenegro to remain in a joint state. However, rather than rebuilding bridges with Belgrade, President Djukanovic moved towards formalizing the large degree of autonomy that Montenegro had in practice already created, thereby causing concern in the international community that any move to establish independence might have destabilizing consequences, both internally and regionally. Consequently, since the fall of Milosevic, the USG and the EU have encouraged a democratic Montenegro within a democratic Yugoslavia. These efforts culminated in a March 2002 EU-led initiative where the two republics signed an agreement in principle for a renewed political relationship between Serbia and Montenegro. The two republics will maintain substantial autonomy that, among other things, allows Montenegro to retain economic sovereignty; that is, it does not have to rescind the reforms it has carried out with substantial international support, in particular maintaining its separate monetary system and customs regime.

The international community believes the EU brokered agreement is a positive step, as it will allow both republics to move forward and concentrate on their respective reform programs. It will provide an opportunity to further strengthen democratic institutions and focus efforts on the needs of citizens in terms of economic growth and improved standards of living, rather than what has heretofore been the dominant politically divisive issue of state status.

Since 1999, when the issue of Montenegrin independence from the FRY became a significant concern of USG policy in the region, USAID has implemented its reform-centered assistance program to promote macroeconomic stabilization and structural economic reform necessary to accelerate the transition from socialist to a market oriented economy. Without these changes the Djukanovic administration could not have successfully stood up to Milosevic. The goal was never to encourage an independent Montenegro. Since the inception of the program, USAID has focused on providing technical support and advice to the Government of Montenegro in its efforts to establish a sound foundation of political and economic reform necessary to change the role of government, modernize and strengthen key economic and political institutions, decentralize political and economic decision making and promote a vibrant private sector. Since 1998, important reforms were put in place that have stabilized and began the transformation of the economy, while significantly improving government, transparency accountability and management.

Given the arrangement of the recent agreement between the two republics, the decision has been made to undertake a three-year strategy, rather than a longer-term plan. This new three-year strategy shifts USAID's focus from one of providing support to create a legislative and institutional reform framework necessary to establish the rule of law and create conditions conducive to a flourishing private sector, to a strategy of providing assistance that supports the capacity of Montenegro's citizens to advance a continued agenda of reform that addresses citizens' priorities for democratic, economic and community-based development. The new strategy also focuses on enhancing the capacity of government to effectively implement reforms, enforce all the new laws and meet citizens' needs while promoting integration of Montenegro into transatlantic institutions, in concert with its union partner Serbia, as envisioned under the EU brokered agreement. Furthermore, this focus supports recently announced USG foreign policy objectives to address "the inability of new democracies to control borders, to promote the rule of law and to respond to the needs and insecurities of their citizens."¹

USAID's Community Revitalization through Democratic Action (CRDA) program will provide tangible and meaningful opportunities for citizens to achieve positive change in their lives and their communities, while a new local government initiative will assist municipalities in the implementation of reforms, increased transparency in their operations, and improved government services. At the national level, USAID's Montenegro Advocacy Program (MAP), independent media support, political party and trade union programs will expand citizens' capacity to engage government in an active public policy dialogue while monitoring government performance. Furthermore, in support of President Bush's recently announced plan to help developing nations, USAID's rule of law and economic policy reform programs will assist the Government of Montenegro in the continued implementation of "sound economic policies that unleash the enterprise and creativity necessary for development."¹

B. Economic Profile

Montenegro is a small republic in a national partnership with the Republic of Serbia. Its land area is about one-sixth that of Serbia and its population is less than one tenth of Serbia's.² The ethnic composition is considered to be predominantly Montenegrin although no recent count has been made. During the 1990s, there were large movements of refugees into Montenegro, reaching a peak of over 100,000 in 1999. Today there are about 45,000 refugees, mainly from Kosovo. Its economy was the smallest and poorest of the republics of Yugoslavia. Montenegro's most productive sectors -- tourism, heavy industry and transport - - collapsed with the separation of the other republics from Yugoslavia, international sanctions against Serbia and Montenegro, and heightened barriers between Serbia and Montenegro. However, Montenegro appears now to be emerging from the political and social instability that have disrupted the economy for more than a decade.

Although official measures of gross domestic product (GDP), employment and industrial production remain well below 1990 levels, the prospects for growth have been strengthened by political and institutional changes that improve the prospects for both domestic and

¹ Presentation by Greg Schulte, NSC Senior Director for S.E. Europe at Georgetown University, March 20, 2002

² Montenegro's population in 2000 was about 660,000, compared to 7.7 million for Serbia, excluding Kosovo. The last official population count in Kosovo was 2.2 million in 1997. Data are from Institute for Statistics, Government of Serbia.

foreign investment. However, when the gray market portion of the economy is considered, real GDP is near 1990 levels (about \$1.3 billion³). Official unemployment exceeded 40 percent of the labor force for 2001, but adjustment for gray market activity reduces that to 17 percent.⁴ Industrial production accounts for the largest portion of GDP in the formal sector (30 percent)⁵, of which two-thirds is in processing,⁶ mainly aluminum production at the Kombinat Aluminijuma Podgorica (KAP) and associated inputs. Trade (26 percent) and agriculture (20 percent) are the other largest sectors in official statistics, but the 2001 performance of tourism may lift that industry's rank among sectors when official data become available. Construction is also rising strongly. Shipping formerly contributed significantly to GDP, but the merchant fleet has collapsed entirely.

Consumption levels have been protected by an extensive system of social payments, the largest component of which is pensions. The 86,000 pensioners in 2001 constituted 75 percent of the number of officially employed persons and their pensions totaled \$70 million in 2001. The Health Fund paid out a further \$50 million.⁷ Remittances contributed nearly \$80 million in 2001, of which about half came from Serbia.⁸

Inflation in 2001 was about 25 percent, up from 2000. Adoption of the deutsche mark in November 1999 and of the euro in January 2002 afforded some monetary stability. The underlying causes of rising prices since 1999 included rising minimum wages and pensions, price decontrol, and increased cost of electricity, 30% of which is imported. Pension payments and government salaries rose substantially in 2000, but net wages remained relatively constant in 2001. Prices on bread and milk were liberalized in August 2001. Controls remain only on the price of electricity, oil products, and utilities. As important as the price rise of imported electricity were the blackouts experienced frequently between November 2001 and January 2002, when the weather was especially cold and domestic production was curtailed by low water levels for hydropower generation.

Montenegro's international trade, excluding Serbia, yielded a deficit of \$400 million in 2001.⁹ Except for electricity, most imports were from the developed countries beyond the former Yugoslavia (57 percent). Commodity exports, including mainly aluminum, are even more strongly oriented toward developed countries beyond Montenegro's neighbors (88 percent). Tourism relies most heavily on visitors from the region, especially Serbia. Trade with Serbia increased sharply in 2001 (240 percent) as tensions and barriers relaxed between the republics. Nonetheless, commodities from Serbia constituted less than 12 percent of imports¹⁰ to Montenegro in 2001 and commodity exports to Serbia constituted 5 percent of all

³ The estimate of current GDP is in year 2000 dollars. A household survey conducted by OCHA and funded by USAID found per capita income, including gray market earnings, of DEM 4,587 in 2000. This implies GNP of about \$1.3 billion. The comparison to 1990 is made in *Economic Reforms in Montenegro*, Veselin Vukotic, report to USAID 2002.

⁴ *Montenegro Economic Trends*, Institute for Strategic Studies and Prognoses, No.7, December 2001, p. 14.

⁵ *Barriers to Doing Business in Montenegro*, Center for Entrepreneurship and Economic Development, 2000, p. 27.

⁶ *Montenegro Economic Trends*, Institute for Strategic Studies and Prognoses, No.7, December 2001, p. 9.

⁷ *Montenegro Economic Trends*, Institute for Strategic Studies and Prognoses, No.7, December 2001, pp. 36-37.

⁸ Central Bank of Montenegro. It is recorded as "compensation of employees" and as "revenues from Serbia for individuals" under "net factors" in the current account of Montenegro.

⁹ *Montenegro Macroeconomic Update :March 2002*, USAID Economic Policy and Institutional Reform Support Project, March 12, 2002 (draft).

¹⁰ Goods and services flowing from Serbia to Montenegro are not, strictly speaking, imports since the two Republics are parts of the same country, but it is conventional to refer to such trade as imports since it represents flows into the economy and there are different tariff rates in the two economies.

Montenegrin exports. International trade by Serbia formerly relied, in part, on the Port of Bar in Montenegro, but this ceased in 1999 due to the breakdown in relations between the republics. It has now returned on a small scale, despite significant differences in tariff rates between Serbia and Montenegro. Average tariffs for Serbia are 3-4 times the levels of Montenegro.

Government deficits have resulted from the burdens of paying wages for a large public workforce, maintaining extensive social payments and subsidizing electricity for consumers and state enterprises. Over \$100 million in cash transfers from USAID since 1999 significantly alleviated the shortfall. Maintenance of infrastructure, such as roads, sewers and water supply systems, has deteriorated since 1990, severely hampering the recovery of tourism. Government revenue in 2001 was about 20 percent higher than planned, but approximately equal to 2000 in real terms.¹¹ The cash deficit in 2001 was \$54 million (15 percent of expenditure) before accounting for \$30 million in USAID budget support. If arrears accumulation is also considered, the deficit for 2001 is \$90 million.¹²

About 60 percent of the formal economy has been privatized, but the strategic industries of telecommunications, petroleum distribution, electricity generation and distribution, aluminum production, and major hotels are still being prepared for sale. There are interdependences among these strategic industries, with aluminum consuming 40% of the electricity in Montenegro, supplied by the utility at about half the price it pays for imported electricity. The banking sector is also dominated by state or socially owned banks. Foreign investors have not been active in Montenegro, apparently awaiting political stabilization and implementation of the new legislation relevant to business. Even then Montenegro may have a difficulty competing with others in the region for foreign direct investments given, among other things, its small market size, lack of infrastructure, electricity shortages, relatively high wages and labor rigidities. Several tenders for state enterprises failed to attract bidders in 2001, but the Government of Montenegro appears less interested in a high purchase price than in attracting foreign investment subsequent to sale, and privatization of several strategic enterprises is realistically being sought in 2002.

C. Political Profile

In October 1997, Milo Djukanovic was elected President of Montenegro with support from a broad multi-ethnic coalition, ousting the cronies of Slobodan Milosevic from power in Montenegro. Djukanovic took office in January 1998. This political change in 1998 laid the foundation for democratization of Montenegrin society. Social and political life became more open, NGOs and the media enjoyed greater freedoms, and the government embarked upon a series of potentially far-reaching political and economic reforms. However, the supportive legislative and institutional frameworks needed for moving towards a consolidated democratic system, free market and Euro-Atlantic integration are far from being complete. The profound division of society over the issue of redefining or terminating the relationship between Montenegro and Serbia, years of war, and systemic deficiencies, including the legacy of the one-party rule and the socialist economy, has impeded reform. Corruption and patronage while ostensibly being addressed also remain part of the landscape. While the government has the task of carrying out legislation to address social, economic, and political

¹¹ *Montenegro Economic Trends*, Institute for Strategic Studies and Prognoses, No.8 (draft), March 2002, pp. 26-27.

¹² *Montenegro Macroeconomic Update: February 2002*, USAID Economic Policy and Institutional Reform Support Project.

problems, it also must demonstrate that it has the capacity to put laws into practice. Further, it is crucial that the government enjoy wide public support for the democratic transition, which can only be ensured by a transparent reform process, and closer cooperation with civil society.

Since 1998, when the Government of Montenegro distanced itself from the Milosevic regime, the issue of Montenegro's status has dominated the political agenda. The reform-oriented multiparty government, comprised of the Democratic Party of Socialists (DPS), Social Democratic Party (SDP), and People's Party (NS), started articulating the need for Montenegro to have an equal position in the Yugoslav federation. However, the deepening of the antipathy between the Djukanovic and Milosevic governments, accompanied by the escalation of conflict in Kosovo in 1999, led Montenegrin authorities to break remaining ties with Yugoslav Federal institutions. By 2000, Montenegro acquired a large degree of independence and established a separate economic system; it remained minimally subordinate to Yugoslavia in foreign affairs and defense matters. The U.S. and EU welcomed the government's efforts to democratize society, and provided critical financial and technical assistance for reforms.

The ouster of Milosevic from power in October 2000, followed by Yugoslav federal election victory in December 2000 by the Democratic Opposition of Serbia (DOS), marked a dramatic change in the political landscape. The international community viewed DOS' landmark victory as providing scope for further democratization of the region, and shortly thereafter began to evince a strong preference for Serbia and Montenegro to remain in a joint state. The Montenegrin ruling coalition fell apart: the pro-federation People's Party (NS) left the ruling coalition and joined the Socialist People's Party (SNP) and the Serbian People's Party (SNS) to comprise the opposition "Together for Yugoslavia" coalition. In April 2001 crucial parliamentary elections were held with both sides campaigning largely on the independence issue. "Together for Yugoslavia" did much better than expected; the narrow victory of the moderate pro-independence DPS/SDP coalition led by President Djukanovic confirmed the depth of division in Montenegro over the republic's status. With some difficulty, the pro-independence ruling parties formed a minority government in cooperation with the radically pro-independence Liberal Alliance (LSCG), which conditioned its participation in the ruling coalition on a commitment for a referendum on independence.

Following Milosevic's ouster from power, Podgorica and Belgrade began consultations on redefining the two republics' relationship. Although the Montenegrin Government made clear its strong preference for an independent Montenegro, in the fall of 2001, EU High Representative initiated a process between Belgrade and Podgorica to facilitate a solution that would result in a joint state, and with the EU expressing deep concern about the prospect of an independent Montenegro. The U.S. provided its full support to the EU initiative, which culminated in an agreement in March 2002 that establishes principles for a renewed arrangement that preserves the outline of the federal state. Under the joint state agreement, a new Constitutional Charter regulating relations between Serbia and Montenegro should be concluded by the end of 2002; there will continue to be a joint President and Parliament and joint ministries of defense, foreign affairs, internal economic relations, external economic relations, and protection of human and minority rights. The two republics will maintain substantial autonomy, and Montenegro should not have to rescind the reforms it has carried out, insisting on maintaining its separate monetary system and customs regime. The arrangement will last for a three-year period, after which either of the republics can exercise the right to hold a referendum on independence. President Djukanovic has expressed desire

to use the three-year period to prepare for independence. Following Djukanovic's acceptance of the EU-brokered agreement, his pro-independence coalition partners announced their withdrawal of support for the Montenegrin Government. It remains unclear whether a new government will be formed, or whether extraordinary Parliamentary elections must be held.

