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FIGHTING POVERTY IN MONTENEGRO THROUGH RESPONSIVE EVIDENCE-BASED SOCIAL AND CHILD PROTECTION

A REVIEW OF SUSTAINABLE REFORM SCENARIOS

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The authors further acknowledge that the research results are limited by the fact that they are based on the 2018 Statistics of Income and Living Conditions (EU-SILC) database – which entails information for a minimum wage that was significantly lower than what was introduced in 2021. Nonetheless, the model has replicated the new tax brackets and tax rates, with the caveat that the revenues from Personal Income Tax (PIT) may be underestimated.

The results published are based on the authors' own assessments and may slightly differ from the official EU-SILC statistical results collected in 2018 and published in 2019. Where such differences exist, they are noted in the document. After the research was carried out, Montenegro adopted a series of social protection reforms in 2021, which the publication takes account of to the extent possible.

The publication is based on the comprehensive micro-simulations report 'Simulating Redistributive Social Policy Scenarios for Montenegro' including detailed analysis and references. The document is available on request.

Abbreviations

At-risk-of-poverty (AROP)
Gross domestic product (GDP)
Financial Support Allowance (FSA)
Child Allowance (CA)
Personal Disability Allowance (PDA)
Care and Support Allowance (CSA)
Personal Income Tax (PIT)
Statistics of Income and Living Conditions (EU SILC)
United Nations Development Programme (UNDP)
United Nations Children's Fund (UNICEF)



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FOREWORD

Social protection is a beneficial way to mitigate poverty. It can improve the effectiveness of other anti-poverty measures and reduce inequality in Montenegro. However, to ensure the success of the social protection path, it is vital to:

- Be responsive to the specific needs of children and families living in poverty
- Carefully consider different social protection policy scenarios and find the right mix of schemes
- Ensure that the social and child protection system is sustainable

To support evidence-based policy making and support the Government of Montenegro in developing a social protection system that is well-designed, well-targeted and cost-effective, a team from Maastricht University developed a tax-benefit microsimulation model, with the support of UNICEF and UNDP Montenegro. Such an ex-ante performance assessment of social protection cash benefits is considered crucial when aiming to understand the ability of social protection to reach its targets, especially among vulnerable parts of the population.

Based on the national Statistics of Income and Living Conditions (SILC) anonymized data collected from 4,280 respondent households or 12,810 individuals, as well as discussions with key stakeholders, a set of different reform scenarios has been developed with the potential to combat national and child at-risk-of-poverty rates in Montenegro through social protection. The model allowed an estimate of the impacts, costs and cost-effectiveness of income tax and social benefit reform scenarios. The simulated scenarios considered improvements in the adequacy of the Child Allowance (CA) and the Financial Support Allowance (FSA), as well as new rates and brackets of the Personal Income Tax (PIT) to ensure the financial sustainability of the considered reform scenarios.

This document summarizes:

- an insight into the approach and background of the social protection scenarios development, together with
- considered alternatives towards universal CA and FSA expansion in Montenegro, supported by
- an alternative tax-benefit reform scenario with an optimal cost/effect ratio.

SOCIO-ECONOMIC TRENDS AND POVERTY IN MONTENEGRO

A BACKDROP FOR SOCIAL PROTECTION REFORM SCENARIOS

Montenegro's economy has grown substantially in the recent past. Its annualized growth rate was 4.2 per cent over the five years preceding the 2020 pandemic crisis. However, the difference between the overall revenues and expenditures remained negative over the same period, exposing the country's economic weaknesses (a high trade deficit, low productivity, high informality and significant risks related to public debt sustainability).

In 2020, Montenegro's economic outlook worsened. The global crisis hit the country hard, and growth contracted by about 15 percentage points. Labour force participation suddenly dropped by 5 percentage points, while unemployment increased to 19 per cent, exposing the newly inactive and unemployed and their families to the risk of poverty and deprivation. In 2020, the World Bank estimated that more than 34,000 Montenegrins may have fallen into absolute poverty¹ due to the economic downturn related to the pandemic.

