



Institute for Strategic Studies and Prognoses

International Conference: “**Economic Policies for Viable Micro State**”

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»Montenegro – microstate«

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Montenegro – microstate

Abstract

Over the last 130 years, public consumption in today's developed countries has increased from 10% of GDP to around 45%. The sixties and seventies were years when the idea of great power of Government was extraordinarily strong – these were the golden years of Keynesians. Reganism and Thatcherism were the first state policies aiming to reduce public consumption and to redefine the role of the state. New industrialized countries in the world, which have achieved high economic growth rates, have had almost two times lower public consumption than developed countries.

Does this indicate that high public consumption impedes economic development?

Where is Montenegro positioned in terms of the size of its state administration?

All indicators show that Montenegro has high public consumption, at the same level as the most developed countries in the world, and twice as much as newly industrialized countries. How should Montenegro deal with the challenges and necessities of its new institutional framework and increase efficiency of Government and state administration?

In this paper, some elements of the concept Montenegro as a microstate are presented, as the answer to these questions. Our hypothesis is that products from Montenegro cannot be competitive in the global market with such high public consumption.

Key word: *Microstate, Economic Freedom, Entrepreneurial Economy*

Preliminary remarks

The ISSP has developed the idea of Montenegro as a microstate over the last five years. Microstate, in the sense we are using it here, is more focused on the state playing a minimal role in the economy and having limited political power, as opposed to the mechanistic application of criteria concerning microstates (size of territory, population...). When you apply the criteria of minimal state governance to a small state, the result is a microstate.

We wanted to discuss the idea of a microstate during an international meeting of reputable participants in Montenegro, such as this one. Up to now, the concept of Montenegro as a microstate has been discussed in several meetings organized abroad, and the idea attracted attention and interest. On the domestic scene, it was politically unacceptable and also attacked the famous sense of Montenegrin size and importance, which would have been negated by the term "microstate". In order to understand this term in Montenegro, maybe it is time to start reading Negos's »Luča mikrokozma«, instead of his »Mountain Wreath «!

The purpose of this meeting is to discuss some questions concerning the idea of Montenegro as a microstate. Above all, to discuss questions on economic policy making in:

1. A small state, like Montenegro¹
2. In the time of the creation of a new developing paradigm based on globalization and informatization, aka, the development paradigm of the twenty-first century

Three key issues to be discussed today are concerned with: (a) Tax rates and protectionism; (b) competitiveness policies and free trade (c) size of state administration! A significant number of other great issues, I hope, will be discussed in some other conference!

Discussion of these issues should serve as an effective answer to at least three challenges Montenegro is facing:

1. Challenge of globalization
2. Challenge of harmonization within state union and EU
3. Challenge of new Constitution of Montenegro. The Constitution as a strategic vision of development, but not purely a legal act!

¹ Montenegro is a small state, with populaton of 660,000 people. Gross Domestic Product (GDP) in 2002 was € 1,850 per capita.

This conference is attempted to make discussion with, before all, young generation, young people, who know, on one hand, that they will live in a globalizing world, and on the other, the necessity to retain their cultural and national identity!

The objective of meetings like this is not to make any final decision, but to send strong and effective messages. Messages based on arguments. I hope this approach will be adopted by those who have opposite opinions, as well.

1. Relation between state and economy

Discussion of the role of state in economy is endless!

Three elements are important in order to understand the role of state:

1. Increase in the role of state, especially measured by participation of public consumption in GDP, evidenced during past 130 years. According to Vito Tanzi, around 1870 (Berlin's congress), public consumption as percentage of GDP, was 10,8%, 1913-13,5%, 1920-19,6%, 1960-28%, 1980-41,9%, 1996 – 45%. This 45% is not equally distributed among different countries. For example, in France it was 55%, Germany 49,1%, Italy 52,7%, Sweden 64,2%, while in Switzerland 39,4%, Austria 35,9%, US 32,4%. Chile 19,9%, Argentina 22,5%, Malaysia 22,6%, Mauritius 25,4%.²

How to limit the growth and influence of public consumption is a question that, during the 1980s, was being asked across the whole world.

2. Twentieth century is the century of socialism- meaning a strong, paternalistic state in East Europe. In West Europe we had and still have so called snailing socialism, or the welfare state. The paternalistic state in East Europe went to bankruptcy. But, concerning welfare state, I am in a dilemma, and asking: What is the future of European capitalism?³ Is the welfare state simply a replacement for the paternalistic state? Does the path from a paternalistic state to a welfare state have to pass phase based on cheating?
3. Is democracy, understood only as a majority role won in free parliamentary elections (which is the way most transition countries interpret democracy) sufficient protection for individualism, or the individual? Should we believe more in honesty of political parties and politicians, or in constitutionally arranged limitation of their power?⁴

Does the mental framework for understanding the relation between the state and the economy, based on three elements (high state consumption, welfare state and unlimited

² Tanzi divides states into three categories: small (Less than 40%), medium sized (40-50%) and big (more than 50% share of public consumption in GDP)

³ Vivien A. Schmidt: "The Futures Of European Capitalism", Oktoih, 2002

⁴ See Bjukanen: The Economics and The Ethics of Constitutional Order, The University of Michigan Press, Ann Arbor, 1991

power of majority) provide enough scope to change the economic and political system in Montenegro?