D. Conflict Vulnerability

Political divisiveness over the issue of independence from Serbia, a sense of not benefiting from the economic restructuring process, crime and corruption and potential regional instability are the four main areas of Montenegrin vulnerability to potential conflict.

Most political analysts in Montenegro are of the view that Montenegro will be free from near-term impending hostility, as was the case during the Milosevic crackdown of Montenegro in 1997 and 1998. At present, there is broad consensus for resolving Montenegro's polarization over state status through political means and void of violence. Nevertheless, in the recent years the division between the main political forces in Montenegro, pro-Yugoslav versus pro-independence, has distracted significant resources and energy from society, which could have been channeled to accelerate the reform process.

The consequent political polarization in society has spilled over to other areas, including Montenegro's rival Orthodox churches. Supporters of a joint Serbian-Montenegrin State, strongest in the North, pledge allegiance to the Serbian Orthodox Church, while Montenegrin nationalists, strongest in the South, support the Montenegrin Orthodox Church. While Montenegro has a tradition of ethnic tolerance, fears in the ethnic minority communities could surface under a pro-Yugoslav majority government. Some pro-Yugoslav parties (SNP and SNS) have made public statements against perceived ethnic threats. Additionally, past experience shows that regional conflict in neighboring countries could spill over into Montenegro, disrupting an already politically and economically stressed society.

The pro-independence political-bloc, which is dissatisfied with the EU-brokered agreement of March 2002, has triggered a crisis that has left the government currently in power without majority support in parliament. While President Djukanovic's party and the pro-Yugoslav bloc in parliament have the votes to ratify the accord by June 2002, the Liberal Alliance Party has threatened to call for a no-confidence parliamentary vote. Potentially, this can result in early parliamentary elections or possibly President Djukanovic's ouster from office in the presidential elections later this year. The government is hoping compromise with the Liberal Alliance is still possible so that in three year's time the option of holding a referendum on independence is still viable.

The current government crisis and political uncertainty logically puts in motion trigger points that can affect negatively the reform process and continue to aggravate polarization in society. There is speculation that a pro-Yugoslav bloc devoid of political will to carry out reform could hamper further progress to date on reform implementation. At the same time, the EU brokered agreement has exacerbated dissatisfaction among important parties, such as the Liberal Alliance Party and Social Democratic Party.

President Djukanovic's argument that the EU brokered agreement is the best solution for Montenegro, at a time when society is deeply split on the issue of independence, will need time before it receives public acceptance. Similarly, the question of whether the accord

represents a transitional arrangement toward full independence for Montenegro will depend on the political bloc in control at that time of decision.

In view of the current government crisis, triggering extraordinary parliamentary elections scheduled for October 20, 2002, together with the projected federal accord elections in fall 2002, municipal elections in May 2002, and presidential elections by the end of 2002, USAID will respond to these developments through its political party/elections support program. That is, assisting parties to engage voters effectively in the pre-election periods, and helping ensure that the processes are free and fair. Similarly, USAID will support unbiased NGO election monitoring efforts in order to decrease electoral tensions.

USAID's economic assistance program seeks to rapidly provide tangible economic benefits of reform, and turn around the stagnant economy by front-loading assistance to the pro-reform government. Legal and judicial reform, imperative for the resolution of a bankrupt banking system and insolvent state sector, are among the most important initiatives under this strategy. USAID will assist in more rapidly applying new commercial legislation, and will train court judges to adjudicate commercial cases and protect security and investor interests. This effort is essential to building a strong business climate that will promote growth, create jobs, and thus mitigate the potential for conflict arising from painful economic reform and restructuring.

Inadequate attention to social safety-net issues, such as pension and health care system reform and benefits for the unemployed, could negatively affect public support for reform. The strategy will respond to the social impact of economic reform by assisting with pension reform. In general, more government action is needed to help ensure that economic reforms in Montenegro are complemented with attention to the social consequences of reform.

In addition to its efforts to ensure sound structural reform and economic revitalization, USAID's civil society activities will support community revitalization, local government and NGOs as service-providers.

Unmet expectations continue to be expressed. Popular perceptions regarding the republic's performance in managing political, economic, and social transition are extremely critical to the country's continued support for reform. Polling data indicate that the public at large is increasingly dissatisfied with the pace of economic transition. This dissatisfaction will merit close monitoring of all USAID activities effecting reform and its impact throughout the life of the strategy.

USAID is supporting NDI efforts to monitor public opinion. Elements of these polls are shared with party leaders to identify areas where attention can be focused to improve policy coordination and outreach, which will help to solidify support for reform. Results also are communicated widely within the official U.S. community and discussed with USAID partners engaged in economic reform support to ensure that programs of greatest importance to Montenegro's development and its citizens receive priority attention. USAID will continue to support monitoring of public opinion as a potential "trigger". In response to this "trigger" OTIs initiative to accelerate the pace of reform in selected areas to help meet popular expectations and shore up support for democratic and economic transition, will be pursued in the continuing support to civil society, including the CRDA program.

E. Other Donor Support

In 1993, international sanctions were placed against the Federal Republic of Yugoslavia (FRY), cutting off assistance from the international financial institutions and potential bilateral donors. With changed conditions in the region, USAID began a small assistance program in Montenegro in 1997. The Kosovo crisis in 1999 brought in a wide range of donors with emergency assistance, particularly for refugees. Since then, USAID has been the largest donor by far, but the international financial institutions are now beginning to expand their assistance to Montenegro.

The World Bank plans to sign in June 2002 an IDA credit of \$540 million for FRY covering 2002-04. The Montenegro portion of this agreement is expected to provide about \$15 million per year for budget support and \$3 million per year for project assistance. This budget support represents a shift from USAID in stabilizing the government through short-term deficit reduction. The areas anticipated to receive project support include energy, trade and transport facilitation for the Southeast Europe Program, and water and sanitation. A water supply rehabilitation project in Tivat is expected to cost \$2 million. Conditionality associated with this funding will be closely tied to IMF conditions, including pension reform.

The International Monetary Fund is currently negotiating a 3-year program with the FRY that would include conditionality for Montenegro.

The European Union initiated direct assistance to Montenegro in 1998 with small programs supporting both political and economic development. In 1999, the EU assisted with refugee relief and budget support, in addition to its development programs. Altogether, 40 million euros were programmed by the EC from 1998 through 2000. In 2001, administration of the program shifted to the new European Agency for Reconstruction (EAR). In that year the budget of 19 million euros was allocated to road rehabilitation (7.0 million), municipal development (4.5 million), institution building, e.g. the Statistical Institute, vocational training, etc.

In 2002, EAR has a budget of 13 million euros. In several areas this assistance is designed to coordinate with the more extensive USAID program. The largest component (3 million euros) is directed toward restructuring of SMEs, particularly those privatized through the mass voucher privatization and the state-owned enterprises preparing for privatization in 2002 and 2003. Since similar assistance is available through USAID programs, there will be close coordination of coverage and approach. EAR assistance in the energy sector (2.6 million euros) will build institutional capacity in the Ministry of Economy and the electric utility company, as well as rehabilitating 3 transformer stations. This, too, will be carefully coordinated with USAID assistance to the sector.

In other areas, EAR assistance fills gaps that USAID has not attempted to fill. EU advisors are helping to draft legislation and to train staff for public administration reform (2 million euros). The program of assistance for customs and taxation (1 million euros) is being managed from Brussels rather than Podgorica. Several studies will be funded for designing infrastructure improvements.

Other donors mainly have been important for their emergency assistance in 1999 and 2000. However, Germany funded a masterplan for tourism that guides the development of tourism and it is continuing to advise the tourism industry. The European Bank for Reconstruction

and Development is aiding privatization by participating where it can identify a strategic partner to invest in hotels and, possibly, the larger industries like KAP.

F. Anti-Corruption

Good governance is essential for developing an environment that promotes economic growth and minimizes poverty. Montenegro is known for having historical roots in endemic corruption that is associated with most political and economic institutions. While corruption involves the misuse of public power, office or authority for private benefit, it also is prevalent in the private transactions.

Surveys indicate the public views corruption as a serious social problem occurring across a spectrum of public officials, political parties, state media, customs administrators, managers of socially owned enterprises, and health and other professionals. The general public in Montenegro perceives the causes of corruption to be weak rule of law and a social system that provides for a privileged elite instead of equal opportunities for citizens.

Civil servants in Montenegro are grossly underpaid and often depend on small favors from the public or kickbacks to support their families. Larger scale corruption is known to exist among higher authorities, who participate in public contracts.

USAID's approach to combating corruption in this strategy is to address it in the context of four basic principles: transparency, prevention, awareness and enforcement. Transparency sharply reduces opportunities for corruption by removing the atmosphere of withholding information and secrecy through accountability and disclosure. Prevention deals with systemic reform of institutions to decrease incentives for corruption, while promoting preventive incentives such as efficiency and effectiveness. Awareness involves media and advocacy organizations in public education to inform people about the adverse consequences of corruption and decrease tolerance for accepting it. Enforcement includes enactment and promotion of rule of law that fosters oversight and control, self-regulating organizations and an independent judiciary. Anti-corruption is a cross-cutting issue and each SO has interventions concerning these four principles.

USAID's economic reform program, SO 1.3, is addressing corruption by advocating a comprehensive set of legal, regulatory, and policy changes. The emphasis on greater transparency, ethical standards, checks and balances, and commercially-based decisions will substantially reduce corrupt practices when these changes are fully implemented. For example, under the bank supervision activity, regulations are being established to minimize non-market based "connected lending" and replacing this practice with risk-based commercial criteria. Under the privatization program, marketable state-owned enterprises are being sold to private foreign and domestic interests through open, competitive tenders. Pursuant to the new company and accounting laws, all joint stock companies and companies with over euro one million in annual revenues will provide audited financial statements annually to the government and public. In addition, accountants and auditors are being trained in the newly adopted international accounting and auditing standards, including a new code of ethics. Under the securities law, publicly traded companies must provide disclosure reports and shareholders are offered free audited statements. For Montenegro, corporate governance also includes improved practices relevant to a developing population of shareholders. The establishment of a Treasury Department and transparency in the budgetary process make it more difficult to use tax revenues for other than approved budget-related

purposes. Increased reliance on indirect taxes makes evasion more difficult. Tax administration reforms, including training and improved oversight, are expected to reduce corruption in the tax collection system. Reform in public procurement procedures, particularly reliance on competitive tendering, will enhance the integrity of government purchases.

USAID/Montenegro's DG strategy under SO 2.0 promotes greater transparency and accountability at all levels of government, and builds societal support for combating corrupt practices. Civil society support will include grants and capacity-building for NGOs working to encourage more open, efficient government through advocacy and government-NGO partnerships, and for programs that encourage greater respect for democratic values by raising awareness of progress addressing corruption issues, promoting equal application of the law, and encouraging respect for human rights. The rule of law program focuses on increasing independence in the judiciary. Judicial training and capacity-building includes attention to institutionalizing ethical codes of conduct and standardizing judicial practices with regard to both criminal and civil cases. USAID's independent media program increases the flow of objective information available to citizens through a vibrant, competitive free press. Support to independent trade unions engages workers in critical decisions regarding privatization and economic reform, thereby reducing the potential that economic policy will be made in a vacuum, without attention to social impacts. Similarly, USAID-supported assistance to reform-oriented political parties helps develop a new generation of leaders that recognize the value of opening the policy process to greater public input and scrutiny, and of communicating openly with constituents concerning key policy decisions. Opening the policy process reduces the potential that decision making will be left in the hands of a potentially corruptible few.

In addition, SO 2.0 will continue to support the development of anti-corruption legislation affecting the legislative and executive powers, political parties, and judiciary. Specifically, regulations concerning conflict of interest by members of the executive and legislative powers, and regulations on financial disclosure and gifts received by public officials will be prepared. USAID is supporting a series of other anti-corruption legislation associated with political party financing, the public prosecutor, police and security, public administration, the ombudsman and a specific anti-corruption law. Another effort includes work with the commercial courts to train judges to better adjudicate and enforce commercial law. Early activities are already bearing fruit as evidenced by court-ordered closure of several banks found guilty of financial crimes. Support for codes of ethics across the professions are also part of USAID's strategic approach in combating corruption. Presently, journalists and media professional associations have jointly developed a code of ethics for journalists. Similarly, plans are underway to develop a code of ethics for judges and for civil servants, spearheaded by NGOs and the Ministry of Justice, respectively.

The Mission's local government activity under SO 2.1 will encourage transparent, efficient, decentralized government and greater fiscal autonomy at the local level, while helping municipal officials implement sound financial management systems. Finally, USAID's Community Revitalization through Democratic Action (CRDA) program promotes openness in local-level decision-making regarding key community priorities by institutionalizing a participatory process at the level of governance that most directly impacts citizens' daily lives.

G. Gender Considerations

USAID/Montenegro recognizes that it is essential to take gender issues into account in order to maximize interventions designed to further the republic's political, economic, and social development. While "gender" is not another word for "women," in Montenegro gender issues that USAID is most concerned with as constraints to development are those that relate to women's status in a highly patriarchal society.

Montenegrin society, across ethnic lines, is anchored on tightly-knit, large, extended families. Divorce is extremely rare. Although it is legally possible, women seeking a divorce stand to lose everything, since property settlements overwhelmingly favor men. Family violence is a significant problem. A new law, currently in draft, would reduce the penalties for convicted rapists to an almost token prison sentence (Montenegrin NGOs are currently working to block this legislation). Beliefs concerning women's participation in the job market and in politics are deeply held, and constrain women's full participation in society.

Women in Montenegro make up 51 percent of the electorate. According to some surveys, they vote in higher numbers than men. Most of the 230,000 registered women voters have university degrees. Despite their strength in numbers on the voter rolls, women hold no ministerial positions, mayor's jobs, or senior positions in the police. Only eight hold parliamentary seats. Women occupy merely 32 out of 716 municipal council seats in Montenegro's 21 municipalities.

Montenegrin NGOs active in gender activities have attracted a fair amount of donor funding. Capacity in the NGO sector as a whole, however, is lacking, which limits the effectiveness of these groups. USAID's recently launched civil society strengthening program will boost the capacity of Montenegrin NGOs, including organizations focused on gender issues.

Gender is actively incorporated into other democracy and governance initiatives as well. IREX, for example, is aiming to increase journalists' interest and capacity in covering critical issues such as trafficking and family violence. Training and capacity building will be backed up by grants to journalists to ensure that these issues receive broader coverage. NDI has actively engaged women in political party development activities. A series of NDI seminars and training activities expected to continue over the life of this strategy seek to boost women's participation in politics and in the leadership of democratically-oriented political parties. ACILS assists the independent trade union (CITUM) in further developing its already active women's branch. This program also conducts activities that give working women a greater voice and help mitigate the consequences of rising female unemployment. ACILS, CITUM, the Institute for Strategic Studies and Prognoses (ISSP), and the Center for Entrepreneurship and Economic Development (CEED) recently held a seminar on women's participation in Montenegro's large grey economy to explore and recommend strategies for helping women move into legal self-employment. Also, USAID is planning to support anti-trafficking initiatives under this strategy.