Montenegro's economic outlook worsening in 2020

Economic growth	▼	by 15 percentage points
Labour force participation	▼	by 5 percentage points
Unemployment rate	▲	to 19%
People falling into absolute poverty (est.)		> 34,000

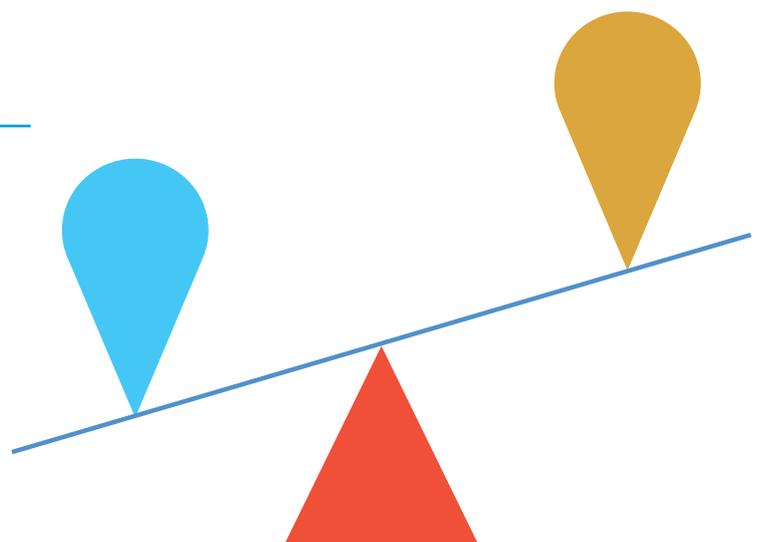
Before the pandemic, the at-risk-of-poverty rate (AROP)² in Montenegro was already among the highest in the region and higher than the EU-28 average. According to simulated results, with the national at-risk-of-poverty line at €188 per month for a single-person household, the at-risk-of-poverty headcount was 24.8 per cent in 2018.³ All social transfers combined (excluding pensions) contributed to reducing the AROP rate by 5 percentage points. Income inequality is also among the highest in the region and within the EU-28. The income of the 20 per cent of the highest income earners in the country is 6.7 times higher than the income of the lowest 20 per cent.

Post-pandemic income inequality

The income of the richest 20% of the country

6.7 times higher than

The income of the poorest 20% of the country



¹ This is calculated based on a poverty line of \$5.50/day in 2011 Purchasing Power Parity.

² It is measured as having equivalized disposable income that is less than 60 per cent of the national median disposable income. In 2019, the at-risk-of-poverty line (60 per cent of the disposable median income) corresponded to €188 for a single-person household and €395.60 per month for a four-person household including two adults and two children younger than 14 years.

³ The assessment is slightly different than the official statistical results published in 2019 which calculated the poverty headcount at 24.5 per cent.

CHILDREN AND ADOLESCENTS:

AMONG THE MOST VULNERABLE GROUPS IN MONTENEGRO

As per the SILC, one third of Montenegrin children from 0 to 18 are at risk of poverty, and among young adults (18–24), the AROP incidence was 30.5 per cent in 2019. These rates are considerably above the national average (24.5 per cent), indicating that children and young people are at a higher risk of living in poor households. According to 2021 EU Progress report for Montenegro, the proportion of young people not in employment, education or training (NEETs) increased to 27%.

Furthermore, the incidence of underweight children has more than doubled in the past five years and currently affects 3.7 per cent of children under the age of 5, while the share of young people and adolescents not in employment, education or training increased by approximately 10 percentage points between 2019 and 2020.

Children from 0 to 18

One in three at risk of poverty

Situation
may have
worsened
during the
pandemic.



BEFORE THE 2021 REFORMS

PREVIOUS SOCIAL PROTECTION BENEFITS

COVERAGE AND ADEQUACY

Social protection transfers contributed to a reduction in poverty and inequality in Montenegro, although the social protection system was limited in its effectiveness by low coverage and adequacy.

Overall, 60 per cent of the population lived in households reached by at least one social protection benefit. More than 50 per cent of financial social transfers (including contribution-based transfers, e.g. old-age and survivors' pensions) were distributed to the wealthiest two income quintiles, as compared to only 16 per cent of the population and 38 per cent of the poorest quintile covered by non-contributory benefits. While close to 70 per cent of non-contributory transfers were concentrated into the two poorest quintiles, the system failed to entirely cover the lowest end of the income distribution.

Coverage of the poorest fifth of the population by non-contributory benefits before the 2021 reforms

Covered by benefits	38%
Exposed to poverty risk	62%

Out of the 14 benefits and programmes of the main policy instrument regulating non-contributory social protection (also known as social assistance) in Montenegro – the Law on Social and Child Protection – two are the focus of the social protection scenarios development presented in this document: the Financial Support Allowance and the Child Allowance.





Social protection instruments in the focus of the reform scenarios

FINANCIAL SUPPORT ALLOWANCE – INADEQUATE FOR THE NEEDIEST

The main non-contributory benefit in the country, the FSA, had a very low coverage – covering only 9 per cent of people.⁴ Despite being the main poverty alleviation programme, it only reduced the AROP rate by 1 percentage point.