My question is: what is more important to be changed, ideas or interests. Here we are facing key philosophical differences between Adam Smith and John Maynard Keynes; Adam as the founder of economic theory, and John as the founder of macroeconomics. Maybe it is an important fact that both were born on the same date (June 5), showing that, even when though there are significant differences between their ideas, the base is the same.

Actually, Smith insisted on personal interest, division of labor and free trade, spontaneous market order, as Hayek said; while Keynes on the importance of planned, introduced planning, constructivism in economy.⁵

The question is: Does higher public consumption (meaning lower level of economic freedom), lead to higher economic growth (as Keynes's theory claims), or, higher level of economic freedom lead to faster growth?⁶

Sixties of the previous century were golden years of Keynesians! Those were years of high optimism and belief that state is capable of solving all economic and social problems by increasing public consumption (increase of tax rates, customs, and public debt).⁷

Empirical analysis of Vito Tanzi shows this idea is not supported by indicators. As Tanzi says, "our analysis does not show that small governments (less than 40% share of public consumption in GDP-V.V) produce less desirable socio-economic indicators than big states" (more than 50% share of public consumption in GDP-V.V).⁸

Additionally, in a significant number of papers and studies, the level of relationship between economic growth and economic freedom was analyzed. In a paper by Naau and

⁵ "Each person", Adam Smith said, "has its own egoistic and non-egoistic part. Smith said that nature of humans recommends to each individual to take care of himself, and it is more natural to take care of himself than of someone else. Even we assume that individual may be selfish, it is obvious that some principles in human nature exist making him to be interested for happiness of others and provide some joy, even that is the only way to get help from others" (Wealth of Nations, Volume IV, page 43)

⁶ »Adam Smith was the first who proved that political interference into free market trade, reduce economic wealth and individual freedom. But, Smith was naive, because he believed that government, when finally accept that fact protectionism-mercantilism makes only damages, rationally eliminate barriers. We know that government won't do that. They will act according to their interests, to attract voters.... This will initiate a game between interests to introduce protectionism« (Dž. Bjukanen: The Economics and The Ethics of Constitutional Order, The University of Michigan Press, Ann Arbor, 1991, page 247)

⁷ Generation of old economists criticize liberal approach and economic freedom, as a result of their »ideological« basis and makes an argument that we should return in sixties (or even thirties – Keynes and Galbraith). But, question is, if that model was successful, why failed? Maybe, as Madzar said, model was self-destructive? Why that system, created after Big Economic Crisis (1929-33) and Second World War (1939-1945) didn't survive big oil crisis from seventies? Where are from Reaganism and Thatcherism as philosophies to increase economic freedom from eighties?

⁸ Vito Tanzi, L.Schiknecht: Public Spending in the mid 20th Century, Cambridge, 2000, str.119. »In areas as economy, labor market, financial management, environment protection, small government makes better results than in countries with big government and public consumption« (page.119). See table II (Annex)

Stern⁹, where this interrelation was analyzed for the period 1975-1992 in 80 countries, and based on Index of Economic Freedom by Heritage Foundation and Fraser Institute, the final conclusion is that economic freedoms accelerate economic growth, but also that the level of economic freedom does not directly influence the level of economic growth. Toretensson showed that insecurity in terms of property rights protection leads to a slowdown in economic growth¹⁰.

Analysis of public consumption done by Vito Tanzi in new industrialized countries shows that in these countries, the current level of socio-economic development has been achieved with lower levels of public consumption (lower share of PC in GDP). Also, the level of public consumption in new industrialized countries is still lower than industrialized economies, and amount to 18,2% of GDP.¹¹

These indicators from new-industrialized countries (Singapore, Korea, Hong-Kong, Chile, Mexico...) should be analyzed in terms of **understanding the role of state** in those countries. Their approach is not based on the pro-consumption attitude that was characteristic of western countries during 60-ies and 70-ies in the previous century. While many industrialized countries did experiments with Keynes and created welfare states, new industrialized countries encouraged economic growth and economic policies based on market and economic initiatives, while retaining public consumption at the same level.¹² Also, in successful new industrialized countries investment in human capital was high (education and health). Structure of public consumption in these countries is, approximately: one third for government consumption, one third for subsidies and transfers and one third for public investment. All these cumulated is less than one fifth of GDP.

Even though public consumption in these states was low, average growth rates were three times higher than in developed countries. These countries still have good performance in terms of economic and political freedom and employment, as we can see from the table attached in annex (table I).¹³ The experience in new industrialized countries gives us the message that those countries achieve the same level of economic and social indicators as developed countries; even public consumption is significantly lower. Why?

⁹ Jakob de Naau, Jau-Edgert Stum: On The Relationship between Economic Freedom and Economic Growth, University of Groningen, 1999

¹⁰ Tortenson J. (1994): Property Rights and Economic Growth, An Empirical Study, Kuklos, 47

¹¹ Annex: table I

¹² »In Singapore, Lee Kuan Yew, architect of the postcolonial success, believed that policie should focus on a few key principles of good governance promoted by many political philosophers, including Adam Smith or David Hume, such as: »maintaining the rule of law and the sanctity of property rights, fair commercial practices, a level playing field between all players whether they be well-connected insiders or unconnected outsiders, and transparency and accountability in decision making«. The application of these principles has made Singapore one of the freest economic areas in the world today.