In economic reform programs, USAID seeks to ensure that women participate in activities that build their involvement in economics issues. A significant number of economists trained under the USAID program are women, including the chief economist at the Central Bank.

USAID recognizes, however, that it is important to devote sustained attention to ensuring that gender issues are fully taken into account and addressed in its programs. For that reason,

a planned gender assessment in May-June 2002 will include both Serbia and Montenegro. USAID will incorporate gender in its activity planning, implementation, and performance monitoring, with indicators being gender disaggregated and relevant to measuring change in the status of Montenegrin women.

H. Customer and Partner Participation

Since 1997, USAID/Montenegro has engaged in partnerships with U.S. NGOs to carry out a broad range of USAID programming. USAID's portfolio almost exclusively was implemented through grants and cooperative agreements. These organizations, working under threats of military intervention by Yugoslav troops, demonstrated flexibility, creativity, confidence and initiative to implement a broad range of activities that were highly regarded by the Montenegrin public and private sector. These NGOs had a critical role in introducing programs that assisted the society in developing, understanding and advocating reform concepts.

The former Yugoslavia had a long, but highly restrictive, history of associational activity. During the Communist era the primary organizations throughout the country were youth groups, unions and political party branches with some chambers of commerce. All were tightly controlled and heavily influenced by government and the political system. Beginning in the early 1990s, independent NGO activity emerged in response to the armed conflicts of Yugoslavian republics, primarily organizations attempting to end war, assist victims and protect human rights. A few emerged in other sectors, but only a smattering have managed to develop both requisite organizational structure and vision to allow them to build a broad, active and supportive constituent base.

U.S.-based NGOs worked closely in partnership with indigenous parent-teacher associations, judges associations, municipal government associations, journalism societies, farmer associations, independent labor unions, women's groups and the like to advocate a broad range of civil society issues. ICNL (the International Center for Not-for Profit Law) assisted the Government of Montenegro to develop the Law on Non-Governmental Organizations, which has been the foundation for establishing one of the most open environments for NGO formation in the region. The act provides a supportive, transparent climate regarding registration procedures, tax treatment of donations, scope of activities, etc.

Nevertheless, most of the more than 1,500 NGOs that have registered with the government under the new law are in their infancy. The great majority tends to be driven by a single personality. Although small in number, a core group of these NGOs are genuinely professional and development-oriented.

In late 2001, USAID initiated a \$3 million civil society activity to strengthen local NGO's, implemented through a U.S.-based NGO. This project is designed to develop the capacity of a core group of indigenous Montenegrin NGOs, that are both visible and active in building support for issue-based agendas, and lobbying public officials and other decision-makers in order to influence the public policy process and act as a watchdog over government. In early 2002, USAID competitively selected two U.S.-based NGOs to implement the Community Revitalization through Democratic Action (CRDA). This activity aims to stimulate democratic, social and economic progress at the community level. The first 90 days of the program are planned to result in 100 community projects, but more importantly assist citizens to become active partners and decision-makers in community change and development.

I. Environmental Factors

In September 1991, the republic parliament declared Montenegro to be an Ecological State, committed to promoting sustainable development through, among other things, the protection of its natural resources and habitat. Nevertheless, Montenegro's economic development is directly related to the exploitation of the very natural resources that the government is trying to protect by virtue of the declaration. Vast stands of trees in northern Montenegro are now being utilized to support a flourishing wood products industry. Rivers are producing hydroelectric power to support the needs of industry and citizens. Mineral extraction of bauxite and coal are critical to the production of energy, aluminum, steel, and other products. Previously, these industries were essential for providing employment, but in the last ten years, with the aging of its industrial base and the imposition of sanctions, most plants are closed or operating at far below their capacities. The extent of environmental degradation from these industries is unknown. The major exception is the Kombinat Aluminijuma Podgorica, which is the largest industry in Montenegro and one that contributes significantly to air and water pollution in Montenegro's largest urban area and political capital.

The economic sector that depends most on Montenegro's natural resources and environmental quality is tourism. Montenegro's narrow coastal plain is vital to tourism and a cornerstone of the republic's economic future. Prior to the conflict in the region, Montenegro attracted large flows of tourists from Western Europe and the Balkans. With the relaxation of tensions, tour operators and investors alike, are beginning to once again view Montenegro as an important potential tourist destination. This fragile coastal zone will begin to experience the impact of renewed and potentially intensive exploitation. In 2001, a Tourist Master plan for Montenegro was prepared. It has received strong endorsement by the Montenegrin government to address natural resource and environmental needs in development of the tourism industry. A critical element of the plan is to address protection of coastal resources and mitigate pollution through the development of a regional water supply network and waste management infrastructure. Detailed plans are being developed in response to the initial plan. The mountainous North also is being viewed as a potential region for eco-tourism and winter sports. While this may be a longer-term prospect, it could further impact a region that, with the exception of mining and forestry, has remained in a relatively pristine state.

Despite the potential negative impact from economic growth on Montenegro's natural resources, Montenegro's ability to address biodiversity issues and environmental degradation may be increasing. Successful tourism demands sound environmental management. Also, with expanded donor programs, Montenegro will be required to consider environmental quality issues in conjunction with donor development programs.

As USAID and other donors conduct environmental reviews, this should help sensitize public and private sector institutions of the need to improve natural resource and environmental management. USAID is providing short-term technical services to the Ministry of Tourism on resource and conservation management of the national parks that is related to park concessions. Through civil society strengthening programs USAID expects to identify and support environmental NGOs. CRDA community level development activities and municipal level infrastructure efforts will be designed with specific environmental considerations.

In conjunction with this strategy, in April 2002 USAID completed a biodiversity assessment to comply with sections 117 and 119 of the Foreign Assistance Act of 1961. The assessment will assist USAID in defining how its interim strategy contributes to conservation needs, as required by Agency guidance. It will serve as well as a tool to better integrate environmental concerns into the overall USAID program. A copy of the FRY findings can be accessed in EEEEST.

PART II: FACTORS INFLUENCING PROGRAM SELECTION

The USAID Serbia Interim Strategic Plan prepared earlier in 2002 contains a discussion of factors that affect the strategic approach and program plan through 2004. This Montenegro Interim Strategy coincides with the Serbia plan, both in timeline and in terms of overall goal and objectives.

The important geographical position of Montenegro in the Balkans and in Europe, along with its longstanding tenuous relationship with Serbia has made Montenegro a primary locus for establishing stability in the region. Consequently, a stable democratic polity and growing market economy oriented toward Europe is of vital U.S. foreign policy interest.

This strategy directly advances a number of U.S. International Affairs Strategic Goals including regional stability, economic development, open markets, global growth and stability, democracy and human rights and environmental improvement. In terms of overall USAID goals established in the Pillars, the strategy directly pursues goals of broad-based economic growth, human capacity development, sustained environmental protection, and strengthened democracy and good governance.

Central to meeting these goals is further resolution of the differences between Montenegro and Serbia. A significant step was taken on March 14, 2002 when leaders of both republics signed the EU brokered agreement to replace the Federal Republic of Yugoslavia (FRY) with a new State of Serbia and Montenegro. Features of the interim arrangement include the need for its approval by existing parliaments; drafting of a new Constitution that creates three branches of a union government; establishment of five ministries (foreign affairs, defense, international economic relations, internal economic relations, and protection of human and minority rights); and an opportunity for either party to withdraw from the agreement after three years. Whether the current Montenegro government will withstand opposition to a joint state with Serbia remains uncertain, as are the implications associated with carrying out the agreement. However, resolution of the political and economic relationships between the two entities is essential for Montenegro to achieve economic growth, investment and political stability. All of these factors impact on the success of this interim strategic plan.

Despite the atmosphere of uncertainty, during the past two years Montenegro has made major strides in political and economic development. As a result, the USAID vision for Montenegro of a well-functioning, open society with a growing market-based economy and an independent judiciary is valid and attainable. Furthermore, this focus supports recently announced USG foreign policy objectives to address “the inability of new democracies to control borders, to promote the rule of law and to respond to the needs and insecurities of their citizens.”¹

¹ Presentation by Greg Schulte, NSC Senior Director for S.E. Europe at Georgetown University, March 20, 2002

The three Strategic Objectives for the Montenegro program -- accelerated development and growth of private enterprise (SO 1.3); more effective, responsive and accountable democratic institutions (SO 2.0); and increased, better-informed citizen participation in political and economic decision-making (SO 2.1) – are supported by a focused program of assistance. They aim to help broaden the base of individual, community and private involvement in the economic and political systems of Montenegro. The impact of this program will provide for greater economic and political empowerment of citizens; a legal and policy environment that encourages transparent and accountable processes; democratic and open institutions that serve citizen needs; a competitive market economy and a more independent judiciary.

This first strategy for Montenegro concentrates on deepening the economic reform process already underway from previous and ongoing USAID support, and fostering devolution of both political and economic programs to increase citizen participation and empowerment. It will increase substantially the support to democratic transition, with greater concentration on citizen participation in decision-making and governance. The strategy entails a reduction in technical assistance for some areas of economic reforms, particularly in preparation of a legislative framework, much of which already has been accomplished. It will focus on implementation, strengthening of institutions and capacity building in order to ensure implementation and enforcement of laws, regulations and policies. Past areas of support in humanitarian assistance, Public Law 480 food aid, OTI programs and budget support have been or are being phased out.

There are substantial linkages between Intermediate Results (IRs) and across SOs, which give coherence and direction to the strategic plan and its goal of achieving broad-based, market-driven economic reform and democratic governance directed by the citizenry. For example, SO 2.0 and 2.1 both emphasize citizen participation and are mutually supportive. SO 1.3 looks to SO 2.0 to educate the populace on elements of economic reform, to promote advocacy positions on the reforms, and to prepare the judiciary for interpretation and enforcement of the new body of commercial law.

In summary, this three year strategy provides focus and direction to the Montenegro program in the face of diminishing USAID resources and strategic refocusing of the program from drafting of laws to implementation.

PART III: STRATEGIC OBJECTIVE 1.3 – ACCELERATED DEVELOPMENT AND GROWTH OF PRIVATE ENTERPRISE

A. Statement of Objective

For the interim period, USAID’s economic program will support an open, competitive private sector driven economy in Montenegro which is integrated into the region and Europe. The goal is to promote sustainable economic growth, improved living standards and reduce Montenegro’s dependence on donor financing and technical assistance.

The core of the program focuses on addressing fundamental, inter-linked and systemic economic issues relating to promoting continued macroeconomic stability, reducing the role of the government in the economy, improving the legal/regulatory environment, developing the key public and private sector economic/financial institutions and building human capacity. Improvement in all these areas is key to the creation of a dynamic, growing private

sector based on greater domestic and foreign investment flows. The strategy and related activities are designed to support the government of Montenegro's ambitious economic reform program based on a rapid transition from a socialist to market economy. The goal is to deepen and consolidate the significant economic reforms made over the last two years with USAID assistance. Certain components of the current program will be eliminated or phased out in order to focus on institutional strengthening and building capacity necessary to ensure sustainability. Results will be denominated in terms of growing GDP, increased foreign direct investment, increased private sector share of GDP, reduced government expenditures as a percentage of GDP, and reduced public sector employment.

The objective of all USAID S.O. 1.3 activities in Montenegro is to create an environment which provides the right incentives for increased growth and profitability of the private sector as part of the official economy while at the same time reducing corruption. An essential part of this strategy requires reducing the role of government in the economy and improving governance in both the private and public sectors. This entails more than transferring productive assets from state-ownership and promoting a fiscally responsible and reduced budget. It also rests on changing the role of government from owner/controller, creating a level playing field, promoting effective regulatory oversight, and accountability, and enforcing sanctions when laws/regulations are violated. The program thus places great emphasis on promoting: (1) fiscal discipline through effective budget management practices, a stronger, modern tax administration, implementation of new tax laws and pension reform; (2) a larger private sector role in the economy through both the transfer of state-owned assets and strengthening SMEs, with a focus on tourism; (3) banking reform to rebuild confidence in the sector based on cleaning up and privatizing the state-owned problem banks, while simultaneously establishing a strong bank supervision capability to ensure that the problems are not repeated; and (4) the complete overhaul of the energy sector based on price liberalization, unbundling, increasing private sector participation and regional solutions.

Underpinning these efforts will be an across-the board, intensive focus on implementing the more than 30 new economic/commercial/financial laws adopted and strengthening the myriad of economic institutions (some of which are completely new) key to a market economy, including the Central Bank of Montenegro, the Finance Ministry, the Treasury, the financial market regulatory authorities, business and trade associations, and the Accounting Institute. The weak or nascent state of these institutions combined with the relatively limited pool of skilled talent available in a republic the size of Montenegro, will require an integrated and creative approach to building human capacity. This is critical particularly in the government ministries and the Central Bank. As USAID budget resources for Montenegro decline, these institutions' current heavy reliance on a sizeable number of USAID-funded experts to function will no longer be possible, nor would it be desirable, in order to avoid permanent dependencies. For its part, Montenegro must give higher priority to civil service reform in order to hire the staff necessary to implement their reform program.

Program activities under SO 1.3 will be complemented by activities under SO 2.0 with the objective of increasing transparency, reducing corruption and improving governance in both the private and public sectors. This effort will include a focus on effective implementation of a number of new business regulatory and anti-corruption laws. Of particular importance is the need for a stronger focus on judicial reform, piggybacking on the overall efforts under the democracy program to promote an independent and modern judiciary. The focus in SO 1.3 activities in this regard will be on building capacity and working with the commercial courts

and judges to ensure that the large number of new laws are well understood by all affected parties including judges, and can be adjudicated fairly and in reasonable timeframes.

The weak or nascent state of most economic and financial institutions combined with the relatively limited pool of skilled talent available in Montenegro, will continue to require an integrated and creative approach to building human capacity. This is particularly critical in the government ministries and the Central Bank. As USAID budget resources for Montenegro decline, and as reforms take hold, intensive USAID advisory and training assistance to Montenegro will be reduced significantly.

All USAID activities have been and will continue to be based on adoption of international standards, and are consistent and harmonized with EU laws, regulations and policy. The Montenegro strategy supports the provision in the “Agreement on Restructuring Relations between Serbia and Montenegro,” which states, “the member states shall be responsible for unhindered operations of a common market, including the free flow of people, goods, services and capital.”