The current equivalence scale⁵ of the FSA does not differentiate between children and adults, and assigns a steeply declining coefficient to each additional household member. Currently, a two-member household receives 1.2 times the benefit of a one-member household, while families with five or more members are entitled to only 1.9 times the single FSA benefit amount.

Pre-reform social protection system (FSA)

Low coverage⁶ and adequacy⁷

At-risk-of-poverty rate ▼ 1 percentage point

Financial support does not sufficiently meet the needs of additional family members

PRE-REFORM CHILD ALLOWANCE – 84 PER CENT OF CHILDREN NOT COVERED BY THE BENEFIT

Due to being directly connected to the FSA targeting, the Child Allowance (CA), designed to reduce child poverty, only covered 9.5 per cent of all Montenegrin children in 2018 (up to and including 17 years of age), while, overall, one in three children live in households at risk of poverty. With these coverage rates, the exclusion error among children living in such households was 84 per cent, and many others living just above the at-risk-of-poverty line were not covered by the child benefit.

Pre-reform Child Allowance coverage (2018)

CA coverage of children (up to and including 17 years old)	9.5%
Children living in households at risk of poverty	33.7%

⁴ Data from the SILC 2018 round.

⁵ The non-proportional increase in financial needs and financial support for a household for each additional household member. With the help of an alternative equivalence scale, each household type in the population would be assigned a value in proportion to its needs, while taking into account the size of the household and whether the members are adults or children.

⁶ The share of the population receiving the benefit.

⁷ The share of benefit over total household income.

AFTER THE 2021 REFORMS

PROPOSED AND CURRENT REFORMS:

IMPACT AND FINANCING

Montenegro is clearly on the path towards reforming social assistance in the direction of expanded coverage to increase the poverty reduction effect. While expanding coverage can also have other benefits for strengthening the system and optimizing services, this document focuses solely on the at-risk-of-poverty reduction effect and how additional expenditure can be financed.



FINANCIAL SUPPORT ALLOWANCE REFORM TO INCLUDE THOSE CONTINUOUSLY EXCLUDED

Improving the benefit adequacy and expanding coverage through an increase of the FSA eligibility threshold indicates the maximum impact. Increasing the benefit size without adding new beneficiaries may be less justifiable to those that are continuously excluded. If the FSA were reformed to allow beneficiaries with 10 per cent higher income (compared to current beneficiaries who also receive the benefit) and if these additional beneficiaries were to receive 50 per cent of the current benefit size, the covered population would almost double.

The largest expansion in coverage would happen in the lowest quintile. The current equivalence scale of the FSA applies a strict coefficient of 0.2 per additional household member. The simulated option assigns a 0.5 coefficient for each additional adult and 0.3 for each child.



Expected effects of FSA scenarios

Scenario	Old FSA	Reformed FSA
Coverage: Households with children	13.1%	20%
Coverage: Overall population	9.2%	16.2%
Coverage: Beneficiary households	14,260	28,739
Overall at-risk-of-poverty decrease	▼1 percentage point	▼1.5 percentage points



CHILD ALLOWANCE REFORM WITH UNIVERSAL COVERAGE TO LIFT CHILDREN OUT OF POVERTY

Since June 2021, the Child Allowance has been provided to all children from 0 to 6 years of age and to children living in vulnerable families – beneficiaries of the PDA, CSA and FSA, as well as children without parental care. As a result of this, the number of child beneficiaries increased from 14,903 to 48,000.

In December 2021, a new amendment to the law was adopted: further extension of the CA to cover all children below the age of 18 in the last quarter of 2022.

Child allowance, if extended to cover all children under 18, can significantly reduce child and overall at-risk-of-poverty rates with higher cost efficiency

While multiple scenarios were simulated, the brief presents recently adopted reform scenarios that resulted in the CA being extended to cover all children: (i) under 7, and (ii) **under 18, with a flat benefit rate of €30 per child.**

Under all scenarios, national coverage with the CA would increase significantly, while children already receiving the CA would continue to be benefit recipients.