In Hong Kong, governments did not reject public intervention as a matter of principle but believed that: »The primary role of government is to provide public services and economic infrastructure which only the government can sensibly provide« (Haddon-Cave, 1984). In this, Haddon-Cave is essentially restating Adam Smith`s views on the proper role of government. The provision of services was often transferred to the private sector, and consumers had to pay for the full costs of services.

¹³ Annex: table III

2. Re-definition (new definition) of role of state

Analysis of Public Spending in developed countries worldwide shows the necessity of re-definition of the role of state, or level of public expenditures. The question is, what level of public expenditures is necessary to respond to challenges of growth and globalization in XXI century. The answer is: It is not necessary to have such high public consumption. This is shown by experience from new-industrialized countries, as well as from experience from some transition countries. The ongoing re-definition of the welfare state starting with Regan and Margaret Thatcher¹⁴ and privatization of public services in western countries, also support this view. At the theoretical level, these issues are being discussed between monetarists and supply-side economists¹⁵ and new institutional economists¹⁶. More or less, the accepted conclusion is that it is necessary to reduce the size of the state in industrialized countries by decreasing public consumption.

Many changes inside countries and in the international community influenced the need for important reforms. Reforms which were not possible in the past, but today are. The state has to use all advantages from the new environment (globalization, informatization, openness), has to reform its fiscal regime, but also to reduce its role in production of goods and services. Its new role has to be in establishing **adequate game rules, for economic actors and for itself!** More realism what state should do as well as pressure from globalization for small and efficiency government, enforce change of role of state in that direction. Privatization in many government services, including infrastructure, reform of education, pension system and health system, in direction of more involvement from private sector, is the basis for state reform in industrialized countries. This should lead to a reduction in the so called distributive role of state or, to avoid that individuals or households are at the same time getting a service from government and pay taxes (»Fiscal Churning«). Avoiding »Fiscal Churning«, Vito Tanzi estimated that public consumption would be reduced from 50% of GDP to 32%.¹⁷ **An indicative goal of public consumption reduction is to 30% of GDP in industrialized countries and around 20% in new industrialized countries**¹⁸.

3. Where is Montenegro in the context of the mega trend of the reduction of public consumption and redefinition of the role of state?

¹⁴ Harvey Feigenbaumol and other: »Shrinking the State«, Cambridge, 1999

¹⁵ Lukas Robert, Jr. and Thomas J. Sargent: Rational Expectations and Econometric Practice, Volume 2, The University of Minnesota Press, Minneapolis, USA, 1981

¹⁶ Oliver Williamson and Scott Masten: »The Economics of Transaction Costs«, An Elgar Writings Reader, UK i US

¹⁷ Table IV (Annex)

¹⁸ Vito Tanzi; *ibid*, "Our short survey indicates that the role of the state declined in several countries since the early 1980s. Our review of public expenditures in many countries has convinced us that 30 percent of GDP may be a reasonable target for public spending in industrial countries. This is, of course, only an indicative target that can be used as a general reference for industrial countries. One would expect that some countries would aim at higher and some at a lower figure. Newly industrialized countries may be well advised to maintain the public spending level at about 20 percent of GDP."

The answer has to start with an explanation of a few facts concerning Montenegro. Actually, there is no universal recipe for transition as a whole, as well as for the role of state in that context.

Population of Montenegro is 660.000, Area of 13.812 km², or per capita 0,02 km². GDP in Montenegro in 2002 was € 1,221 million or € 1.86 per capita.

Official number of employed in Montenegro is 114.000, while in state administration 37.336. Estimated number of employed persons is 202.000

Does Montenegro has »the big state «?

In order to analyze this, we will take two indicators:

1. Share of public consumption in GDP
2. Index of Economic Freedom in Montenegro

Public consumption. Analysis is based on official fiscal statistics, excluding expenditures related with new union of states of Serbia and Montenegro.

Table 1: Share of public consumption in GDP in Montenegro

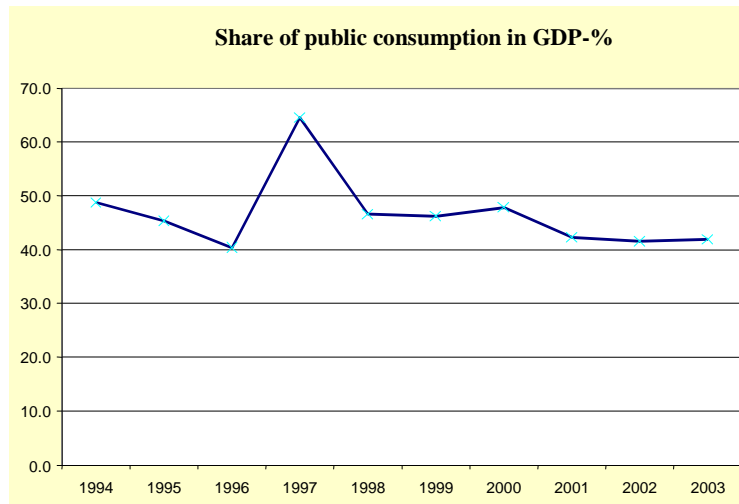
Year	Public consumption	Gross Domestic Product (GDP)	Share of Public Consumption in GDP
	Million €	Million €	%
1994	255.7	524.8	48.7
1995	243.3	536.4	45.4
1996	290.0	718.2	40.4
1997	470.3	729.1	64.5
1998	349.8	751.0	46.6
1999	320.8	694.8	46.2
2000	374.0	781.3	47.9
2001	443.6	1,049.0	42.3
2002	507.5	1,221.0	41.6
2003	555.9	1,327.0	41.9
2003**	600.9	1,327.0	45.28