B. Problem Analysis

Montenegro finds itself at the beginning of 2002 with an economy facing challenges from a number of directions. The Republic’s economy has suffered from years of deterioration under the ravages of a crony-centric central planning system, regional conflict and international sanctions. The economy was in shambles following years of Milosevic misrule when in 1997 a reform minded government came to power and began to institute market reforms. As the Republic moves rapidly ahead with instituting a sweeping economic reform program oriented towards building an open, regionally integrated market economy, some critical weaknesses remain. These generally fall into the areas of: general investment and political uncertainty coupled with a small domestic market, poor infrastructure and attendant effects; growing but still low institutional capacity to institute and sustain reforms; and low levels of formal private sector activity in the economy.

Uncertainty and structural factors from a number of sources continue to affect the investment climate in Montenegro. Labor, wage and social policies lead to rigidity in the labor markets and disincentives to employ registered workers or invest in companies with a large, redundant workforce. A dispersed shareholder structure, poor management, weak corporate governance and inadequate accounting practices are prevalent in recently privatized enterprises and state companies. There is a backlogged and difficult to navigate court system where outcomes can be uncertain and clear judgments difficult to obtain. Such uncertainties extend to public administration and oversight in general. Also, there is an improving, but still incomplete transition of the business regulatory environment. In terms of Montenegro’s state status, an agreement was reached in mid-March 2002 to form a union with Serbia. Though many details remain to be worked out, along with ratification by the parliaments of Serbia, Montenegro and the FRY, this may indicate the beginning of a final political solution. Under the agreement, Montenegro retains a large degree of economic autonomy, with the ongoing economic reform program essentially remaining intact. However, a clause stating that Montenegro will not hold an independence referendum for at least three years could mean a prolonged period without a final political resolution. This uncertainty may be expected to continue to affect the investment climate.

Many of the key sectors with the greatest potential for rapid privatization and growth and/or in most immediate need of capital, require significant amounts of long-term investment, which is historically sensitive to the above factors. Privatization of the telecommunications company has already been delayed due to investor unease over state status. Finding new long-term investors for the electric power company also may be subject to many of the concerns above. Similarly, and at least as importantly, domestic investors will be less inclined to free up pools of capital either for direct investment or for deposit into local banks until they believe that the investment climate has improved or at least stabilized.

As a small state with a limited domestic market, Montenegro also is missing other strong incentives and competitive advantages that often can lure investment. This is compounded by severe problems in the energy sector stemming from over a decade of deferred maintenance in all parts of the system, and below cost recovery rates leading to sustained losses and arrears throughout the network. Exceptional cold weather across southern Europe that limited availability to import electricity resulted in periods of rotating blackouts in the Fall and mid-Winter, 2001-2002, and led to work stoppages all over the republic. The absence of an adequate water supply infrastructure along the coast will be a factor in the expansion of the tourism industry.

The historic centralization of technical, managerial and administrative skills in Belgrade has left Montenegro with a weak institutional capacity to implement and sustain reforms in both the public and private spheres. Political and economic tensions between the FRY and Montenegro led in 1999-2000 to an effective break with the FRY in several important areas, including the payments, customs, and currency systems. Following this break, Montenegrin institutions found themselves with a general lack of experience in fiscal, monetary, financial, and macroeconomic policy management. Although central bank functionality is improving, it is still weak in execution of its regulatory and supervisory authority over the commercial banks, foreign asset management, fiscal agency and macroeconomic advisory functions. As much of the economy was state owned, Montenegro also suffers from a lack of entrepreneurial and market oriented managerial capacity in the private sector, one symptom of which is weak management in many recently privatized companies.

Though the licensed commercial banks are solvent and liquid, they continue to be burdened by large amounts of bad debt and lack of commercial banking know-how. As the financial sector deepens with the progressive dismantling of ZOP, the payments bureau, and the reduction in reserve requirements, the Central Bank will need to maintain strict supervision to ensure prudential and sound practices in order to maintain a healthy banking system and gradually restore private sector confidence in the system. Only in this way will the financial system be able to generate the resources needed to spur investment, consumption, and economic growth.

Reforms so far have gone a long way toward liberalizing and modernizing Montenegro's economy and strengthening its management capacity in both the public and private sectors. However, while much progress has been achieved over the past two years, it is recognized that the human resource constraint in Montenegro is a critical factor hindering the acceleration and deepening of reforms. Therefore, sustaining and deepening the reform effort over the next few years will entail a continuation of major training and institutional development efforts in each of the areas of focus.

Large public sector payrolls, the continued state ownership of key commercial assets, and low levels of growth in the formal private sector indicate a less than optimal role of the private sector in the Montenegrin economy. Moreover, vested interest controlled by political cronies continues to dominate certain areas of the Montenegrin economy and stifle competition. The recent completion of the mass voucher privatization (MVP) has nominally reduced the size of the public sector. However, many of the newly privatized companies lack international, private sector standards of management and governance, have an excessive workforce, suffer from low productivity, and are badly undercapitalized. It will require an intensive effort and improved functioning of the financial sector before these companies can better contribute to growth in the economy. In the interim, restructuring of these and other to be privatized companies likely will lead to lower employment levels, some asset retirement and redeployment, and changes in production modes and outputs.

The so-called informal or “gray” economy is immeasurable almost by definition, but current estimates are at least 40 percent of the total economy. A major challenge over the interim period will be to both integrate these companies into the formal economy and to continue to implement policy reforms that lead to greater private sector growth overall. Continuing reform in the tax and pension systems will help to reduce incentives to remain in the informal economy. Similarly, the continued implementation of simplified rules for engaging in the formal economy, quicker, clearer and more reliable dispute resolution, and a functioning banking system will provide incentives for companies to maintain accurate accounts, take advantage of formal credit schemes, and generally participate increasingly in the formal economy. In addition, the effort to build a dynamic private sector will continue to require extensive training, support to restructuring efforts, and support for entrepreneurs.

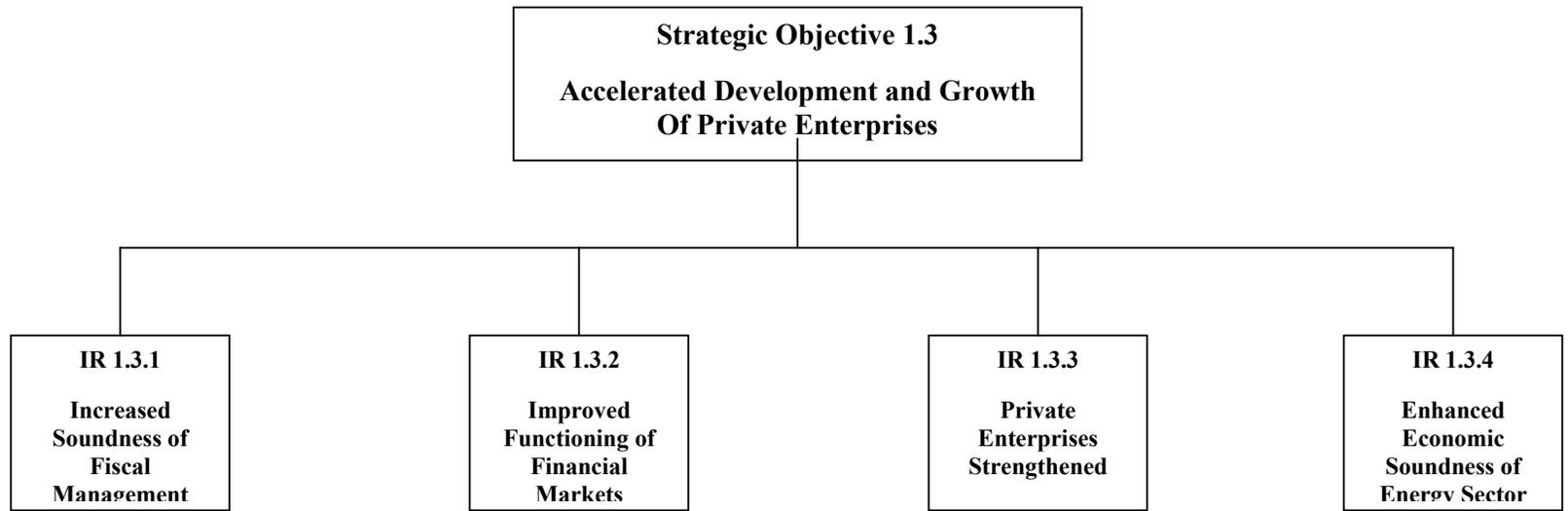
C. Critical Assumptions

- Montenegro’s government will remain democratic and committed to a market-based economy.
- Resolution of issues concerning Montenegro’s status with Serbia will not have a negative impact on Montenegro’s economic reforms.
- The euro will remain Montenegro’s legal tender over the foreseeable future.
- Public support for the Montenegrin government’s economic reform program will continue.
- Other donors and government will provide necessary assistance to meet non-USAID supported efforts required to achieve this SO.

D. Results Framework

For the period covered by this interim strategy, USAID Montenegro will support a program to advance sustainable private sector growth through improvements in the domestic economic environment and accelerated integration into the region and Europe. Strategic Objective 1.3 is, Accelerated Development and Growth of Private Enterprise.

In order to achieve SO 1.3, USAID will implement activities supporting four tier one intermediate results. These four results directly target the issues identified in the Problem Analysis section and will significantly contribute to an environment more conducive to private sector growth. The programmatic focus will be on activities that are coordinated and reinforce each other to the greatest extent possible. For example, improvements in the business regulatory environment and accounting reform will strengthen private enterprises, fiscal management (tax collection), and financial market functions (reduced credit risk). Similarly, USAID support in establishment of an SME bank will serve to strengthen the financial sector, as well as to provide critical support to SMEs. By providing technical assistance on these distinct, but related, aspects of the reform program in a coordinated manner, the impact can be maximized.



IR 1.3.1: Increased Soundness of Fiscal Management

Sound fiscal management, a transparent budgetary process and non-distorting tax system are essential to maintaining economic stability, promoting growth and providing incentives for the private sector development as part of the official economy. Improvement in all these areas are underway. In order to achieve fiscal discipline, Montenegro needs to give high priority as well to pension reform.

IR 1.3.2: Improved Functioning of Financial Markets

A sound vibrant private banking system, which performs functions critical to a market economy, primarily financial intermediation and payment functions is essential to enterprise growth. There is currently no confidence in the Montenegrin banking system. Problem banks must be cleaned up and state-owned banks privatized in order to break the non-commercial ties between the government and other special interest and the banking system. Bank supervision must be strengthened and prudential standards enforced. The steady transfer to commercial banks of payment operations will contribute to reducing enterprises transactions costs and increased products and services offered by banks.

IR 1.3.3: Private Enterprises Strengthened

Achieving this intermediate result will require changing the role of government in the economy from that of control to oversight. This includes the reduction of burdensome administration procedures and discretionary practices. The goal will be supported by activities to strengthen the business regulatory environment as well as by supporting private sector think tanks, advocacy groups and associations to promote their interest.

Accelerating the growth and development of SMEs is another key element in realizing this intermediate result. The interim strategy will pursue this result through direct consulting and training interventions, the establishment of a new bank focused on the SME lending and the transparent privatization of 19 strategic companies.

IR 1.3.4: Enhanced Economic Soundness of Energy Sector

Development of private enterprise relies upon functioning infrastructure, and energy supply has been identified as a particularly vulnerable sector in Montenegro's infrastructure. In order to minimize the negative impact of power outages on productivity, the program will support realizing a reliable and sustainable supply of electricity. These goals are supported through policy and technical assistance initiatives aimed at price liberalization, better integration into the regional power grid and increased private sector participation in the system.

E. Progress to Date

In a short period of time, since 1999, the Government of Montenegro has made impressive progress in economic reform, putting in place the fundamental building blocks necessary for the transition from a command to market economy. A comprehensive EU consistent economic/commercial legal and regulatory framework has been adopted based on international standards which: (1) will improve governance in both the public and private

sectors; (2) will provide incentives for growth of private enterprise and reduction of the gray economy; and (3) should reduce corruption.

Some of the most important accomplishments include:

Macroeconomic Reform and Stabilization: Since the successful conversion to the deutsche mark, reserves have increased more than threefold to over DM100 million. Inflation, albeit still high, has fallen (and is significantly less than in Serbia), the rise in official unemployment has been halted and prices for most basic commodities have been liberalized (with the significant exception of energy). Trade has been largely liberalized with the average tariff dropping to 3 percent.

Fiscal Reform: The Government of Montenegro now has the tools to address its serious fiscal deficit problems and gain control of the budgetary process. With the passage of the new budget law, the Ministry of Finance now has centralized control over budget classification, planning, management and oversight. Since December 2001, the newly established Treasury Department, which will monitor and track all government expenditures, has been operational. The Treasury now tracks more than 60 percent of budget expenditures. This is a critical element to ensure budget transparency, control expenditures and eliminate off-budget spending. The overhaul of the tax system with the recent passage of six tax laws should increase tax revenues by broadening the tax base, placing greater reliance on indirect taxes, and improving tax compliance due to incentives to bring the gray market into the official economy.

Central Bank of Montenegro (CBM): Under the new Central Bank Law, the former branch of the National Bank of Yugoslavia has reorganized and significantly expanded its mandate to include reserve management, bank supervision, and macroeconomic data collection and advisory services. The CBM has implemented a foreign assets management policy; introduced short-term liquidity facilities for the commercial banks; and begun to act as fiscal agent of the government, managing regular short-term Treasury bill issues as well as the government's accounts. The CBM also designed and successfully completed the process of conversion to the euro at the end of March 2002.

Banking Sector Reform: The fundamentals of good bank supervision, resolution and licensing are starting to be implemented under the new banking and bank bankruptcy laws in order to build a sound private functioning banking sector, which attracts deposits and makes loans based on commercial criteria. Numerous risk-based prudential regulations have been adopted and on-site inspections of all Montenegrin banks have been conducted based on international standards. Nine commercial banks have been licensed by the CMB under stringent new licensing standards, two banks (including the largest bank in Montenegro) are under administration and one is being liquidated. Finally, the government is in the process of bringing the offshore banks under the authority of the CBM.

Privatization: In 1999, only a handful of former state-owned companies were majority privatized. Now, only 19 companies have majority state ownership; those are primarily in the strategic sectors, e.g., hotels, power, ports, and aluminum. Montenegro fully and transparently implemented the Mass Voucher Privatization Program (MVP) for roughly 220 companies. In December 2001, the public auction of shares was completed, with over 90 percent of all vouchers issued applied against shares in companies. Detailed financial information compiled for every firm and an intensive public information campaign helps

explain why this participation rate was one of the highest in the region. As part of the MVP, a secure share registry and clearing and settlement infrastructure system was put in place, supported by a new Securities Commission. Trading of MVP shares has begun. In the important tourism industry, the government has actively tendered various hotel properties to attract foreign investors and management companies, with several successes.