Expected effects of the CA scenarios

Scenario	Old FSA	Children under 7	Children under 18
Coverage: Households with children	8.3%	55.7%	100%
Coverage: Overall population	4.9%	31.4%	56.3%
Coverage: Number of children	14,903	53,768	146,959
Overall at-risk-of-poverty decrease	▼ 0.2 percentage points	▼ 1.4 percentage points	▼ 3.8 percentage points
Child at-risk-of-poverty decrease	▼ 0.3 percentage points	▼ 2.5 percentage points	▼ 6.7 percentage points

The expansion of the CA to cover all children also implies that a larger share of the population indirectly benefits from the transfer. **Currently, more than half of the total population (56 per cent) lives in a household with at least one child under 18 and would hence benefit. Coverage rates would particularly increase among the poorest households, as 68 per cent of the poorest 20 per cent of the population lives in a household with at least one child under 18.**

Once Montenegro starts to distribute universal benefits for all children under 18, the impact is expected to be threefold. The AROP rate may be reduced to 21.2 per cent. Furthermore, with Universal Child Benefit, the child AROP rate may decrease to 24.9 per cent, lifting 10,180 children out of poverty risk.

The expected threefold impact of universal benefits

UNIVERSAL CHILD BENEFIT <18	▶	AT-RISK-OF-POVERTY RATE REDUCED TO 21.2%
	▶	CHILD AT-RISK-OF-POVERTY RATE REDUCED TO 24.9%
	▶	10,180 CHILDREN OUT OF POVERTY RISK

ALTERNATIVE ROLL-OUT OPTIONS FOR UNIVERSAL CHILD BENEFIT

The simulations presented the government with different roll-out options – from immediate to more gradual expansion.

The different options imply a trade-off between:

- immediate expansion of coverage and an immediate poverty-reduction effect, including the ability to appropriately respond to the COVID-19 crisis, and
- a more gradual expansion with a spread-out poverty-reduction effect and at lower budget costs relative to GDP.

Alternative roll-out options considered

Option	Immediate	Gradual
Eligibility age increase	Three years for every calendar year	One year for every calendar year
Children covered	100% by 2025	77% by 2030 100% by 2033
Cost as percentage of current year GDP	1% of 2025 GDP (start decreasing afterwards, reaching 0.56% of 2035 GDP)	0.62% of 2033 GDP (decreasing afterwards)

Notwithstanding the fact that the costs of expansion of the CA to cover all Montenegrin children under 18 in 2022 will be significant in the immediate period (€40 million more than the pre-reform CA), due to projected demographic changes

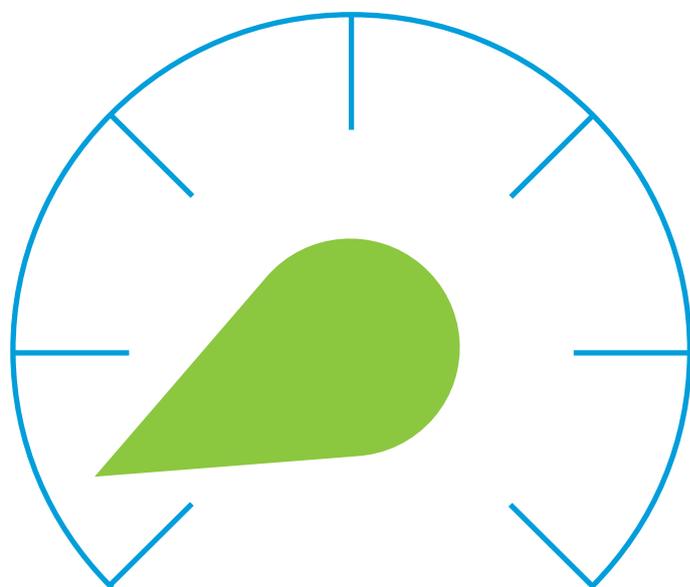
and economic growth the cost of Universal Child Allowance is expected to reduce to 0.56 per cent of GDP in 2035 (continuing to reduce in subsequent years).

COMBINED FSA AND CA REFORM

Nonetheless, the best results can be achieved by combining the two benefit reforms: the “CA <18” and the FSA reform can lift 31,800 Montenegrins out of poverty risk, reducing the AROP rate by one-fifth. Furthermore, the combined reforms could almost halve the gap between poor people’s income and the at-risk-of-poverty line,⁸ reducing it from 2.8 per cent of GDP to 1.6 per cent of GDP.⁹

Synergistic effect of combining CA & FSA reform

-
- ▶ CA <18 & FSA REFORM AT-RISK-OF-POVERTY RATE REDUCED BY **5.3% percentage points**
 - ▶ **31,800** MONTENEGRINS OUT OF POVERTY RISK
-



⁸ Individual poverty gaps are a measure of the “depth” or “intensity” of poverty, measured as the difference between the income of a poor person and the poverty line. The aggregate poverty gap is the sum of all these differences in a country. That amount is generally related to GDP to assess its size in comparison with the national economy.

⁹ If not otherwise specified, GDP refers to the 2018 GDP (the SILC survey calendar year).