*Data in current

yearly changes

prices. Nominal

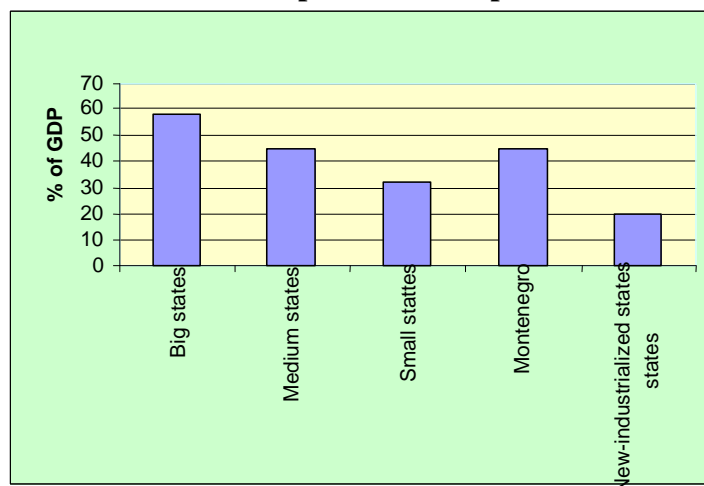
** Finance of Union of States of Serbia and Montenegro included



If we include expenditures of **Union of States of Serbia and Montenegro** financed by Montenegro (around € 45 million), share of public consumption in GDP would be 45,2%.

In chart below, position of Montenegro compared with positions of industrialized and new-industrialized countries is presented

Chart 1. Share of public consumption in GDP



- "Big state" – share of public consumption in GDP more than 50%
- "Medium sized state" – share of public consumption in GDP between 40- 50%
- "Small state" – share of public consumption in GDP less than 40%

In table below, participation in finance of state per capita is presented.

Table 2: Public Consumption per capita

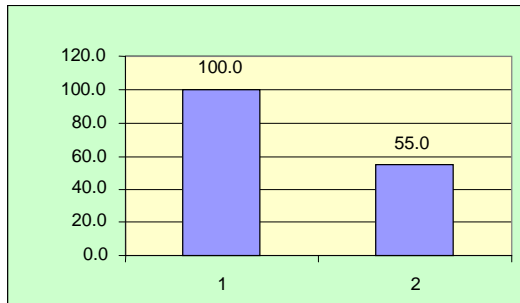
Year	Public Consumption per capita	GDP per capita
	EUR	EUR
1994	402.5	826.1
1995	381.0	839.9
1996	451.1	1,117.1
1997	727.2	1,127.3
1998	537.6	1,154.4
1999	490.1	1,061.5
2000	568.1	1,186.9
2001	669.9	1,584.1
2002	763.3	1,836.5
2003	832.8	1,988.0

Public services are **main employers** in Montenegro¹⁹. 37,336 people are employed in public sector (Education, Ministry of interior, State Administration, Health and other services). It makes 32,8% of official employment in Montenegro. Salary expenditures (wage bill) are 55% of public consumption, respectively, according to estimation of World Bank, 12% GDP.

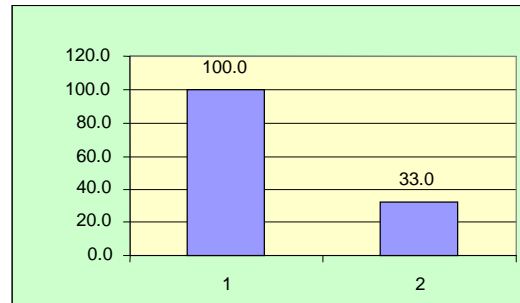
¹⁹ **Tabel 3. Public Sector Employment in Montenegro**

Public Services	No. of Employees
Education	13,525
Ministry of Interior/Police	7,718
State Administration	5,985
Other	1,608
TOTAL PUBLIC SERVICES	28,836
Health Services	8,500
PUBLIC SERVICES +HEALTH	37,336
Total Employment	202,000
Official Employment	114,000
Public services +health as % of total employment	18,5%
Public services +health as % of official employment	32,8%

