

The competitiveness of small European countries: A focus on Montenegro

Milorad Katnic
University Donja Gorica
Montenegro
milorad.katnic@udg.edu.me

and

Bojana Boskovic
University Donja Gorica
Montenegro
bojana.boskovic@udg.edu.me

Abstract: Competitiveness is of particular importance in the countries of the European Union and in the countries that are on the way to becoming members, especially after the adoption of the new Lisbon Agenda. Small countries are as a rule highly vulnerable to external shocks, face limitations in their ability to exploit the benefits of economies of scale and have very limited diversification possibilities a small population usually means limited human resources for the development of administrative capacity and for the workforce in general. In addition, due to the indivisibility of overhead costs, small states, have limited resources for innovation and the application of advanced technologies. Because of these characteristics, one expects that a small economy will find it difficult to meet EU competitiveness standards. A small economy on the path to joining the European Union, such as Montenegro, therefore must develop an effective administrative setup and an efficient regulatory framework in order to foster entrepreneurship and innovation to meet the mentioned competitiveness challenges.

Keywords: administrative costs, competitiveness, European Union, Montenegro, prosperity, small states

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Introduction: Competitiveness

There are various definitions of competitiveness of the country and various ways of measuring it. Furthermore, some authors, such as Krugman (1994) consider that competitiveness is meaningless when applied to the context of a national economy. Schuller and Lindbom (2009) share a similar opinion: they argue that there is no need for measuring the competitiveness of an economy at a national level. Nevertheless, the term 'competitiveness' is commonly used in the economic literature. Country officials in their assessment of the economy often emphasize their commitment to improve competitiveness. The European Commission has published numerous reports and analyses of competitiveness (e.g. European Commission, 2018; 2019a; 2019b; 2019c). When negotiating with candidate countries, representatives of the European Commission refer to the importance of building a competitive economy. In the progress reports of EU candidate countries, a special chapter is devoted to the issue of economic development and competitiveness (European Commission, 2018).

The common element of most definitions of country competitiveness is prosperity and living standards. In its competitiveness reports, the World Economic Forum defines competitiveness as a set of institutions, policies and factors that determine the level of productivity of the country, while the level of productivity represents a sustainable level of prosperity that a country can achieve (World Economic Forum, 2019). The European Commission links competitiveness to the ability of the population to enjoy a high standard of living, with high employment on a sustainable basis (European Commission, 2012). The Organisation for Economic Co-operation and Development defines competitiveness as "the degree to which the country in an open market economy produces goods and services that satisfy the international competition test while maintaining and increasing domestic real income at the same time" (OECD, 2001).

Porter (1990) offers an overview of the four stages in the process of building national competitiveness: 1) the stage of existence of the factors of production; 2) investment phase; 3) the innovation phase; and 4) the phase of wealth. In the first phase, successful industries gain an advantage at the international level with the help of factors of production, such as natural resources or labour. The investment phase implies the willingness and ability of a country's companies to invest intensively, especially in the best technology that allows access to the global market. In a situation where companies are successfully expanding and upgrading their business in specific industries and clusters, it is possible to talk about establishing an innovation phase. These three phases can be achieved if the country continues to upgrade its competitive edge. The wealth phase is the period in which the already achieved income and level of competitiveness are maintained.

Competitiveness indicators are useful for economic decision-makers in order to assess their economy's performance, over time and relative to other countries. In this regard, the most well-known competitiveness reports are: WEF (Global Competitiveness Index), International Institute for Management Development (World Competitiveness Rankings), World Bank (Doing Business Index), Heritage Foundation (Index of Economic Freedom), EBRD (Transition Report). While WEF and IMD indices take into account the performance of the overall economy and are more dependent on the institutional approach, DB and IEF are more focused on company regulation and practice.

Montenegro and its economic development

Montenegro is a small country located in the Balkan peninsula, with a population of 625,000 inhabitants (2003 census). It is bordered by Croatia, Bosnia & Herzegovina, Serbia, Kosovo and Albania, while Italy lies across the Adriatic Sea.

