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The World Bank Interferes with Montenegro's Reform

Ana Isabel Eiras

The Montenegrin parliament is delaying approval of the government's package of free-market measures, designed to improve the investment environment and encourage informal small and medium businesses to enter the formal market. The package includes a reduction of employers' payroll taxes and contributions to pension and health care. This time, however, reform is being held up by the World Bank, not by local interests or politics. The World Bank is narrowly focusing on estimates of how the tax cut might affect government deficits and has threatened to withhold three loans if the parliament passes the package without World Bank approval.

- By limiting economic opportunity, the misguided policy of the World Bank will keep Montenegro mostly poor.
- Only reforms coming from inside a country—not those imposed by outside institutions—are sustainable.

The World Bank's dealings with Montenegro illustrate how World Bank officials use their power to advance their own interests, not those of the country that they are presumably trying to help. In fact, the mere presence of the World Bank and other international financial institutions (IFIs) severely undermines any serious domestic effort to implement reforms, often while politicians around the world use IFIs to enrich themselves at the expense of their people. The Bush Administration should end the harmful activities of IFIs and set an agenda for effectively reforming the lending practices of these institutions. Countries like Montenegro will have far better prospects of advancing reform and developing their economies without the IFIs standing in their way.

The Montenegrin Reform Package. Since 2003, the government of Montenegro has been discussing a bold pro-business reform package. The main item in the package is a 20 percent reduction in employers' payroll taxes and contributions to workers' pensions and health care. These reductions would be implemented in two phases: 10 percent retroactive to April 1, 2004, and the other 10 percent on September 1, 2004. Reducing taxes and contributions is intended to encourage more investment and greater business participation in the formal economy. The Montenegrin government believes that these rate cuts will broaden the tax base and collect more tax revenue.

The World Bank disagrees with the Montenegrin government. It argues that it is too late in the fiscal year to change the budget plan, that reductions in tax rates and contributions are too steep, and that these actions will cause revenue to fall,

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contributing to a budget deficit. The World Bank distrusts the government's dynamic budget projections (i.e., that tax revenues will increase by broadening the tax base) and refuses to give its "blessing" to the plan until it makes its own projections. Meanwhile, reform is stalled.

Cutting taxes may or may not generate a deficit in the short term. Broadening the tax base will offset part, if not all, of the initial drop in tax revenue. However, a short-term deficit does not merit such coercion by the World Bank.

Montenegro is imitating the success of countries such as Ireland, Estonia, and Russia in slashing their top tax rates. It is trying to provide opportunities for small, medium, and large businesses to stay in business, invest more, create jobs, and contribute to higher growth rates while attracting informal businesses to the tax rolls.

Without the tax cuts, economic opportunity in Montenegro is severely limited. By limiting economic opportunity, the World Bank's misguided policy would keep Montenegro mostly poor. If the World Bank's coercion becomes too onerous, Montenegrins would be better off to forgo World Bank loans and implement their own reform package.

The World Bank's attitude toward the Montenegrin initiative brings up an important, often overlooked point in developing economics: reform sustainability. Only reforms coming from inside a country—not those imposed by outside institutions—are sustained. For that reason, conditions and mandates imposed by the World Bank and other institutions are rarely met or sustained. Therefore, if the World Bank is really concerned about poverty, in this case poverty in Montenegro, it should support the government's initiative to reduce taxes instead of imposing its own thoughts of what may or may not work in the country.

What the Bush Administration Should Do. Economic opportunity in Montenegro and other poor countries would flourish if the World Bank did not exist. However, if eliminating the World Bank is not now a viable alternative, the Bush Administration should at least address the World Bank's failure to provide the developing world with incentives to move toward economic freedom.

The Administration should use the work of the International Financial Institutions Advisory Committee (IFIAC) to establish a solid framework for reforming the World Bank's lending practices. The IFIAC advocates a new system of performance-based grants for the World Bank's social programs, with institutional preconditions that countries must meet to qualify for a loan. These include sound fiscal policy, freedom of entry and operation for foreign financial institutions, and adequately capitalized commercial banks. Dependence on foreign loans and economic instability around the world will decline only in an environment that promotes the efficiencies and benefits of open markets.

The Administration should also support the Montenegrin government's efforts to advance pro-market reforms and use these efforts as example for other poor economies. Poor countries have a far better chance of raising the living standards of their people by opening markets and creating opportunity than by following the mandates of international institutions.

Conclusion. The Montenegrin government is trying to implement tax cuts and other reforms to create more opportunity for businesses and thus foster economic growth. However, by threatening to withhold the next three loans, the World Bank, which disagrees with the effects of the proposed reforms, is coercing Montenegrins into raising taxes to avoid public deficits. This coercion will both undermine Montenegro's economic prospects and weaken any reforms imposed from outside.

The Bush Administration should end the World Bank's counterproductive activities and set an agenda for effectively reforming the lending practices of this institution. Countries like Montenegro would have far better prospects of advancing reform and developing economically without World Bank intervention.

—Ana Isabel Eiras is Senior Policy Analyst for International Economics in the Center for International Trade and Economics at The Heritage Foundation.