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## A CRITICAL REVIEW OF THE LEGAL FRAMEWORK OF FOREIGN DIRECT INVESTMENT IN MONTENEGRO

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### Abstract

*The subject of the research of this paper is analysis of the legal framework of the system of foreign direct investments in Montenegro. The authors point out the fact that the regulatory frame of foreign investments in Montenegro has been developed under specific circumstances. Lack of independent regulation of foreign investment law which lasted for a long time, the historical legacy of the legal system without a clear title holder of property rights, as well as the slow pace of implementation of the privatization process significantly restricted the most foreign direct investment. On the other hand, since the beginning of independent regulating of this area, there was a serious intention in Montenegro to create a competitive framework for foreign investments. The paper focuses on describing and explaining objective circumstances in creating and developing regulatory frame of foreign investments in Montenegro, but at the same time it points out to subjective disadvantages of the current solutions. Also, based upon the data from Doing Business Report, the most significant disadvantages in the regulatory frame for foreign investments in Montenegro are identified and analyzed.*

Keywords: foreign investments, Montenegro, legal framework, regulatory reforms

### 1. INTRODUCTION

Foreign direct investments (hereinafter: FDI), analysis of their effects, ways of attracting and removing issues for their bigger inflow are constant topic of numerous researches during the last decades. Also, this topic is still popular and challenging for theoretical analyses and empirical researches. FDI especially gains in significance in the period of the global crisis (Poulsen and Hufbauer, 2011). Namely, in the existing conditions of regulatory competitiveness and decline in number of quality investors, the practice shows that there are all forms of country's efforts against numerous limitations for foreign investments and no legal system is immune to them. Nowadays, in the conditions of sharp competition in attracting foreign investments, regulatory openness towards the investors imposes itself as an imperative. This principle suggests existing qualitative regulation with clear procedures which can be carried out in practice effectively. The details on the relationship of the countries towards the FDI through regulatory reforms after the global crisis confirm this attitude. Namely, according to the World Investment Report during 2011, at least 44 countries adopted 67 policies concerning the FDI.

Out of this number, 52 concert investment liberalization and promotion, whereas in 15 cases new restrictions were adopted. Also, the percentage of restrictive measures significantly decreased from 32% in 2010 to 22% in 2011. This trend is equal in developed countries and in the countries in transition (World Investment Report, 2012).

FDI now get equal attention by the market of developed countries, with a long legal culture, quality of legislation and its effective implementation in practice, as well as by the developing countries and developing countries in transition which build institutions of market economy through the process of transition. With regards to the influence of the quality of the legal regulations on the inflow of the foreign investments in the transition countries, researches conclude that appropriate legal regulation and functional institutions bring to bigger inflow of the FDI (Bevan et al, 2003). Researches in functioning of the legal frame in transition countries show that after nineteen nineties a lot of elements of the market economy were inbuilt in the legal systems of transition countries, but that the common disadvantage was inefficiency of its implementation. Numerous studies confirmed that the improvement in institution creation and appropriate legal system reduce the expected anxiety of the investors and speeds up bringing decisions on investing (Atlamonte, 2000). Murell (Murell, 1996) points out that the institutional transformation in transition countries is a difficult job that requires time. However, experience showed that the process of building market institutions in transition countries lasts much longer than the initial prediction (Meyer and Jensen, 2005). Apart from the quality of law, for attracting foreign investments in practice, its efficient implementation is also important and it is obtained by the country and its institutions. Numerous researches showed to the significance of efficient implementation of the legal frame on the inflow of the FDI. Bevan et al. (2003) empirically prove that *progress in legal extensiveness and in legal effectiveness encourage FDI, with the impact of legal effectiveness being stronger*. Efficient legal frame reduces institutional vagueness towards the foreign investors, it encourages conclusion and execution of contracts and reduces transaction costs for doing business in many other ways (Bevan and Estrin, 2004). A few papers researched the connection between the effectiveness and quality of regulation of the financial market, FDI and economic growth. All researches showed that countries with better financial system and regulation of the financial market attract foreign investments more efficiently and achieve bigger economic growth rates (Alfaro et al, 2004). Also, the study of Busse and Groizard from 2008 confirmed that countries with restrictive regulatory frame are not capable to attract FDI efficiently (Busse and Groizard, 2008).