The history of Montenegro is long and rich. The first Montenegrin state started to take shape in the 8th century with the arrival of the Slavs and their mingling with the local population. Originally it was called Doclea, whose ruler received a royal insignia by Pope Gregory VII in 1078. Montenegro fell under the control of the Ottomans in the late 15th century, but acted as a *de facto* independent state until formal recognition came at the Berlin Congress in 1878. Despite being on the victors' side in the Balkan Wars and in World War I, it was annexed by Serbia and lost its sovereignty in 1918. After the Second World War, it became a part of socialist Yugoslavia, where it remained until 1992. Montenegro remained in a two-member federation with Serbia until 2006 when its citizens voted for independence in a democratic referendum. In 2017, Montenegro became a member of NATO and is on its path to becoming a member of the European Union. Accession negotiations with the EU began in 2012 and, realistically, Montenegro could meet membership criteria and become an EU member by 2025. Montenegro

is already benefiting from the EU accession process, primarily the visa-free regime and the possibility of free trade.

During most of its history, efforts to modernise and economically strengthen Montenegro were eclipsed by the need to defend its freedom. Thus, Montenegro missed the industrial revolution and the waves of enlightenment and liberalism that impacted Western Europe. The aggravating circumstance for economic development was an inaccessible, craggy and infertile territory; obstacles for the development of agriculture, transport infrastructure and trade. In socialist Yugoslavia, Montenegro had made economic progress through the construction of transport infrastructure and large industrial systems. Nevertheless, throughout the existence of socialist Yugoslavia, Montenegro remained one of its poorest republics, reaching a maximum of 71% of the average income per capita of Yugoslavia. The devastating earthquake that struck Montenegro in 1979 severely damaged the coast and the overall economy, increasing its relative stagnation compared with the national Yugoslav average. When Yugoslavia collapsed and, consequently, its common market, large industrial systems remained oversized for a small local market and were uncompetitive for the international market. Sanctions by the international community contributed to the collapse of the economic system, resulting in a drastic reduction in income and an increase in poverty. Per capita income, expressed in purchasing power parity, in 2000 was at the level of 29% of the EU average and the average weekly salary was less than 100 euros.

At the end of the 20th century, with the political distancing from Serbia, Montenegro began to build a separate economic system and take responsibility for its own economic affairs. The most important step on this path was the introduction, at the end of 1999, of the Deutsche Mark as the official means of payment. In parallel with the independent monetary policy, Montenegro started building a separate financial and fiscal policy. In order to establish an open economy, trade and capital flows were liberalised and a radical transformation of ownership relations via privatisation was implemented. Foreign investors gained the same rights as domestic ones (Katnic & Stankovic, 2016; Katnic & Luksic, 2016).

Recognizing the restrictions of a small market, Montenegro signed a Stabilisation Agreement with the European Union, as well as free trade agreements with CEFTA, EFTA, Russia, Turkey and Ukraine. With these free trade agreements, Montenegro became part of a large market and a potentially attractive platform for global investors (World Bank, 2017). Institutional progress in respecting international trade rules was also recognised by Montenegro's membership in the World Trade Organisation in 2012. Membership in the NATO Alliance in 2017 further strengthened the confidence of investors and their interest in investing in Montenegro.

With its improved institutional environment and FDI inflow, Montenegro recorded significant economic progress. In less than 20 years, nominal GDP has quadrupled, from about 1 billion in 2000 to over 4 billion EUR in 2017. Montenegro's GDP increased from 29% of the EU average in 2000 to 45% in 2017, measured by purchasing power parity. The growth of economic activity led to an increase in employment, an increase in salaries and pensions and poverty reduction.

International institutions have recognised the progress made. In its 2018 Human Development Report, the United Nations classified Montenegro in a group of countries with a very high level of human development (UNDP, 2018). Additionally, on the global lists measuring the quality of the business environment and the achieved level of competitiveness, Montenegro has improved its position. From the 70th place that Montenegro held in the 2006 DB Report, it now ranks 50th among 190 countries (DB, 2019). The first time Montenegro was assessed in the

World Economic Forum Report in 2007, it came in 82nd place among 131 countries; and in its Report for 2018, it came in 71st place among 140 countries. Reports on economic freedom also point to an improvement in the position of Montenegro, until 2017, when there was deterioration. In the 2007 Fraser Institute Report, Montenegro took 76th place, so that after the 59th position from 2016, in the 2018 Report, Montenegro fell back to the 72nd place. Similarly, in the Reports of the Heritage Foundation, Montenegro first took (in 2009) 94th place, in 2016 it was at 65th, and in 2018 it was 68th.