Graph 2. Participation of Wage Bill in Public consumption



Graph 3. Participation of Employed in Public Services



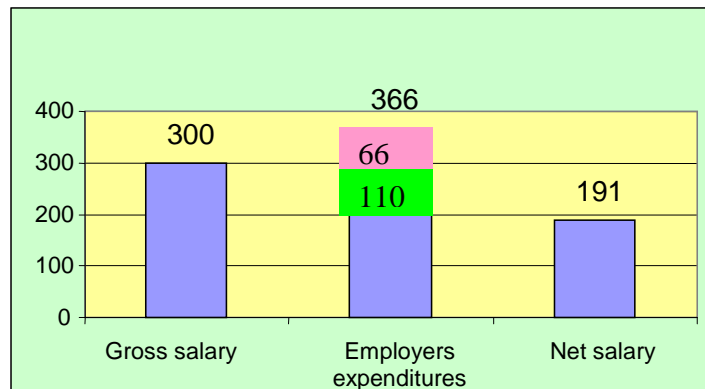
Weight of *tax burden* that is determined at work is quite high, even with quite low-level incomes. Marginal tax rate is high even for minimal salary of € 50 – is 37%, while at salary of € 300 - is 45%.

Besides, employee pays direct taxes and contributions employer also pays direct taxes. When direct taxes paid by employee and employer are added, then at gross salary of € 300, net salary is almost equal to amount of direct taxes²⁰. Should it be expected that in those conditions employers would seek for new employees and decrease of gray economy (non – taxed economy)?

²⁰ **Tabela 4. Tax Burden on salaries**

Kategorija	€	€	€	€
1. Gross salary of a employee	50,00	100,00	200,00	300,00
2. Employers expennditure	61,00	122,00	244,00	366,00
3. Net salary of a employee	40,00	71,50	133,17	191,83
4. Direct tax gap (=2-3)	21,00	50,50	110,83	174,17
5. Tax gap as % of net salary of a employee	52,5%	70,6%	83,2%	90,8%

Graph 4: Tax Burden on Salaries



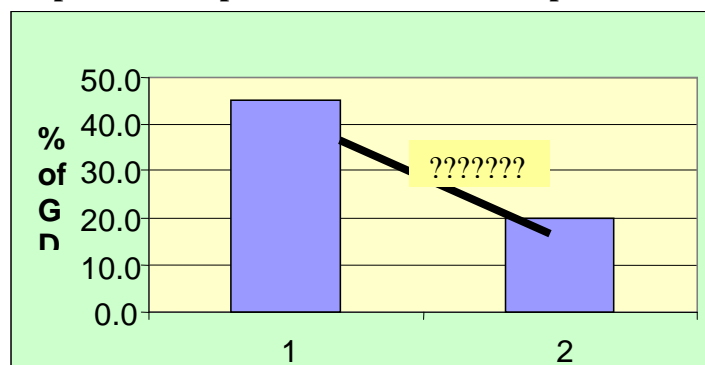
Characteristic of present tax rates is:

- 1) High public consumption
- 2) High tax burden

Tendency in the world in decrease of public consumption to 30% of GDP in industrialized countries respectively to stay at about 20% in new industrialized countries (much more developed than Montenegro).

Problem of Montenegro is how to shift from then 45% of public consumption in GDP to 20%? Is Montenegrin product with participation of public expenditure of 45% competitive at world market?

Graph 5: Participation of Public Consumption in GDP



Another indicator of state size are economic freedoms. One of the measures of economic freedoms is **Index of Economic Freedoms** of Heritage Foundation.

From 156 countries Serbia and Montenegro are ranked at 149 together with Uzbekistan and Belarus. If economic freedom, as surveys are showing, is assumption of growth,

should we expect economic growth under existing institutional framework in Montenegro?

Table 5. Components of index of economic freedom in several countries – comparative analysis

Component of index	S&M	Estonia	Lithuania	Cuba	Albania	Slovenia
1. Trade policy	4	1	2	3	5	4
2. Fiscal limitations	3,5	3,5	3,5	4,5	3,5	4
3. State interventions	4	2	2	4	3	2
4. Monetary policy	5	2	1	5	2	3
5. Foreign Investments	5	1	2	4	2	3
6. Banks and finance	4	1	2	5	3	3
7. Salaries and prices	3	1	2	5	2	2
8. Property rights	4	2	3	5	4	3
9. Regulations	5	2	3	4	4	2
10. Gray economy	5	2,5	3	5	5	2,5
Index of economic freedoms	4,25	1,80	2,35	4,45	3,35	2,85
Rang in world	149	6	29	155	104	62

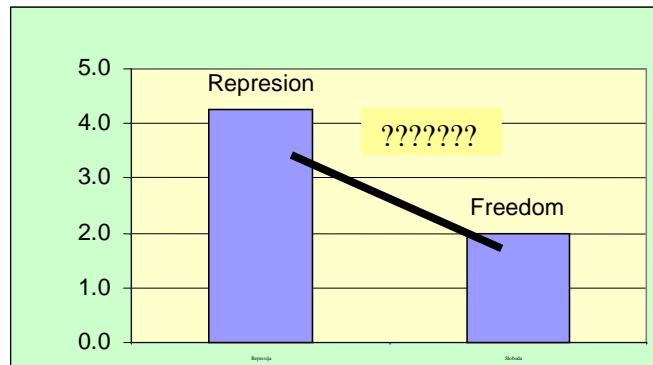
Index has four scales of freedom:

1. Free countries – countries with score 1,95 and less
2. Mainly free (score from 2 – 2,95)
3. Mainly non-free (score from 3 – 3,95)
4. Non - free (repressive) – (over 4,0).