Payments Reform: The monopoly status of ZOP, the Montenegrin Payments Bureau has been abolished. The ability of the banks to deal directly with their business customers is a big step toward building a normal banking system in Montenegro. It will provide banks with the ability to generate sizeable fee-based income and will significantly lower transaction costs to businesses. All payments, clearance and settlement functions of the ZOP have been integrated into the CBM. Tax administration functions are in the process of being transferred to the Department of Public Revenue. A pilot project for migration of normal payment services from ZOP to commercial banks has been successfully implemented, and a rollout plan for completion of the process has been developed.

Commercial Law Reform: A series of new laws have been enacted, which are designed to facilitate expansion of private enterprise and promote investment. The underlying theme of all the laws is simplification, reduction of burdensome and costly administrative procedures, and transparency of procedures. In particular, the new bankruptcy and enterprise laws will ensure ease of entry and exit. The enterprise law should ensure that the registration of most new businesses can be done within four days and costs only one euro. The IT installation, new documentation, training of court personnel responsible for registration, and extensive public information campaign is underway. The new bankruptcy law reduces the complexity found in other systems and redresses the past imbalance that significantly favored debtors over creditors to the detriment of financial intermediation.

Public Procurement: A transparent public procurement process has become possible following the enactment of the new law in August 2001. A Public Procurement Commission has been established, officers have been appointed, procedures have been published and documents made available.

Public Education and Training: In addition to the passage of laws and creation of new institutions, government officials, businesspersons, lawyers, accountants, judges, bankers, and technicians have received a significant amount of classroom and on-the-job training from USAID to enhance technical and managerial capacity in order to accelerate the implementation process. Public education programs also have accompanied all of these reforms, addressing both individual reform efforts and explaining the overall market reform process.

F. Program Approaches

USAID will build on the progress and momentum achieved in the economic reform program over the last two years. Activities will be implemented with key counterparts in government, with domestic non-governmental and private organizations, and in close cooperation with multilateral and bilateral donors. The focus on continued strengthening of key institutions is critical to furthering and sustaining economic reform in Montenegro. The focus has been narrowed to identify priority areas, with a reduction or phase out of other program areas due to budgetary considerations. The phasing of program activities takes into account the

absorptive capacity of Montenegro as well as implementation needs in key areas, including implementation of key legislation.

In the course of designing this interim strategy, two main program concerns arose. The first was the level of USAID budgetary resources, and the second the absorptive capacity of Montenegrin institutions when implementing complex reform initiatives. In order to address these concerns, several approaches will be utilized, as appropriate. The first is the accelerated phasing out of programs in an orderly manner. This solution is directed toward activities that are either reaching maturity or are deemed to be of lower priority. For example, there has been much concern over the long-term sustainability of a secondary market of full functionality in a market of 658,000 people. USAID Montenegro has decided to lower considerably the previously targeted level of support, while assisting in designing a capital markets structure that is more suitable and more likely sustainable given the size of the market.

The second approach is the implementation of activities at a lower level of intensity, but over a longer period of time. This is utilized where some budgetary resources may be saved in the short run, and a lower sustained level of effort will not negatively affect program objectives. Given (1) the evident need for intensive technical assistance and training in most areas, especially where absorptive capacity is limited, (2) that many elements of the program are time sensitive, and (3) the increased overhead from having advisors coming to Montenegro for shorter trips, this approach adequately addresses either problem area only on a limited basis. One area where it will be applied is in the revision work on some major pieces of legislation, such as the Law on Obligations.

The third approach is the implementation of activities at the previously programmed level of intensity, but over a longer period of time. When there are questions about the absorptive capacity and the projects are time sensitive, this method is applied. For example, it was recently determined that the implementation of the VAT would take up to six months longer than originally expected. However, since this period will be taken up by intensive drafting of regulations and implementation of the tax system, reducing the level of effort at any given point in time could put the activity in jeopardy.

The program approach is based on the priorities listed in section III. A above, which focus on ensuring continued macroeconomic stability, and fiscal sustainability and transparency through fiscal reform; revitalization of the private sector through advisory services and continued privatization of public enterprises; market led financial intermediation; and an overhaul of the energy sector.

IR 1.3.1: Increased Soundness of Fiscal Management

USAID is the leading donor working in cooperation with the EU to improve the soundness of fiscal management. Sound fiscal management is essential for continued macroeconomic stability, particularly in view of Montenegro's foreign currency regime. The first priority is to reduce the fiscal deficit, including of the off-budget social insurance funds, to a sustainable level. To achieve this, the assistance envisioned by IR 1.3.1 will focus on effective implementation of the tax reform, including a re-phasing of the implementation of the VAT; the transfer of the tax collection function from ZOP to the Department of Public Revenue (DPR); and a comprehensive reform of the pension system, which is a significant contributor to the present fiscal deficit.

Taking into account the absorptive capacity of Montenegro, the fiscal aspects of the program under SO 1.3 will concentrate on the above priority areas, while technical assistance to improve debt management, and provide effective regulatory oversight of gaming activities will be phased in when the above reforms have been put firmly in place.

The government's overall fiscal position will be positively affected by the revenue impact of effective tax reform implementation, which is expected to reduce the incentive to stay in the gray economy, while at the same time, (by increasing the reliance on indirect taxation) widening the tax net. Considerable strengthening of DPR and the customs department is needed to establish an effective tax and customs administration function. Comprehensive reform of the pension system will replace the present unsustainable pay-as-you-go (PAYG) system with a multi-pillar system, including a mandatory funded pillar. This will be complemented with improvements in the present PAYG system, including a reduction in non-pension expenses as well as in pension benefits, and improvements in administration. Since the pension fund deficit is a major source of the fiscal deficit at present, a return to fiscal sustainability relies crucially on comprehensive pension reform and an associated public education campaign.

Program assistance to establish a fully functioning Treasury system will improve transparency and accountability as well as the ability of the government to ensure that funds are spent as budgeted, and provide a sound basis for expenditure rationalization, including a reduction in the excessive share spent on wages, subsidies and social services. More rational resource allocation will be facilitated by bringing the off-budget accounts on budget. These funds account at present for close to 50 percent of government expenditures. A more rational expenditure structure will result from Public Administration Reform (supported by EAR), enterprise restructuring and rehabilitation, and reform of the pension system and the health system.

IR 1.3.2: Improved Functioning of Financial Markets

USAID is the major donor working to improve the functioning of the financial markets. Technical assistance in this IR will give priority to further strengthening the Central Bank's capacity to provide effective regulatory and supervisory oversight of the commercial banks, to establish the capacity to effectively restructure the bad loan portfolios of licensed commercial banks, and to address problem bank resolution issues.

As confidence in the banking system is strengthened, and financial intermediation is revived, strong Central Bank oversight will be needed to ensure that sound commercial banking practices are maintained and that the banks report in a timely and accurate manner, following the International Accounting Standards and practices. An essential component of the assistance will be on-the-job and formal training for both the Central Bank and the commercial banks in loan restructuring, IAS, risk and portfolio management. At the same time, training will be provided to the judges and their senior staff to ensure that economic reform legislation is thoroughly understood and effectively enforced. The program will also strengthen commercial banks by focusing on completing the migration from ZOP to the commercial banks of counter services, previously the monopoly of ZOP.

USAID is the primary mover behind development of a capital market in Montenegro. Technical services will be sharply reduced now that the market is functioning, and efforts

will focus on institutionalization and sustainability in the short-term of a capital market of appropriate size and functionality for Montenegro.

IR 1.3.3: Private Enterprises Strengthened

USAID is the major donor involved in enterprise strengthening, though some notable areas are beginning to be covered by the EAR.

Efforts to strengthen private enterprise will continue to have strong support from SO 2.0 with a priority focus on strengthening the business regulatory environment. Laws where assistance has been provided, including on concessions, accounting, auditing and IAS, business organization, bankruptcy, contracts and mortgage, and establishing the commercial law framework for a market economy are in line with EU and international best practice standards. The major thrust of the program under IR 1.3.3 will be to complement these activities and train the full range of current and future groups affected by the laws. Programs are being put in place to train, as appropriate: enterprises including staff and management; administrative staff, including registry and line staff; and the public. Activities under S.O. 2.0 will continue to train commercial court judges and their senior legal staff, and law faculty, including development of law school curriculum;

A major focus of the program is on technical assistance to improve shareholder accountability, corporate governance, financial or strategic planning, and managerial experience especially with respect to market forces, including obtaining credit or investment capital in a modern economy. In the interim period, USAID seeks to improve the competitiveness of private firms by strengthening firm level capabilities and institutions that deal with the above issues. Continuing programs are to include extensive training on the new regulatory environment, direct support to SMEs through training, educational and consulting activities and support for market priced credit schemes. An important element of this strategy will be the implementation of USAID supported Micro Credit Montenegro's conversion to an SME bank. This effort complements the EAR's provision of an SME support facility through local commercial banks.

The third area designed to strengthen private enterprises is the continued support for privatization in four key sectors, leading to a less distorted and more competitive environment. These sectors are energy, tourism, telecommunications, and the KAP aluminum plant. In the case of two critical industries, EPCG and KAP, USAID advisors will be involved in pre-privatization restructuring to remove supply chain, accounting and output market distortions, thereby facilitating investor due diligence. The EAR and the EBRD will initiate a project in mid to late 2002 to restructure several of the large strategic properties still majority owned by the state. With the end of MVP and given poor investors response in the "batch" privatizations, technical support in these areas will be phased out.

IR 1.3.4: Enhanced Economic Soundness of Energy Sector

In coordination with other donors, most notably the EAR and the World Bank, USAID is taking the lead in providing technical assistance to the energy sector. Near-term priorities include completion of a new energy law consistent with international best practices and European standards. The energy law will enable the establishment of an independent regulator, a task that will be coordinated by USAID, with the planned participation of a

consultant from DFID. In preparation for privatization, investment and more transparent and effective regulation, USAID advisors will manage the effort to convert EPCG's accounts to IAS and separate the accounts into generation, transmission and distribution components.

Similarly, as a critical precursor to privatization, USAID advisors are providing technical assistance on rate setting, aiming initially for cost recovery tariffs, and then to tariffs that will support an investment and rehabilitation program at market rates of return. On the policy front, USAID is coordinating closely with other donors to advise on the timing and level of tariff increases. In order to maximize public support for these increases, the USAID program also will support an extensive public education program, aimed at rationalizing rate increases in the eyes of the public, and encouraging and presenting options for conservation and substitution of other kinds of energy, especially in heating. Though USAID will initiate these efforts, as EAR funding becomes available in late 2002, the public relations efforts will be coordinated and this burden will be shared.

G. Development Partners

Since 1999, USAID has been essentially the only or primary donor providing technical assistance in virtually all aspects of economic reform and private sector development in Montenegro. This assistance has been on a scale and scope not seen elsewhere in the Europe/Eurasia region, absolutely and relative to Montenegro's population of 658,000. USAID's comprehensive and intensive program of technical assistance was designed to support the Government of Montenegro's priority economic reform program aimed at establishing a market-based economy. It is important to note that the international financial institutions were completely absent until early 2001, when the FRY became a member of the IMF, World Bank and EBRD. To date, USAID has worked closely with the European Union/EAR, which has been providing assistance in only a few areas of economic reform. Over the period of the interim strategy, a number of activities will be transferred to the EU and other donors as USAID scales back its assistance in the economic reform area.

USAID will implement its SO 1.3 activities with both governmental and non-governmental entities. The principal counterparts include the Ministry of Finance, the Ministry of Economy, the Central Bank of Montenegro, the Securities and Exchange Commission, the Privatization Council, the Economic Reform Network, and the Association of Accountants and Auditors of Montenegro. Key implementing partners include KPMG's Barents Group, the Firm Level Assistance Group (FLAG), Center for Entrepreneurship (CFE), acting as a sub-grantee to the Center for International Private Enterprise (CIPE), Opportunity International, Chesapeake Associates, Institute for Strategic Studies and Prognosis, and Agro Invest. USAID's relationship with these counterparts and implementing partners suggests they can be relied upon to work constructively and in partnership with USAID to advance the program envisioned in this interim strategy.

USAID will coordinate its SO 1.3 program activities with the World Bank (pension reform, energy reform, customs reform); the International Monetary Fund (economic reform program); the European Agency for Reconstruction (budget reform, bank supervision, treasury function, SME development, capital markets, enterprise restructuring, energy reform, VAT); and the European Bank for Reconstruction and Development (enterprise restructuring).

H. Sustainability

Achieving the planned results under SO 1.3 is dependent on the government's willingness and ability to stay the course on the ambitious, comprehensive economic reform program currently underway with strong USAID support. The program, when fully implemented, will essentially transfer business activity from state to private management, with appropriate oversight systems emphasizing transparency, disclosure and accountability and, thus, mitigating corruption. The solid progress already attained augurs well for the program's sustainability, including price liberalization, monetary stabilization, a continuing reduction in the budget deficit from 10.6 percent of GDP in 2000 to 5.5 percent in 2001 to a projected 3.5 percent in 2002, a liberalized trading regime evidenced by low customs duties (averaging 3 percent), rationalization of the country's payment system, adoption of a competitive public procurement system, the establishment of a central bank, comprehensive planning for restoring the tourism sector, the successful execution of the mass voucher privatization campaign and related establishment of a secondary trading system, adoption of international accounting and auditing standards, and the passage of new EU-compliant tax laws. But politically difficult decisions lie ahead, including the need for increasing energy tariffs to cover costs, rationalizing the pension system, liquidating or privatizing medium and large state-owned enterprises, reducing rigidities in the labor law, and quickly improving the capacity of the public sector to effectively manage the reform process with decreasing levels of outside technical assistance. Since these actions directly affect citizens' pocketbooks, the government will need to demonstrate strong political will in advancing them. To help mitigate the social and economic consequences of such decisions, USAID will continue to support the accelerated implementation of the reform legislation, an ongoing public education program, and the development of the SME sector.

The economic reform program's sustainability also is enhanced by a number of the program's features. For example, the comprehensive nature of the program helps to ensure that critical aspects of the economy's transition are effectively coordinated and addressed. Moreover, the legal and regulatory framework is EU-compliant, thus facilitating an evolving economic relationship with Europe, which has a vested interest in Montenegro's economic growth and integration with the rest of Europe. Finally, the program is developing the fundamentals of a market-based economy, which should function independent of continued outside assistance.

USAID believes that the proposed SO 1.3 interim strategy, including ongoing and planned donor support and a continued government commitment to economic reform, will achieve the desired results and significantly advance the economic reform program's sustainability.