## **2. THE MOST SIGNIFICANT OBSTACLES FOR ATTRACTING FDI IN MONTENEGRO**

Montenegro is one of the countries that has significantly improved in terms of business environment for foreign investments recently. Results of this process are evident - the biggest inflow of foreign direct investments per capita in Europe for three years continuously. Still, in spite of the above mentioned, the practice shows that the regulatory system is far away from being perfect and disadvantages should be removed in order to enable bigger inflow of the FDI in the future period (Central Bank of Montenegro, 2012). The expert public does not discuss weather to attract the foreign investments or not. Instead of that question, we have an intensive debate on the way how to attract them. One of the issues is whether the existing regulatory reforms that were carried out quickly and without more detailed coordination represent a good way for long term foreign investment attracting. The experience of transition countries in the

previous period confirmed the necessity of constant changes of the regulatory frame (Johnson, 2006). The countries that were late with reforms had problems to attract more significant investments. The best argument for the above mentioned attitude is the case of neighboring Serbia. Namely, the late reform of business environment in this country influenced the reduced level of foreign investments, which had a negative effect on numerous other economic indexes. Still, it is important to point out that some regulatory changes in Montenegro in the previous period often came across the review of the expert public in regards that they are in contrast to the constitutional system and existing legal frames, and in that way the discriminated domestic companies.

Based on the analysis of creating and functioning of the legal frame of FDI in Montenegro in the previous period, we can conclude that there used to be objective obstacles for attracting a higher level of the FDI. The most significant obstacles for attracting the FDI are as follows:

- long-standing inability to independently determine regulatory frame of foreign investments,
- historical legacy of legal system functioning without clear property holder,
- existing legal infrastructure and human resources that did not comply with the needs of social changes,
- incompleteness and inconsistency of the legal system in the beginning of the privatization,
- frequent changes of the legal regulations,
- absence of clear strategy in attracting foreign investments - especially lack of coordination in adopting regulation and adjusting its content;
- absence of sufficient degree of culture of law implementation,
- existing of various types of property,
- under-affirmation of the inviolability of private property,
- insufficient protection of creditors of contractual relations,
- underdeveloped corporate law with a big number of new legal institutes,
- economic, social and political circumstances under which the total transition of Montenegrin economy took place in recent years (since socialist republic within SFRY, republic within SRY, member of the State Union of Montenegro till independent country of Montenegro);
- not enough connectivity of the process of privatization with other transition and reformed processes (creating and efficient functioning of the market institutions, as well as protection of property and contracts).

The biggest number of above mentioned obstacles comes from inherited fifty years of socialist system which was not easy to transform according to the principles of the European law that Montenegro is striving to as well as other countries in the region. Upon starting the transition process, a lot of time was needed in order to provide good quality of law and to create appropriate institutions which will obtain its efficient implementation in practice. Comprehensive social changes through which Montenegro passed as a transition country left consequences on its legal system. Total loss of legal subjectivity and participation of Montenegro in various forms of Yugoslav federation put out many characteristics of Montenegrin legal system (and also legal

systems of other countries which used to form the Yugoslav federation). Former Yugoslavia, as a country between the east and the west had its own legal system with characteristics that nobody could sort into any popular legal family, because its legal system differed from the legal systems of other European countries due to the ideological differences. Specific approach to the socialism in which there was no state by social ownership, distinguished this legal system from other East European countries. On the other hand, countries of western Europe continued to develop their legal systems based on the private ownership. All above mentioned influenced the issue of quality of law and its efficient implementation in the area of foreign investments.

Apart from inherited historical obstacles, we think that the slowness in implementation of the process of privatization and choice of certain privatization models significantly limited a bigger inflow of the FDI. This process also took part unwillingly at a certain degree as Montenegro didn't have bigger capabilities to influence on it. According to some researches, business environment and the privatization are key factors for FDI development in transition countries (Holland and Pain, 1998). The researches also confirm that specific choices of the privatization models as well as legal, political and economic environment represent significant factors which influence decision making upon the investment (Roland, 2000, Carstensen and Toubal, 2004). Since the beginning of the privatization process in 1990, Montenegro privatized more than 90% of the state property. Without any doubts, privatization of the state companies brought to the increase of foreign direct investments, and later the privatized companies influenced the productivity growth with their operation as well as creating the new system of values.

### **3. DIRECTIONS OF FURTHER REGULATORY REFORMS**

Answer to the question of directions of further regulatory reforms in Montenegro in the area of FDI should be looked for in the movement of Montenegro towards the European Union, obeying and detailed monitoring of the attitudes and reviews of the investors, but also in more careful following of the reports on the competitiveness which can empirically measure the improvement of some countries in carrying out certain policies. By concluding and enforcing The Stabilization and Association Agreement, Montenegro undertook a contractual obligation to adapt its legislation with the EU law. The work on implementing the above mentioned obligation was intensified during 2012, upon bringing the decision on opening another set of talks for Montenegro to join the EU and educating working groups for the negotiation preparations. All above mentioned positively influences the attitude of the foreign investors towards the quality of Montenegrin legislation and it will be expressed in the upcoming period. Also, the practice accepts the opinion of the foreign investors on the quality of business environment and removing the business barriers. We have opinion that in the future period we should pay more attention to the reports on competitiveness of the well known international organizations in the parts in which the area of foreign investments is treated.