Source: 1993 Index of Economic Freedom, Heritage Foundation

If level of economic freedoms is assumption of economic growth in Montenegro, and it is, then the question is: **How to increase economic freedom in Montenegro?**

Graph 6: Index of economic freedom



Based on this data, I do not have a question whether Montenegro with such high public consumption can survive, as many raise it, including some international organizations.

Question raised by researchers of ISSP is different:

How should Montenegro develop? How to provide sustainable level of modernization and cultural renaissance?

Our answer is that Montenegro in the longer term should follow development concept named **“Montenegro as a microstate”!**

4. Montenegro – microstate²¹

Today’s event has as a goal discussion about some segments of this concept. Respectively, those are policies applicable at microstate. Other question will be successively discussed.

Concept of Montenegro as a microstate is concept of comprehensive political, economic and cultural turnover. It is about change of concept of system and institutions that would enable faster integration into region, Europe, world organizations. A result of that should be increase in quality of life of its citizens.

Our starting point is that each country in transition has its specificities, cultural, historical, mental and others that should be taken into consideration while choosing reform model and way of their implementation. There is no universal solutions and mechanical transfer of others experiences. Type of reform undoubtedly depends on size of state, population, resources, geographic position ...

Key idea of microstate is to build, instead of paternal allover present but weak state as we have now, minimal but strong state.

It is liberal approach to development of relations between state and economy. Approach that refuse concentration of power and stress individual and its freedom in creation. This approach specially shows importance of:

1. Moral
2. Law
3. Institutions

for behavior of people.

Liberal economy is not non-regulated economy, as well as relations in majority of families are not without regulation. Liberalization is rule of law, rules, institutions, and not rule of citizens, leaders, groups, political parties, ...

According to this approach, our Institute and our Economic Reform Network do not understand economy as one **organism, as engine searching for engine driver.**

²¹ More details: Veselin Vukotić: «State and transition», Milocher conference, 2001 i »Montenegro – microstate«; Veselin Vukotić: Macroeconomic trends and Economic Reforms in Montenegro, Suedosteuropa-Gesellschaft, Germany, 2003

Buccanen's understanding of economy, as group of rules and institutions that influence the behavior of an individual is acceptable for us.

»Economy doesn't have a purpose, or goal, or career«, says Buccanen. An important mental conclusion deriving from this is: **economy is different from a company**.

Company has a purpose – it is a creation of profit in a market game!

Economy, by itself, does not have a purpose – it is an institutional framework for game.

What is the subject of reforms?

Concerning that question, our Institute and Economic reform network are different from a large number of local experts, NGOs and political parties: In our opinion, **subject of reforms is institutional framework, rules of game and not just a game!**

Our critics say that subject of reforms is also a game, actually that state has to be included in work of enterprises, to help them, invest money in them (where does state get money?)

Our concept is that state is the same as the referee in sport. Protect change of rules made in a democratic procedure. Performs it very strictly, without exceptions and transparently!

Criticizers of liberal approach, especially politicians, say that state has to “participate in the game”. Respectively, how enterprises know what they should “if I don't show them that”? Imagine referee in sport participating the game? What does “rule of law” look like in that case?

Our concept is not based on the engine- driver, on locomotives pulling forward, at tracks constructed in advance leading to an exactly determined goal. In our concept each individual is important, its energy and creation, each entrepreneur, investor, manager is important ... In our concept people are not just passive passengers in a locomotive driven by an “all-knowing engine- driver”! Before it is a set of attempts and mistakes, then it is a ride on tracks toward a bright future!

There is no constructivism in our concept nor do we believe in all-knowing individuals and a so called all-knowing mind! Knowledge of each individual is limited! Life has much more spontaneity and non-determinacy than the followers of Newton's understanding think. This is the time when Einstein's “relativity principle” is accepted, or Haizenberg's “principle of non-determinacy” or “black holes of universe” of Steve Hoking, ...

Devotion to a minimal role of state means:

1. Openness of micro state in all areas (»open state«)
2. Small but strong authority in legal protection
 - a. Rights of individuals

- b. Protection of property rights
 - c. Protection of contract freedom and execution of contract
3. Transparency

Why can't a microstate or a very small state rely on big paternalistic power?