FINANCIALLY SUSTAINABLE FUNDING OF UNIVERSAL CHILD BENEFITS AND FSA WHILE REDUCING WEALTH INEQUALITY

Considering that increased poverty reduction cannot be achieved without additional costs, the researchers have elaborated how the Personal Income Tax (PIT) could be reformed to cover the additional funding required. The different options considered hypothesized that the revenues obtained from a more progressive PIT (up to a maximum of €130 million per year) would be more than sufficient to support an expansion of the CA and FSA reforms considered in this document.

Overall, if both reforms (FSA and “CA <18”) were adopted, the government would need an additional €57.8 million (1.24 per cent of GDP¹⁰). In total, the two benefits cost 2.15 per cent of GDP. Using the model, the results are presented from the simulation of the following:

- the previous personal income tax system,
- the 2021 reform (called “Europe Now”), and
- an alternative PIT scheme adapted to Montenegro's income distribution.

Until 2021, Montenegro's Personal Income Tax scheme consisted of a simple scheme, imposing a flat tax rate of 9 per cent. This tax was inherently regressive since lower-income households had to allocate a proportionally higher share of their budgets.

In 2021 Montenegro adopted a new PIT system with the aim of reducing the labour tax wedge and increasing employees' net wages.

The alternative scenario proposes the most sustainable scheme as measured by the impact on both tax revenue and wealth inequality. It must be noted that the brackets are based on the minimum and average gross wages in 2018, and that before the recent minimum wage increase:

- the first bracket consisted of a non-taxable part of the wage up to the 2018 minimum gross wage;
- the second bracket included income up to the 2018 average gross wage, to which a tax rate of 15 per cent is applied; and
- the third bracket included incomes above the 2018 average gross wage, applying a tax rate of 22 per cent.

Tax reform scenarios: Impact on revenue

Scenario	Tax brackets			Tax rate	Additional revenue from PIT ¹¹	Share of total GDP from PIT ¹²
	Bracket	From	To			
Old	1	0.0	...	9%		
Europe Now	1	0.0	€700	0%	▲ €10.2 million	3.6%
	2	€701	€1,000	9%		
	3	€1,001	...	15%		
Alternative	1	0.0	€288	0%	▲ €63.4 million	4.75%
	2	€289	€766	15%		
	3	€767	...	22%		

¹⁰ The GDP refers to 2018, the SILC survey calendar year.

¹¹ Additional money collected from PIT comparing the old and reformed PIT.

¹² Total GDP from PIT within the reformed PIT scheme.



By introducing alternative brackets and higher tax rates for higher incomes, the government could invest the additional revenues from taxation in social protection benefits, creating a more redistributive tax benefit system. As revenues from PIT may increase by €63.4 million (to reach 4.75 per cent of GDP), with this new fiscal space Montenegro would be able to finance the FSA and the “CA <18” reform and ensure their long-term sustainability.

A PIT reform such as the alternative scenario would reduce income inequality as well. While the two tax reform scenarios are expected to have similar impacts among the two lowest quintiles (the poorest) of the income distribution, the alternative scenario is expected to collect its additional revenues from the richest – the fourth and (especially) the fifth quintiles.

SUMMARY OF SOCIAL AND CHILD PROTECTION REFORM SCENARIOS WITH POLICY RECOMMENDATIONS

- **One in four** Montenegrins overall and **one in three** children are already living at risk of poverty
- Universal Child Benefit extended to **all children under 18** can significantly reduce child and overall poverty
- A reform **combining** Child Allowance with Financial Support Allowance could possibly reduce poverty by 5.3 percentage points, lifting 31,800 Montenegrins out of risk of poverty
- The reforms could likely be **fully funded** by a new Personal Income Tax system increasing PIT revenue by €63.4 million (to reach a total of 4.75 per cent of GDP)
- An alternative Personal Income Tax scheme could possibly ensure the social and child protection reforms' long-term **sustainability** while **reducing** income **inequality**.

Policy recommendations

- To continue reforming the progressive Personal Income Tax system to collect additional revenue from higher income earners;
- To invest the additional revenues from taxation in social protection benefits, creating a tax benefit system that pays dividends to its participants proportionally;
- To increase the basic amount of the Financial Support Allowance and expand the FSA beneficiaries' base;
- To introduce a new methodology focusing on adequacy of the Financial Support Allowance which will better match with the needs and size of households;
- To continue extending the Child Allowance to cover all children under 18 to significantly reduce child and overall poverty with higher cost efficiency;
- To adopt a nationally defined absolute poverty line.



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