PART IV: STRATEGIC OBJECTIVE 2.0 – MORE EFFECTIVE, RESPONSIVE AND ACCOUNTABLE DEMOCRATIC INSTITUTIONS

A. Statement of Objective

This strategic objective supports the democratic transition in Montenegro by improving the capacity of citizens to participate more effectively and more knowledgeably in political and economic processes, and by strengthening the capacity of key governmental institutions to effectively implement reforms and protect citizens' essential civil, political and economic rights. Recent public opinion polls have begun to track a downward spiral of public confidence in central government institutions and growing frustration with the pace at which the economic benefits of reform have tangible impact at the community level. Activities

under this SO will encourage continued public support for reform by expanding opportunities for citizens to have their voices heard, exercise their political and economic rights, monitor government performance, and more broadly participate in the benefits of economic reforms.

SO 2.0 will improve the ability of civil society organizations to represent citizens' interests and monitor government performance in the process of democratic and economic reform, improve the professional skills of independent media so that citizens have increased access to the balanced news and information necessary to participate knowledgeably and effectively in democratic and free market institutions, improve the performance of the judiciary so that it is capable of fairly and expeditiously adjudicating cases and protecting citizen's rights, and strengthen reform minded political parties so that they can stand for election based upon concrete policy proposals to address the needs and concerns of their constituents.

Strategic Objective 2.0 complements and supports USAID's other strategic objectives, SO 1.3 and SO 2.1, by preparing citizens to participate with greater knowledge and effectiveness in their communities, and in the process of political and economic reform, through informed associative participation in NGOs, trade unions, political parties, and other key institutions that help them assure the protection of their rights and support continued and proper implementation of reform. Further, SO 2.0 complements SO 1.3 by strengthening key institutions of an independent judiciary that provide the legal underpinnings for the protection of economic rights.

B. Problem Analysis

After its election in 1997, President Djukanovic's government embarked on an ambitious path of economic and democratic reform that directly challenged the authority of the Federal Republic of Yugoslavia (FRY) under Milosevic, which eventually led to negotiations on the restructuring of the Federal relationship between Serbia and Montenegro. Montenegrin society, however, remains deeply polarized between pro-independence and pro-Yugoslav sentiments. The manner in which these issues are resolved can have important implications for stability in the region and the pace and content of continued democratic and economic reforms in Montenegro. A March 14, 2002 agreement to replace the Federal Republic of Yugoslavia with a new joint state called "Serbia and Montenegro" and delay of a referendum on Montenegrin independence for three years, has the potential to resolve the situation for at least the period of this strategy and allow Montenegro to focus on continuing the implementation of its ambitions agenda of economic and political reform.

Substantial new changes are being put in place that are changing the way that government does business, improving transparency and accountability, and transferring substantial authority to local governments. Nevertheless, much remains to be done to increase the capacity of citizens to competently participate in substantive public debate on important policy issues and expand avenues for citizen engagement in the political processes that will help them to protect their rights, make government policy more responsive, and create pressure for continued reform.

Montenegro's political parties lack strong ideological bases beyond the question of state status, have limited concepts of representation, and lack the effective internal and external communications structures necessary to fully engage their members and the citizens at-large in the political process. Independent media remains dominated by political interests and continues to lack an appropriate legal and regulatory framework, despite a generally liberal

environment that is largely tolerant of free speech. Journalists lack sufficient professional investigative reporting skills and rely largely on the content of press releases for their stories. Self-censorship continues to be a substantial problem.

The NGO sector lacks a sufficient number of institutionally sound organizations to engage government effectively, build public support and mobilize citizens for issue-based agendas, and monitor government performance. NGOs are largely reluctant to share information, create networks, or form coalitions, thus limiting their effectiveness in encouraging citizen participation and pressing effectively for continued political and economic reform. Trade unions need technical assistance to constructively engage both government and business leaders in a dialogue that will promote transparency, limit corruption in the privatization process, and assist workers in preparing for market-oriented economic reform.

In terms of rule of law, the principal problems relate to the capacity of the current justice system to deliver legal services in a timely and just manner, and to ensure proper implementation of social and economic reform efforts underway. A large amount of new legislation has already been enacted, which will substantially increase the volume of civil litigation and create a need for new enforcement strategies. The courts will also need to develop capacity to cope with the passage of even more planned legislation, particularly in the area of economic reform. In addition, the judiciary itself is in the process of internal reforms which will introduce significant, largely positive ways of doing business into the system. All legal professionals within the system, as well as the institutions themselves, must be properly prepared to effectively implement these changes.

Despite the enactment of the new Law on the Courts, concerns remain about continued executive involvement in the judiciary. While both courts and the prosecutors see themselves as currently operating with a substantial degree of independence, there is concern that the new Law and its pro-judicial independence reforms may not be fully or quickly implemented and that opportunities remain for executive pressure on the judiciary through manipulation of the budget and operating rules. Additional strengthening of the judiciary remains necessary to assure the full institutionalization of reforms that will better protect this branch from executive control.

C. Critical Assumptions

The following critical assumptions are necessary for achievement of this SO:

- The Serbia-Montenegro status agreement, reached under mediation by the European Union, will be fundamentally respected over its three-year lifespan.
- Conflict triggers identified in Part I of this strategy will be taken into account by both government and donors to ensure that the reform is not blocked.
- Montenegrin Government will maintain a continued commitment to implement legal sector reforms.
- Montenegrin Government will continue to uphold its position of support for judicial independence.

D. Results Framework

This strategic objective is supported by three intermediate results (IR): IR 2.0.1, Enhanced Capacity and Competitiveness of Independent Media; IR 2.0.2, Strengthened Civil Society, Political Party and Trade Union Capacity to Serve and Represent Citizens; and IR 2.0.3, More Effective, Independent, and Accountable Legal Institutions.

Progress toward achieving this strategic objective will be measured by tracking citizen attitudes toward continued political and economic reform, by assessing Montenegro's progress in developing a sustainable, constituent-focused NGO sector, and through performance indicators developed for each activity. Public opinion polls, the E&E Bureau's NGO Sustainability Index, the IREX Media Sustainability Index, and other measures such as ABA/CEELI's annual Judicial Independence Index and Transparency International's annual Comparative Index on Corruption, will be used to gauge progress.

Strategic Objective 2.0

More Effective, Responsive and Accountable Democratic Institutions

IR 2.0.1

**Enhanced Capacity
and Competitiveness
of Independent
Media**

IR 2.0.2

**Strengthened Civil
Society, Political Party
and Trade Union
Capacity to Serve and
Represent Citizens**

IR 2.0.3

**More Effective,
Independent and
Accountable Legal
Institutions**

IR 2.0.1: Enhanced Capacity and Competitiveness of Independent Media

Support to independent media remains a critical element in providing citizens with reliable and objective news coverage that can support their active and informed participation and further the process of political and economic reform. Montenegro currently has approximately 30 radio and television stations, more than half of them private. There are five daily papers and three weekly or bi-weekly magazines that reach both urban and rural areas.

Activities under this IR will include sustained attention to developing a more professional independent news media through training, institutional capacity building, and limited equipment support for private broadcasters. Journalists will be trained in such areas as investigative reporting, women's issues, and business and economic coverage. USAID will provide continued support to develop the capacity of the Union of Independent Electronic Media of Montenegro (UNEM) to serve as an effective representative of the interests of independent broadcasters and as an advocacy group for media law reforms. USAID support will reinvigorate MontPress, to revive its capacity to provide similar associational support and improve professionalism in the print media. USAID support will also focus on media business development skills such as strategic planning, market research and other business skills that support sustainability.

IR 2.0.2: Strengthened Civil Society, Political Party and Trade Union Capacity to Serve and Represent Citizens

Activities under this IR will support Montenegro's NGO sector, trade unions and political parties that support citizens in protecting and exercising their political rights. USAID-supported NGOs and trade unions will assist communities and individual citizens in articulating their needs and priorities to political parties and to all levels of government, pressing political leaders to respond with concrete proposals and actions, defending and applying their rights, and monitoring government performance. USAID will also support civil society efforts to form and maintain partnerships with government that build an inclusive society, create positive change, and manage the social effects of political and economic reform. Attention will be placed on increasing the NGO sector's long-term viability through capacity-building assistance to individual organizations, NGO service providers and resource groups, and to informal and formal NGO networks.

Sustained assistance to democratically oriented political parties that support continued reform will center on building the capacity of parties to represent their constituents effectively, engage citizens in all aspects of the policy process, and to communicate policy messages clearly to the electorate. Attention will be placed on developing women and youth leaders to take these parties into the future. Assistance in this area remains critical to Montenegro's ability to resolve its long-term status vis-à-vis Serbia, and to further democratic and economic reforms.

IR 2.0.3: More Effective, Independent, and Accountable Legal Institutions

In terms of rule of law, the principal problems relate to the capacity of the current justice system to deliver legal services in a timely and just manner and to ensure proper implementation of political and economic reform efforts already underway. The combination of increasingly heavy and complex caseloads and the lack of material and human resource

investment in the judiciary over the last decade has resulted in a system ill-prepared to take on these essential challenges. While the current criminal caseload is being handled reasonably well in terms of quality and timeliness (although there is a lack of capacity to process complex economic and organized crime cases), substantial civil case backlogs exist.

The recently enacted Law on the Courts is an encouraging indication of the Montenegrin Government's commitment to legal sector reform. The new law, if effectively implemented, will make important changes in the structure and operation of the judiciary that should make the courts more independent and more effective. The new law also introduces new concepts of transparency, accessibility, public information, and freedom from influence. Considerable effort will be required to ensure that the institutional and process changes which are developed in response to the Law are consistent with these new principles. Additional laws (such as the Law on Public Prosecutors, Law on Misdemeanors, and the Criminal Code) are currently in draft and need to be passed to ensure reform of other important elements of the legal system. In addition, legal professionals, both in and outside of government, require new skills and knowledge to effectively implement all of the new legislation. Legal advocacy-focused NGOs also continue to require support to fully develop the capacity to effectively promote, participate in and monitor legal reform and the performance of the judiciary.

This IR will support efforts to draft several new laws relating to the structure and operations of the judiciary; the implementation of the new Law on the Courts (including assistance in establishing the new courts and other offices called for in the law) and to develop operational procedures for those organizations. It will also support capacity-building training for legal professionals and judicial branch staff; institutional strengthening for key legal sector institutions such as the judicial training center and the law faculty to encourage the indigenization of training resources that will be accessible to large numbers of judges and lawyers; and attention to developing judicial and bar associations as sustainable, effective advocates for their constituents and for legal sector reform. Assistance also will be provided to continue support for other important legal initiatives in such areas as women's rights and anti-corruption.

E. Progress to Date

The USAID Program in Montenegro is designed to facilitate Montenegro's democratic transition based on ethnic diversity, rule of law, and a market-driven economy. It has made significant strides since its commencement at the end of 1997, specifically in advancing the adoption of a legal framework that establishes the foundation for an independent judiciary and a press incrementally better positioned to inform the public on political and economic reforms. USAID recently established a program designed to strengthen the advocacy skills, management, financial controls and sustainability of the numerous NGOs that have been established under Montenegro's supportive legal environment. Likewise, ACILS is providing support to a labor union movement that is increasingly engaging government and business in constructive dialogue with regard to economic policy issues such as wage levels, privatization, and pension reform. A Parent-School Council Network has been established to strengthen parents' role in educational reform. Political parties have enhanced skills to represent constituency interests, and NGOs carried out nonpartisan election monitoring during the Montenegrin Parliament elections of 2001.

Rule of Law: A USAID-supported ABA/CEELI rule of law program has resulted in an improved legislative and regulatory framework for the judiciary that will, if effectively

implemented, increase the independence and efficiency of the court system. CEELI facilitated the drafting of the Law on the Courts at the heart of this framework. Additionally, ABA/CEELI co-founded the establishment of the Judicial Training Center of the Republic of Montenegro (JTC) in November 2000, which in its first year of operation organized successful seminars for both civil and criminal law judges.

Media: Through USAID's support to IREX, independent media reforms have begun to take root. IREX provides capacity-building training for journalists, media professionals, media outlets, and media professional associations advocating for an improved legal framework for the press. Specifically, media outlets like Montpress, UNEM, Montenegrin Broadcasting Company (MBS), and Montena News Agency have received marketing training and targeted donations of equipment that have improved their ability to deliver news to citizens. As a result, independent media is beginning to provide comprehensive news and public affairs coverage on reform. For example, Onogost, Monitor, Dan, and Publika have established dedicated economic sections in their respective publications to cover business and market reform topics. Additionally, the IREX-supported Montenegro Media Institute (MMI) is acknowledged to be a credible non-affiliated training institute, conducting practical state of the art courses for journalists and media professionals in areas such as crime reporting. Similarly, professional associations like UNEM are functioning in the interests of independent media, advocating for improved media and broadcasting laws based on international best practice, and facilitating business marketing training for their members. Government and civil society have partnered to draft legislation, educate the public, and submit for enactment to Parliament a legal and regulatory framework that supports free media. The National Working Group, composed of media professionals, NGOs, and government representatives are cooperating on a media legislation package, including a Media Law, Broadcasting Law, and a law that will transform state TV and radio into a public service broadcaster.

NGOs: USAID has recently introduced the Montenegrin Advocacy Program (MAP) to develop and strengthen a core group of NGOs to act as a watchdog over government and to promote effective NGO participation in policymaking and reform. ORT International is the U.S. implementing partner. MAP will empower Montenegrin NGOs to identify public policy concerns that resonate with a broad cross section of stakeholders, and provide NGOs with the capacity to mobilize expertise and resources to effectively tackle citizen issues, based on principled leadership and transparent democratic management.

Trade Unions: USAID's program support to ACILS has helped the independent and free labor union movement encourage participation of its members in the economic reform process. ACILS programming facilitates advocacy and dialogue with business and government sectors about wage levels, privatization, and pension reform. ACILS has created a core group of local trainers able to educate union leaders, members and activists across Montenegro about the role of labor unions in market economies, modern union organizational reform and bargaining techniques, and privatization and economic transformation. With ACILS support, the Confederation of International Trade Unions of Montenegro (CITUM), ACILS principal local partner, established a youth branch and is increasingly strengthening its women's branch.

Community Schools: Through a USAID-supported CRS parent-school councils program, parents have mobilized at the community level to improve the condition of local schools through in-kind labor, material donations, and financial support from businesses. With CRS

support, twenty-eight parent-school councils were created that completed twenty school projects ranging from repairs of heating systems, electric systems, and sanitary systems, to setting up computer rooms and foreign language labs. CRS has supported the creation of a grassroots Parent-School Council Network that seeks to strengthen parents' role in educational reform policymaking. The Network will incorporate as a NGO in 2002.