1. Microstate has to avoid imitation of big states in respect to the structure of public administration. It makes large expenditures, which increases taxes and decreases competitiveness.
 2. Large administration in small state creates a danger that majority of population works in state administration and Para-state institutions. It endangers democracy and sovereignty of individual (dependence from state). Who is going to make income for such large administration? Who is going to pay tax in order to support such large administration?
 3. If a state is small, its internal market is small. This is the case of Montenegro. Companies cannot grow very large based solely on a market of such small power, but have to focus on export markets out of Montenegro, which requires openness of the economy.
 4. The power of the economy has to be greater than the power of state, specifically politics. Our insisting on openness and market unavoidably raises the question: how to increase competitiveness of Montenegrin products at market! Increased competitiveness is the essence of the concept of a microstate!
- 5. Microstate, or how to Increase Competitiveness of Montenegrin Products to a Wider Market?**

Discussion about this question includes:

1. Selection of type of economy and macroeconomic policies
2. Reform of administration
3. Constitutional and political changes

a) Selection of Type of Economy and Macroeconomic Policies

State has to stimulate type of economy that is based on economic freedoms, on entrepreneurship, on individual creativity, on efficient management. The role of new state administration in macroeconomic policy in Montenegro should be considered in this context, and particularly how this influences the size and organization of state administration.

Macroeconomic policies in our model are based on the following principles:

Monetary policy. By the introduction of the Euro, the function of monetary authority no longer rests with Montenegro.

Foreign trade policy. Openness of microstate requires a liberal trade policy, i.e. abolition of all barriers, quotas, contingents, tariffs.

Fiscal policy. More and more international standards should be accepted, lower taxes, and a wider tax base, a transparent budget.

Policy of regulation of utilities (especially after their privatization, in area of telecommunications, energy, media, water supply). Regulation should be based on international standards.

Development policy. Attracting investors and development of entrepreneurship as well as investments into human capital.

In order that the state answers these macro economic policy requirements, a new organization of state administration should be established, with a professional instead of political basis.

A new understanding of the role of state administration, its size and organization in respect of macroeconomic policies, is influenced by:

1. Necessary increase of participation of private sector in public services. Public services shouldn't be organized just by the state, but also by private investors and entrepreneurs. It is a mega trend in the world
2. Transparency and the importance of transparency in a microstate. It is much more important in a microstate than in a large state (disabling rent-seeking and corruption).
3. Role of independent institutions, associations and NGOs should increase! Governments are losing monopoly positions! Additionally, a larger number of people is included in the creation of market institutions and participates in public life!

Based on this role of state and macroeconomic policies, what type of economy is suitable for a microstate?

1. Entrepreneurial economy, economy where market is more important than state, big companies than political parties, economy than politics.
2. Importance of non-material factors of production in that type of economy is enormous: knowledge, information, and services. These factors are becoming more important than its resources.
3. Importance of small and medium enterprises and their flexibility.

Does state redistribution increase income? Can we believe in the statement: higher state consumption has multiplicative effects on development? That is not the case in a small state!

In short, if they want next generations to live better, citizens of Montenegro will have to produce more goods and services that are not based solely on natural resources, but on knowledge, creation and entrepreneurship above all!

b) Organization of state administration

In order to satisfy requirements of entrepreneurial type of economy, it is necessary to establish and build new **principles** of functioning of state administration at all levels – municipality, local and republican.

Key principles are:

1. Practicality, i.e. efficiency in production of services (importance of results)
2. Rationality: total costs of administration have to be bearable for citizens.
3. Directness: direct connection with citizens (decrease in transaction costs)
4. Internationalization of business and behavior: ability to communicate with environment
5. Transparency and publicity: holding back personal relations and discretionary power.
6. Anticorruption: reduce possibility of using public function in private purposes
7. Professionalism: creation of professional instead of political obedient administration at all levels

Some practical steps:

1. Strategy of marketization (“narrowing state”): privatization of state companies and introduction of private sector in public services (strengthening role of private agencies)
2. Decrease of administration at all levels (not mechanically but in accordance with concept of microstate). For example, decrease number of ministries to maximum 7.
3. Montenegro, in this concept, doesn’t need army or military service.
4. Decrease of police and increase of their professionalism.
5. Montenegro has to have just several embassies and representative offices abroad.
6. Introduction of E-governance and government without paper.
7. De-monopolization of state education and University
8. Reform of education financing and preparation for introduction of vouchers in this area.
9. Introduction of English language as second official language.
10. Development of philanthropic activities.
11. Larger investments into culture, art, sports.
12. Development of NGO and institutions of civil society.

c) Political reforms in Montenegro

All of these ideas have to be considered in the scope of changes of Constitution and political reforms in Montenegro, policies of changes.

One of the questions is whether Montenegro has to introduce presidential system or more efficient combination of presidential – parliament system! It is a question for serious discussions, special conferences. We are, in this phase, supporting introduction of presidential system.

6. Instead conclusion

There are three key messages of this paper:

1. Motto of our understanding of economy is »Even God encourages Entrepreneurs«. Why shouldn't state and state administration encourage them too?
2. If we want to live in the light of integration and internalization then we have to understand that Smith's free trade and division of work is a precondition.
3. If we want to live in peace, we have to understand Hayek's message that »the market is a mechanism that makes friends from enemies «.