Competitiveness of the countries is measured according to various criteria and methodologies by various organizations. The data from the World bank through the Report on the easiness of doing business were analyzed for the needs of this paper. According to the index of the easiness of doing business of the World bank for 2013, Montenegro took the fifty-first place (table 1). Comparing with 2012, the worse result was achieved in the area of starting business (from 47th to the 58th position), registering the property (from 108th to the 111th position), oversea trade (from 34th to the 42nd position), protection of the investors (from the 29th to the 32nd position),

obtaining building permits (from the 173rd to the 176th position) and execution of the contract (from the 133rd. to the 135th position). On the other hand, a significant movement was made in the area of taxing and closing business. Also, if we compare Montenegro with other countries of the South East Europe, we can see that Montenegro represents more convenient environment for doing business than Albania, Bulgaria, Romania, Croatia, Serbia, Bosnia and Herzegovina, whereas it is a somewhat worse ranked than Macedonia.

**Table 1. Montenegro rank according to the World Doing Report 2011-2013**

<b>Indicator</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
Ease of doing business	56	56	51
Starting a business	46	<b>47</b>	<b>58</b>
Dealing with construction permits	170	173	176
Getting electricity	68	71	69
Registering property	117	108	117
Getting credit	8	<b>8</b>	<b>4</b>
Protecting investors	28	<b>29</b>	<b>32</b>
Paying taxes	125	108	81
Trading across borders	35	<b>34</b>	<b>42</b>
Enforcing contracts	134	133	135
Resolving insolvency	48	52	44

Source: World Bank

Still, the position of Montenegro (51) and the results of the index for certain areas lead to the conclusion that there is still a lot of space for improving administrative procedures connected with doing business and if Montenegro wants to remain an attractive destination for the FDI, it has to make efforts to improve business environment in the future as well.

By analyzing real problems of functioning of the legal frame of the FDI in Montenegro, comparative review of the indexes from the Report on the easiness of doing business but with accepting the attitudes of the foreign investors who do business in Montenegro, we can conclude that according to the following sectors we should pay more attention in the regulatory reforms:

- more efficient implementation of the law in practice,
- enforcing the level of the legal security,
- simpler and more efficient procedure for issuing building permits,
- better coordination among the institutions in charge of law implementation,
- sharper relation towards the investors who break contract obligations,
- further affirmation of the private property,
- improvement of the protection of the creditors,
- further reform of the judiciary,
- affirmation of the arbitration dispute resolution,
- more rapid changing of the legislation in certain areas,
- more effective resolving the issue of expropriation,
- increasing the degree of efficiency of the administration on all levels (municipal and federal).

#### **4. CONCLUSION**

The heritage of historical circumstances in which the legal system functioned, slowness in privatization and inappropriate choice of privatization models are modified by the authors as the most significant obstacles for bigger inflow of the FDI in the previous period. On the other hand, inefficiency in implementing law represents the most important disadvantage in the whole institutional system of foreign investments in Montenegro.

Although the paper mentioned some limitations and disadvantages, the regulatory system of the FDI in Montenegro is improving gradually. The basic conclusion of this paper is that the inflow of the foreign investments in the future period will significantly depend on further improvement of the quality of law and its efficient implementation in practice. The authors support the creation of liberal environment for foreign investments, but at the same time they point out to the need of protecting the legal security in the whole system of foreign investments. The authors especially emphasized the fact that during the review of the effectiveness of the institutions in charge of implementation of the law, we should show understanding for the intensity of social changes in the last twenty years in which the regulatory frame for foreign investments was developed. Without any doubts, the law with enough quality should monitor its appropriate implementation - i.e. the effectiveness of law as legal value. This discrepancy between legal and actual is especially expressed in the policy of attracting foreign investments. Regulatory competitiveness among transition countries influenced that the choice of the investor depended on the quality of the legal regulation at the beginning. Nowadays, it mostly depends on its implementation in practice because majority of transition countries liberalizes their systems both in a declarative and normative way, and adjusts them towards attracting direct foreign investments.

On the other hand, the culture of implementation and obeying law is not achieved by laws or the Government's decisions, but it takes time and social maturation for increasing the level of the efficiency of implementation of the law. Finally, the authors point out that further maturation of awareness of the need for foreign investment, strengthening the culture of the necessity of the application of law, institutional maturation of Montenegro's path towards the EU in the future will undoubtedly lead to the creation of a stable legal environment for foreign investment.

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