Political Process: USAID's agreement with NDI has helped political parties begin to aggregate citizens' interests and foster productive political dialogue. Through NDI's efforts political parties are improving their organization and public outreach efforts to become more representative and effective political organizations. For example, a number of party branches have developed newsletters and citizen questionnaires on key community issues. Likewise, parties report that their membership ranks have grown and communication between party headquarters and branches has improved. The NDI polling project is providing political parties with information necessary to craft messages that are responsive to the concerns of voters. Moreover, political parties have improved the work of their respective caucuses inside parliament as a result of NDI training in emphasizing constituency contact, functioning of committees, and ethical conduct. NDI has also worked to strengthen civic organizations' engagement in political reform activity. NDI helped create two civic organizations, the Center for Democratic Transition and the Association of Young Journalists, which for the first time, provided nonpartisan monitoring of elections and media during the Montenegrin Parliamentary elections in 2001.

F. Program Approaches

U.S. NGOs will carry out the SO 2.0 program in partnership with local institutions committed to reforms in civil society and rule of law, including Montenegrin NGOs, independent media outlets, trade unions, reform-oriented political parties, and professional associations (e.g., the judges' association and media associations). Programs will be coordinated with key multilateral and bilateral institutions engaged in DG assistance programs, and with USAID's SOs 1.3 and 2.1. During the first part of this strategy period USAID will cooperate with OTI in the transition of OTI civil society initiatives into the DG portfolio. Specific gender initiatives will be carried out in the civil society, political party, and rule of law programs. Other DG activities will integrate gender in planning and reporting. This approach integrates support for reform within government with the engagement of civil society necessary to advance democratic transition across Montenegro.

IR 2.0.1: Enhanced Capacity and Competitiveness of Independent Media

USAID's independent media support will be carried out by one U.S. NGO over a three year period, in partnership with a core group of Montenegro independent media outlets, professional associations, and news service organizations that will receive training, consulting, and targeted grants. USAID's approach places an emphasis on developing the skills and capacity of independent media to provide citizens with objective news and information necessary to effectively participate in democratic and free market institutions. Assistance will be provided to a cluster of potentially self-sustaining institutions such as: MMI, established to provide practical state of the art training for journalists; UNEM, responsible for advocating on behalf of independent broadcasters; Montenegrin Broadcasting Company (MBC), to cover the newly established stock exchange NEX; and Infomont-Montena News Agency to provide factual and balanced news on the economic reform process in the region and general business news. These organizations will indigenize

independent media development, as USAID and other donor organizations phase out support. USAID's rationale for focusing on a selected group of media outlets, journalists, editors, and associations is to ensure cost efficiency and attainable results. The following outlets and organizations have been chosen based on past performance with USAID-supported IREX programs and their openness to innovative ideas: Montena Fax and Montena Business news agencies; Vijesti (daily), Monitor and Onogost (weeklies), Montenegrin Broadcasting Company (MBC), M-production (production house), UNEM, the Montenegrin Media Institute (MMI), Montpress and the Association of Young Journalists (AYJ). Other journalists and media outlets will be provided USAID sponsored training.

IR 2.0.2: Strengthened Civil Society, Political Party and Trade Union Capacity to Serve and Represent Citizens

USAID has initiated a three-year activity to develop the capacity of a core group of indigenous Montenegrin NGOs that are both visible and active in building support for issue-based agendas, and lobbying public officials and other decision makers in order to influence the public policy process and act as a watchdog over government. This program represents USAID's first intervention focusing entirely on the Montenegrin NGO sector, taking a longer-term perspective and trying to stimulate a growing sense of empowerment among ordinary citizens. USAID's OTI has been providing individual grants to support civil society and media development initiatives since 1997. USAID's NGO sector development program will provide highly integrated and individually tailored training, long-term technical assistance and operational sub-grants to a core group of indigenous organizations that show the greatest potential and interest in becoming actively involved in influencing the policy-making process at the local and national levels. The program is being implemented by a U.S. NGO, ORT International, in conjunction with a consortium of regional NGOs, the Foundation for Development of Democratic Rights (FDDR) (Hungary) and the Albanian National Training and Technical Assistance Resource Center (ANTTARC), in cooperation with a local NGO partner, the Association for Democratic Prosperity (ADP-Zid). The Central and Eastern European members of the consortium will provide critical regional expertise to the program.

USAID, in partnership with NDI, seeks to implement party-specific training that focuses on long-term strategic planning, increased internal democratic decision-making structures, improved communication mechanisms between central and municipal party branches, policy planning based on constituent interests, and the significant incorporation of women and youth activists. NDI will train women and youth in communicating their policy needs and interests to the party leadership, fundraising, membership development, and public outreach. USAID also seeks to improve parliament's capacity to represent constituents and efficiently manage the legislative agenda through the appropriate use of committees and caucuses. Finally, USAID seeks to support NGOs that provide credible monitoring of electoral processes in order to guarantee free and fair elections and assist in reducing societal tensions during divisive election periods.

IR 2.0.3: More Effective, Independent and Accountable Legal Institutions

In the area of rule of law, programs will be primarily focused on building the capacity of legal professionals, government legal institutions, and non-governmental organizations to deliver legal services in a timely and effective manner and to ensure rapid and proper implementation and continuation of reforms. Initial emphasis will be on assistance for

implementing changes made by the recently enacted Law on the Courts. This will include expert advice on the establishment of two new courts, a new administrative office for the courts, development of new procedures and court rules for judge selection and removal, and rules for random case assignment. Training and adoption of procedures regarding transparency, public information accessibility and judicial independence will be given priority attention

A second area of priority will be in training judges, lawyers and other legal professionals on the body of new commercial and other laws that affect economic growth. Although supported and managed under SO 1.3, knowledge by the legal profession about these laws is vital for the success of this strategy.

A third approach is aimed at the grassroots, focused on improving the institutional capacity of the lower, basic courts, to better adjudicate cases, thus improving the timeliness and quality of decisions. The basic courts are the courts that handle the bulk of the cases within the system and have the greatest delays and case backlogs. They are the first point of contact by citizens with the judicial system, and where the greatest contact is made to rely on basic protection of their rights. These courts have the most varied and challenging workloads, the youngest and least experienced judges, and little material support from government.

G. Development Partners

Since 1997, USAID and other major donors such as the Organizing for Security and Cooperation in Europe (OSCE), the European Agency for Reconstruction (EAR), the Council of Europe (COE), the Open Society Institute (OSI), and the USAID Office of Transition Initiatives (OTI) have in varying degrees contributed to supporting civil society and rule of law reform initiatives in Montenegro. EAR complements USAID activities in SO 2.0 by its work on media and judicial reform, providing long-term strategic planning advice to the Judicial Training Center (JTC) on legal curriculum development and assisting in the transformation of state TV/Radio into a public service broadcaster. The COE provides regular expert evaluations of draft legal and media reform laws, while OSI has been the principal donor supporting JTC's operational costs.

OTI began its Montenegro Program in July 1997, to engage citizens and promote activities that increase knowledge and the pace of reform. OTI's efforts target five key sectors of reform: the judiciary, the economy, local self-governance, anti-corruption issues, and law and order reform. Additionally, OTI pioneered USG assistance to civil society in Montenegro by working to increase awareness and knowledge of human rights issues, expand the dialogue on truth and responsibility, and support electoral activities. OTI offices in the FRY, including Podgorica, will phase out its operations in 2002.

USAID's principal U.S. NGO implementing partners for SO 2.0 are:

The American Bar Association/Central and Eastern Europe Law Institute (ABA/CEELI) has been working in Montenegro since 1998 to help develop an independent judiciary and related legal institutions. ABA/CEELI focuses on legislative reform, strengthening associations, modernizing legal education curricula, and training judges.

Since 1998, the National Democratic Institute (NDI) has been providing technical assistance to political parties, conducting polls on citizens' attitudes, and training on NGO election monitoring.

IREX commenced its new Montenegro Independent Media program in November 2001. IREX's program is designed to enhance professional journalism, improve economic reporting, and helping to develop sustainable media entities.

The American Center for International Labor Studies (ACILS) activity promotes open, popular participation of the Montenegrin independent labor movement. The program emphasizes greater discussion concerning the reform process.

Catholic Relief Services (CRS) promotes participation of parents and communities in education programs at the local level, as well as assists with minor school rehabilitation initiatives. The program operates in 28 schools affecting over 12,000 students throughout the republic.

The Montenegro Advocacy Program (MAP) strengthens the advocacy skills, management, financial controls and sustainability of a core group of NGOs established under Montenegro's supportive legal environment. The activity is being implemented by ORT International, two Central Eastern European organizations, and a local NGO partner.

H. Sustainability

Civil society programs actively seek to promote greater sustainability by assisting NGOs in broadening and deepening their constituencies, establishing more effective systems for financial management and governance, and by exploring avenues for greater financial sustainability, e.g., through income generation activities. NGO financial sustainability is constrained by the overall economic situation in Montenegro at present, and by the lack of clear tax legislation affecting NGOs, but will remain a priority of USAID's civil society program over the life of the strategy. Progress in advancing NGO sector sustainability will be measured through annual reporting for the E&E Bureau's NGO Sustainability Index.

In media assistance, promoting a more competitive independent media sector is a direct goal. Not all independent electronic or print media outlets will survive a competitive media marketplace, nor should they. Our assistance seeks to ensure that media outlets are armed with the business skills to compete fairly in the marketplace, once an adequate legal framework that promotes transparent competition is in place.

In rule of law, sustainability depends on a long-term government commitment to judicial reform and independence, including adequate court finance. Future programming should address the problem of assuring adequate funding through court financing reform. Progress in this area will affect long-term prospects for sustainability of investments in structural reform, court administration and management improvements, and in judicial training, particularly through the existing judicial training center. Since capacity building through training is critically needed and will remain so for some time, programming solutions will have to be developed which first address critical, immediate training needs and then the problem of assuring, if possible, the longer-term sustainability of any local training institution. Rule of law programming will also continue to promote greater sustainability of

important legal sector NGOs by providing assistance to organizations in developing program and financial sustainability plans.

PART V: STRATEGIC OBJECTIVE 2.1 – INCREASED, BETTER-INFORMED CITIZEN PARTICIPATION IN POLITICAL AND ECONOMIC DECISION-MAKING

A. Statement of Objective

So 2.1 promotes democratic processes and citizen empowerment at the grass roots level with the Community Revitalization through Democratic Action (CRDA) program and will support local government capacity to actively engage citizens as partners in community development. These efforts will support tangible, meaningful opportunities for citizens to achieve positive change in their lives and their communities through direct, participatory action and partnership with local government. USAID local government assistance programs will prepare local governments to pro-actively educate, inform and engage their citizens in meaningful interaction, and improve government capacity to understand expressed community priorities and meet community needs. USAID activities under SO 2.1 also will empower citizens to take an active role in creating positive change in their own lives, and in active partnership with their local government, to address the problems that their communities face after twelve years of economic decline and the deterioration of community infrastructure following years of official government neglect.

Increased understanding and cooperation across community, political, ethnic and gender lines can be forged through tangible and positive experiences of engagement in collaborative community projects that solve issues of common concern. Such cooperation can translate into the identification of shared interests, reduced tensions along dividing lines within communities, and the development of improved leadership skills among women and ethnic and religious minorities

Strategic Objective 2.1 complements and supports USAID's other strategic objectives by developing leadership skills, reducing tensions within communities, empowering citizens to participate effectively in their communities, and demonstrating tangible results that improve their economic opportunities, their lives and the well being of their families. It will serve as well to assist communities in managing the short-term impacts that tend to accompany major structural reform. SO 2.1 contributes to the Mission's goal of bringing about rapid and sustainable changes within the republic that will create an inclusive, democratic and prosperous society.

B. Problem Analysis

Since the establishment of the State of Yugoslavia, community organization in Montenegro has been based upon the Mijesna Zajednica, a form of community level mobilization geared to a variety of ends, including community development projects to address local needs. These organizations, however, were more instruments of the State than mechanisms of community empowerment based upon consensus building and civic involvement. From 1974 to 1991, local governments in Montenegro enjoyed substantial independence and a relatively broad range of authorities. Approximately 42 percent of all public employees worked for local government. Municipalities provided a wide range of services and exercised substantial autonomy regarding the administration of taxes. In 1992, as a result of new government

legislation, most local government authorities were placed under the republic ministries and the Department of Public Revenue, thereby centralizing local decision-making authorities.

The government of Prime Minister Vujanovic has initiated an ambitious agenda of local government reform in Montenegro that will substantially return authorities, responsibilities and financial decision-making to local governments. These reforms will place new demands on local governments, and create unique new opportunities for citizens to reinvent their historic relationship with local government taking an active role in the identification and resolution of community needs and problems. Local government reforms will create new opportunities for citizen involvement in the local budget process and require new levels of citizen participation in community and municipal decision-making. These reforms will mandate the direct popular election of mayors and require citizen participation in budget hearings, capital improvement program planning, and other public hearings on local issues.

The current USAID local government activity is focused on reform legislation, small grants for community infrastructure improvements piloted in targeted municipalities and limited citizen participation activities. A new planned USAID local government initiative, which will be designed to complement the CRDA program, will strengthen local governments' response to citizen demands for improved performance and service delivery. The new initiative will work with all 21 municipalities in Montenegro and will provide more extensive technical assistance and training to facilitate the absorption by local governments of the increase in authority, responsibly and resources which will flow from the anticipated decentralization legislation and create a more favorable enabling environment for more democratic local self governance.

Public opinion polls have tracked a downward spiral in public confidence in republic institutions, frustration with the inability of local government to address community needs, and impatience with the pace at which economic reforms are improving community life and conditions. To maintain continued public support for political and economic reform, SO 2.1 programs will engage citizens in civic activities that produce immediate and tangible improvements in community life, and help citizens establish a personal stake in the economic benefits that reform creates.

CRDA will assist citizens in taking charge of the process of creating positive change in their own communities, actively participating in the identification of shared community priorities and needs, and designing and implementing projects to meet their own specifications. They will participate in all aspects of CRDA community development projects, learning to form cohesive networks across community lines, and establishing partnerships with local government agencies and officials. They will learn how democratic and transparent decisions are made, how public projects are implemented, and using this understanding of government processes, they will be able to establish new local traditions of government transparency, responsiveness and inclusiveness.

The most recent NDI poll (March 2002) indicates that 56 percent of respondents expressed interest in participating in local decision-making. USAID local government assistance will support the establishment of new procedures and reporting mechanisms to inform citizens about how their government operates, assist local government in undertaking projects that meet community needs, and facilitate citizens in monitoring local government performance. Public hearings will be established to solicit citizen comment on budget priorities, community needs and improvements, and other operations of local government, empowering

citizens and representative community organizations to shape decisions that immediately impact the quality of community life. Citizens will participate actively in local government decision-making and take concrete actions that will result in immediate improvements in the level and quality of municipal services and infrastructure.