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Annex

Table I: *Size of Government and Public Expenditure Composition, about 1960 and 1990 (percent of GDP)*

	Industrialized countries						Newly industrialized countries ^d
	Big Governments ^a		Medium-sized Governments ^b		Small Governments ^c		
	1960	1990	1960	1990	1960	1990	1990
<i>Total expenditure^e</i>	31.0	55.1	29.3	44.9	23.0	34.6	18.6
Consumption	13.2	18.9	12.2	17.4	12.2	15.5	9.1
Transfer and Subsidies ^f	11.9	30.6	10.4	21.5	6.9	14.0	5.7
Interest ^f	1.5	6.4	1.3	4.2	1.3	2.9	1.5
Investment ^f	3.1	2.4	3.2	2.0	2.2	2.2	2.7
<i>Expenditure by function</i>							
Health	2.6	6.6	3.0	5.9	2.3	5.2	1.8
Education	4.5	6.4	2.9	5.6	3.4	5.0	3.3
Social Security	13.5	19.5	9.6	13.9	6.2	7.9	1.0
Research and Development		2.0		1.6		2.0	
Environment		0.6		0.8		0.7	

Source: Compiled by Tanzi and Schuknecht from previous tables

^a Belgium, Italy, the Netherlands, Norway, Sweden (public expenditures more than 50% of GDP in 1990)

^b Austria, Canada, France, Germany, Ireland, New Zealand, Spain (public expenditures between 40- 50% of GDP in 1990)

^c Australia, Japan, Switzerland, UK, USA (public expenditures less than 40% of GDP in 1990)

^d Chile, Hong Kong, Korea, Singapore, early 1990s

^e Please note that the components of total do not add to the totals because some expenditures are not netted out from the subcategories

^f Central Government, 1972 instead of 1960 for interest and dividends. Transfers and subsidies for 1960 is mostly general government.

Table II Size of Government and Governance-Related Indicators, about 1990 (Percent of GDP)

	Industrialized countries			Newly industrialized countries
	Big Governments	Medium-sized governments	Small governments	
<i>Economic and Political freedom indicators^b</i>				
Political rights	10.0	10.0	10.0	7.5
Civil liberties	10.0	9.9	10.0	7.5
Economic freedom	6.6	7.2	7.6	7.5
<i>Administrative efficiency indicators^b</i>				
Efficiency of judiciary system	9.3	8.6	10.0	8.3
Red tape	8.1	7.8	9.0	8.9
Corruption	8.2	8.2	8.1	7.2
<i>Regulatory Efficiency indicators</i>				
Size of shadow economy	17.7	12.0	9.4	
Patents/10.000 population (intentiveness coefficient, 1990)	2.0	2.3	8.6	

Table III Government Performance Indicators, Selected »Small« Governments, and Newly Industrialized Countries, Early 1990s (% of GDP)

	Industrialized countries			Newly industrialized countries		
	United States	Japan	Switzerland	Chile	Korea	Singapore
<i>Economic Indicators</i>						
Economic Growth (percent, 1991-5)	2.3	1.3	1.6	7.4	9.5	8.8
PPP-based per capita GNP (US\$, 1995)	26.980	22.110	25.860	9.520	11.450	22.770
Inflation (1991-5)	3.2	1.4	3.2	13.9	6.2	2.5
Gross Public Debt (1994-5)	64.3	81.3	48.2	17.4 ^a	8.0	15.2
<i>Labor market indicators</i>						
Unemployment (mid 1990s)	5.4	3.3	4.7	4.6	2.4	2.7
<i>Social and distributional indicators</i>						
Life expectancy (1995)	77	80	78	76	72	77
Infant mortality (per 1000 live births)	9	4	6	12	10	4
Secondary School enrollment ratio	97	96	91	70	93	84
Educational attainment (mathematics scores, eight grade students, 1994)	500	605	545		607	
Income share of lowest 40% of households (about 1990)	15.4	17.7	18.1	10.5	19.7	17.3
<i>Economic and Political freedom indicators^b</i>						
Political rights	10.0	10.0	10.0	7.0	9.0	7.0
Civil liberties	10.0	10.0	10.0	8.0	8.0	7.0
Economic freedom	8.0	7.3	7.9	6.2	6.7	8.2
<i>Administrative efficiency indicators^b</i>						
Efficiency of judiciary system	10.0	10.0	10.0	7.3	6.0	10.0
Red tape	9.3	8.5	10.0	9.3	6.5	10.0
Corruption	7.8	6.7	8.8	7.9	4.3	9.3

Sources: Tables 2.10-2.12a

^a External Debt only

^b Ranking between 0 = worst and 10 = best

Table IV. Level of Fiscal Churning in Selected Industrial Countries^a (%)

Country/Year	Churning as a percentage of income taxes and transfers	Government expenditure as a % of GDP	Public expenditures without Churning
United States (1995)	9.0	32.9	23.9
Japan (1994)	11.6	34.4	22.8
Germany (1994)	15.7	48.9	33.2
Italy (1993)	22.7	57.4	34.7
Canada (1994)	11.7	47.5	35.8
Australia (1993-4)	6.5	36.8	30.3
Belgium (1995)	23.7	53.8	30.1
Denmark (1994)	28.0	59.3	31.3
Finland (1995)	15.5	57.9	42.4
Netherlands (1994)	21.1	52.8	31.7
Sweden (1994)	34.2	68.3	34.1
Average	18.2	50.0	31.8

Source: Arranged from OECD Economic Outlook (june 1998), p.163

^a Fiscal churning measures the extent to which the same households both receive government payments and pay taxes.