C. Critical Assumptions

The following critical assumptions underline the achievement of this SO:

- The Montenegrin Government will enact its proposed legislation to decentralize government, which mandates the direct popular election of mayors, and transfers substantial authority to local governments.
- USAID financial resources will be available to implement the reform legislation in place and planned to be enacted in the next three months.
- Human resources will be available at the local level of government to assume the expanding responsibilities of local government.

D. Results Framework

SO 2.1 Increased Better Informed Citizen Participation in Political and Economic Decision-Making, seeks to empower citizens to overcome the deteriorating economic and physical conditions that they face, the lack of tangible results and benefits from a reform program that has been underway for three years, and rising frustrations with central government officials and politicians. Greater participation in public decision-making and local governments more capable of responding to citizens' needs and priorities can help rebuild trust in institutions, support democratic processes, encourage stability in Montenegro (and the region) and support a climate favorable to economic growth and private sector development. This SO is supported by two intermediate results (IR): IR 2.1.1, Citizens Improve Their Living Conditions through Participation in Community Development Committee Activities; and IR 2.1.2, Improved Interaction between Citizens and Their Local Government.

Progress toward achieving this strategic objective will be measured by tracking levels of citizen participation in Community Development Committees, citizen and local government satisfaction with the results of Committee projects, and levels of interaction between citizens and their local governments as measured by performance indicators developed for each IR.

Strategic Objective 2.1
**Increased, Better-Informed Citizen Participation
In Political and Economic Decision-Making**

IR 2.1.1
**Citizens Improve
Their Living
Conditions Through
Participation in
Community
Development
Committees**

IR 2.1.2
**Improved Interaction
Between Citizens and
Local Government**

IR 2.1.1: Citizens Improve Their Living Conditions Through Participation in Community Development Committee Activities

This IR will be achieved if citizens actively participate in democratic to identify problems, develop priorities, manage resources and implement actions that create immediate and positive change in their communities and daily lives. This IR will support indigenous community groups that effectively address critical community problems through participatory problem solving and informed decision-making. It will demonstrate how civic engagement can accelerate the process of social and economic recovery in Montenegro and support the process of democratic, community decision-making. Consensus building will occur across community, ethnic, political and gender groups. Through the work of Community Development Committees, this IR will empower citizens to actively participate in local decision-making on issues affecting their lives. Emphasis will be placed on encouraging broad ethnic and gender participation in Community Development Committees, which will be monitored as an indicator during the implementation of CRDA.

IR 2.1.2: Improved Interaction Between Citizens and Local Government

The Government of Montenegro has set in motion a series of reforms that will expand local government authorities, increase financial responsibilities and enhance transparency. Achievement of this IR will result in local governments that are more capable of meeting their new decentralized responsibilities and obligations, and a more informed citizenry actively participating in decision-making processes with their local governments. Local governments will be more capable of understanding citizen needs and will have increased resources to respond to community demands, resulting in better and more effective local government services. Citizens will be better informed about municipal priorities, decisions on how money should be spent, whether public expenditures are made according to plans and priorities, and the processes for issuing public contracts. This IR focuses on strengthening local governments' capacity to respond to citizens and local government, furthering grass roots democratic processes and maintaining support for continued political and economic reform.

E. Progress to Date

There has been limited progress in establishing grass roots community approaches to solving local problems. Humanitarian assistance organizations such as UNCHR, USAID's Office of Transition Initiatives, and the Danish Refugee Council have carried out participatory community development activities targeted to specific communities, particularly those being affected by large refugee flows. In early 2002, USAID evaluated the feasibility of a large-scale civil society intervention focused on citizens' taking action to improve their lives. There was broad support from community leaders, civic organizations and local government officials to the principles of citizens solving problems for themselves.

Local government reform is further along. The International City/County Management Association (ICMA), with USAID support, has provided technical assistance for the local government reform process and has organized participatory forums at the local and national level on all local government reform legislation. ICMA has worked closely with local governments to encourage them to hold hearings on budgets, capital improvement hearings and the like. The Municipal Infrastructure Support Program (MISP) that began in August

2002 is reinforcing community decision-making processes. ICMA, in conjunction with the government and a range of local NGOs, has facilitated public hearings in seven communities where approximately 20 infrastructure and community service projects are to be financed by USAID grants. This effort is being coordinated with other public hearings on capital improvement programs in which community projects are identified and prioritized. In just seven months, seven projects have gone through an intensive community identification and review process and the remainder are in process at this time.

Major tax reform legislation was enacted by the Parliament in January 2002. A key provision of this overall tax package transfers administration and enforcement of property taxes to local governments. This level of control of property taxes by local government is unparalleled in the region. Municipal treasury systems, which among other things track expenditures, will have to be established during the next year. In addition, new public procurement legislation has led to the establishment of a system of oversight and procedures that will make local governments more accountable in terms of the acquisition of goods and services.

Legislation on intergovernmental finance reform has been drafted and will be sent to the cabinet in April. This legislation will establish a stable and transparent policy framework for revenue transfers to local government units and allocates revenues in accordance with sound expenditure criteria and strong revenue enhancement incentives. This legislation has broad support at the local and national level.

Under reforms currently planned, local government functions will be expanded and direct election of mayors will be mandated. Moreover, the legislation on local government requires hiring professional administrators and public information/citizen participation officers. This framework provides the potential for greater citizen participation in various decision-making processes (budgets, capital improvements programs, etc.) and more resources to shape and improve local conditions.

F. Program Approach

SO 2.1 focuses on rebuilding the key elements of a democratic society by helping citizens shape communities, address problems and interact effectively with local government. Two American NGOs in partnership with local groups, communities and municipal government will implement this program. The CRDA program will spur grass roots democracy empowering citizens to improve their living conditions. Priority will be given to projects that produce immediate improvements in living conditions as defined by community groups. The organizational structures put in place to do this will concurrently lay the foundation for longer-term social and economic development. These projects include small-scale road, water, waste management, electricity and similar modest environmental and infrastructure activities. Income generating and community dialogue activities will be identified and implemented as well. CRDA will help citizens to build consensus across community, political, ethnic, and gender dividing lines to solve local problems, building an atmosphere of greater cooperation and confidence in one another.

The CRDA program will be republic-wide in scope. Each of the two NGOs selected to implement CRDA will focus on a discrete region, the North or South. The program will be structured to be inclusive and broad-based, focusing on a significant number of communities. The unique social, political, cultural and economic characteristics of each region will be addressed. CRDA is designed to foster positive interaction between local governments and

communities in terms of financial support, permits, and other forms of cooperation. A focal point of the citizen participation component of the CRDA program will be the participation of women and minorities in decisions affecting their communities. Indicators on such participation will be monitored in relation to targets established in the design of the CRDA program.

SO 2.1 focuses on assisting citizens in establishing a system of local self-governance that has the resources and capacity to address needs of citizens and community groups. Local government will be provided support to promote transparency in their operations and decision-making. Citizens will be empowered to improve their lives on a sustainable basis through community participation, and partnership with local government.

A new local government initiative will complement the CRDA program providing local government support to respond to the rising expectations of citizens receiving better information and demanding improved performance and services. The ongoing local government activity is focused on reform legislation, pilot programs in targeted municipalities and limited citizen participation activities. The new initiative will work with all 21 municipalities in Montenegro and provide more extensive technical assistance and training to enhance the capacity of local government to address citizen needs.

G. Development Partners

Support for grass roots democratic action first began with the introduction of humanitarian assistance and development programs that started before the war in Kosovo. It gained momentum as donor activities expanded after the war and especially after the fall of the Milosevic regime in Serbia. The Office of Transition Initiatives (OTI), OSCE, the European Agency for Reconstruction, the Open Society Institute, and Council of Europe have been involved in programs to strengthen local governments. UNICEF and the Danish Refugee Council supported outreach programs to community groups. USAID, first through OTI and then through the ICMA, is clearly the lead donor in citizen empowerment, local government reform, training, and the financing of infrastructure projects. As OTI phases out its activities in Montenegro during 2002, high impact, and successful activities will be handed off to the CRDA and the new local government program where applicable.

H. Sustainability

CRDA activities will stress citizen empowerment, transparency and accountability. The process of constructive community engagement, cooperation, consensus building and inclusiveness will foster community groups to utilize democratic means to address community problems. The local government reform process will provide a framework for sustaining and rewarding positive citizen participation.

PART VI: SPECIAL INITIATIVE 4.1 – BUDGET SUPPORT

Since 1999, USAID has provided budget support to help stabilize the Government of Montenegro as it faced the extraordinary stresses associated with the Kosovo crisis and its aftermath. As more normal conditions are established in the region, the annual amount of this assistance is being substantially reduced. USAID will provide its last budget support to

Montenegro in 2002, conditioned on specific progress in economic reform. The World Bank and EU are expected to provide budget support after USAID ends this form of assistance.

USAID provided \$32 million of budget support to Montenegro from 1999 funds, \$40 million from 2000 funds, and \$30 million from 2001 funds. After providing \$15 million from 2002 funds, USAID does not anticipate any further U.S. budget support. Ongoing negotiations between Montenegro and the World Bank are expected to conclude in June 2002, and to include \$15 million of budget support for each of the next three years.

To ensure accountability of these funds, their use was limited to areas where complete documentation of expenditures could be compiled. In practice, three final uses of funds were allowed: import of medical supplies, import of electricity and payment of pensions. The imports purchased by the government with these funds were not sold and, thus, did not generate local currency.

PART VII: RESOURCE REQUIREMENTS

A. Program Budget

Barring continued extraordinary Congressional earmarking of funds for Montenegro, which resulted in \$60 million in SEED funding for FY 2002 of which \$53.8 million will be managed by USAID, funding requirements over the term of this strategy will drop. A robust program, however, will be maintained with \$25 million per year of SEED funding, of which USAID manages approximately \$23 million. Approximately \$6 to 7 million will support economic restructuring, \$4 to 5 million democratic institutions, \$10 million citizen participation and local government strengthening, and \$1.5 to 2 million program development and support.

B. Operating Expenses

Management of the Montenegro program transitioned from Pristina to Belgrade during FY 2001, with Belgrade picking up full financial management responsibilities, except for ongoing renovation of an office complex, on October 1, 2001. No USDH personnel are anticipated for Podgorica. Except for the USPSC Officer-in-Charge and administrative support personnel, all other personnel and costs will be program funded. The new office building in Podgorica is expected to be completed around July 1, 2002. Some Department of State personnel will be co-located with USAID in that building but final USAID ICASS services, and resulting charges, after FY 2002 will not be determined until the arrival of a long-term USPSC Executive Officer. For FY 2002, we project \$3 million being required to fund administrative type expenses, including \$660,000 for limited ICASS services that will be billed to program funds and the Department of State.

C. Management Plan

As mentioned above, full Belgrade based management of the program in Montenegro became effective on October 1, 2001. USDH staff from Belgrade is handling mission management direction, controller and program functions for the Montenegro program and the USDH EXO in Belgrade backstops the USPSC EXO in Podgorica. A highly experienced retired USAID officer is supervising day-to-day management. The Strategic Objectives outlined in this

Strategy will is being pursued under the management of four USPSCs and five FSNPSCs with administrative support from an experienced retired USAID Executive Officer. The full complement of six planned USPSCs will be reached by July 2002. FSNPSCs remain to be hired to reach the full 18 anticipated staff.

Experience in implementing the \$61.5 million FY 2001 program, indicate that the above staffing and management arrangements, supplemented with support from the Regional Service Center in Budapest and E&E Bureau, will adequately assure sound management of the program

MONTENEGRO
RESOURCE REQUEST BY STRATEGIC OBJECTIVE
FY 2002 – FY 2004 (\$000)

SO	Name of Strategic Objective	FY 2002	FY 2003	FY 2004
<i>ECONOMIC RESTRUCTURING</i>				
1.3	Accelerated Development and Growth of Private Enterprises	12,843	5,934	7,209
<i>DEMOCRATIC TRANSITION</i>				
2.0	More Effective, Responsive and Accountable Democratic Institutions	0	4,946	4,393
2.1	Increased, Better-Informed Citizen Participation in Political and Economic Decision-Making	23,977	10,060	9,838
<i>SPECIAL INITIATIVE</i>				
4.1	Budget Support	15,000	0	0
<i>CROSS-CUTTING PROGRAMS</i>				
4.2	Audits, Evaluations and Program Support	2,000	2,000	1,500
	632 Transfers	6,180	2,060	2,060
<i>TOTAL COUNTRY BUDGET</i>		60,000	25,000	25,000

Appendix A

ECONOMIC and SOCIAL INDICATORS on MONTENEGRO¹³

	<u>2000</u> ¹⁴	<u>2001</u>
Population	658,280 ¹⁵	
Gross Domestic Product		
Formal economy ¹⁶	DM 1.3 billion	DM 1.5 billion
Whole economy ¹⁷	DM 3.0 billion	
Employment		
Formal economy	115,000	113,000 ¹⁸
Agriculture ¹⁹		24,000
Gray economy ⁴		65,000
Unemployment, whole economy ²⁰		17 percent
Average net formal wages, December	DM 210	DM 219
Government ²¹		
Expenditure	DM 732 million	DM 895 million
Surplus (+)/Deficit (-)	+ DM 3 million	- DM 57 million
Change in retail price level	17 percent	25 percent
Trade, formal economy		
Commodity exports	\$161 million	\$194 million
Service revenues	\$120 million	\$92 million
Commodity imports	\$354 million	\$640 million
Service expenditures	\$41 million	\$47 million
Trade deficit on commodities and services	\$114 million	\$400 million
Birth rate, per 1000 population ³	13.5 (1999)	
Death rate, per 1000 population ³	8.2 (1999)	
Infant mortality, per 1000 in first year ³	13.9 (1998)	
Land area ³	13,812 km ²	

¹³ Unless otherwise specified, the source is official data of Government of Montenegro, as interpreted in *Montenegro Macroeconomic Update: March 2002*, USAID Economic Policy and Institutional Reform Project, March 12, 2002.

¹⁴ Data are for calendar years.

¹⁵ *Statisticki Godisnjak: 2000*, Montenegro Bureau of Statistics

¹⁶ Office of the Prime Minister

¹⁷ Based on per capita income of DM 4,587 in OCHA household survey.

¹⁸ The Office of the Prime Minister reported official employment of 130,000 in 2001.

¹⁹ Office of the Prime Minister. Agriculture is additional to formal employment figures.

²⁰ *Montenegro Economic Trends*, Institute for Strategic Studies and Prognoses, No.7, December 2001.

²¹ Includes budget and off-budget accounts; and donor grants. On cash basis, i.e., does not include accumulated arrears.