In addition to the achieved general progress, distinct changes for the better can be observed by analysing the position of Montenegro in international reports. Until 2014, Montenegro recorded constant progress in almost all of the reports while in the last few years there has been a decline in the ranking position. What is common in all reports is the assessment of the areas that pose a challenge to competitiveness and economic freedom. These include the rule of law, combating corruption, registering property, issuing construction permits and paying taxes.

Montenegro in the Global Competitiveness Report

WEF assesses the competitiveness of economies which together account for around 98% of world GDP. Up to 2017, the methodology used included 12 so-called areas or pillars, considered to have an impact on a country's competitiveness. Each pillar is quantified by a numerical indicator, on the basis of which countries are ranked in terms of competitiveness. The rank of the country is determined by scores from 1 to 7, with 7 being the best score for each indicator. The areas assessed are: institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication and innovation.

Methodologically, 12 indicators were sorted into three groups that explain factors of economic development: basic requirements; efficiency enhancers; and innovation and sophistication factors.

Each of these groups consisted of some of the 12 pillars. The WEF places each country at a certain stage of development and accordingly determines which of the 12 pillars are more relevant to its competitiveness. Montenegro is placed in the "efficiency driven phase", which means that the indicators from the efficiency enhancers group are relevant: education and training, labour market efficiency, technological readiness, state of financial markets and market size.

In 2018, the World Economic Forum changed the methodology for determining the global competitiveness index. The index continues to cover 12 so-called pillars, which are considered to be of particular importance in how they impact on national competitiveness. However, the total number of sub-indicators was reduced from 114 to 98, obtained on the basis of data from other organisations and from an Executive Opinion Survey.

Country ranking is determined by points from 0 to 100, with 100 being the ideal state for a single indicator. The areas being assessed are: institutions, infrastructure, application of information and communication technologies, macroeconomic stability, health, education and skills, goods market, labour market, financial system, market size, business dynamics and innovation capacity. These competitiveness pillars are grouped into four groups: business environment, human capital, market and innovation ecosystem.

The new Global Competitiveness Index 2017-2018 emphasises the fourth industrial revolution. It is also based on the idea that economies in their aspiration towards greater competitiveness should be led by a holistic approach rather than focusing only on a particular factor. Strong performance in one pillar cannot compensate for poor performance in the other. In order to increase competitiveness, no single area can be ignored.

The Global Competitiveness Report is designed to help policymakers, business leaders and other stakeholders around the world to shape their economic strategies during the Fourth Industrial Revolution. The essence of the "Agenda of Competitiveness" is the recognition that economic growth is the main driver of human development.

As the previous one, GCI 2017-2018 assesses competitiveness through factors that determine the level of productivity of an economy - which is considered the most important determinant of long-term growth and revenue generation. In order to prosper, economies must be open to new ideas, more resilient to external shocks, more efficient in accepting changes, determined to build an innovation ecosystem where innovations are present at all levels, and must adopt an approach in which human capital is a crucial factor in achieving success.

The top 10 countries in the world from the aspect of competitiveness in the GCI 2017-2018 report are: USA, Singapore, Germany, Switzerland, Japan, the Netherlands, Hong Kong, the UK, Sweden and Denmark. With a competitiveness rating of 85.6, the USA is closest to the concept of an 'ideal state'.

The high ranking of the USA is attributed to the following indicators: the labour market (1st place), the financial system (1st place), business dynamics (1st place), the capacity to innovate (2nd place) and the market size (2nd place).

In this report, Montenegro is ranked at 71st place, which represents an improvement of 2 positions relative to the previous year's revised ranking. Montenegro scored best in the 2010/2011 report, in 49th place, and the worst in the 2016/2017 report, in 82nd place.

Observing individual indicators and their movement, through the ten-year period 2007-2017, for which it is possible to perform methodological comparison, two characteristics can be observed: 1) expressed volatility, 2) deterioration of the position in recent years. This is especially reflected in the indicators that fall under the heading of 'basic requirements'. Significant deterioration in the ranking is related to indicators with regards to: institutions, macroeconomic stability and health and primary education. In this group of indicators, the only significant improvement made has been in terms of infrastructure, as the consequence of large investments in physical infrastructure in the previous period.

With regards to efficiency indicators, relevant to the current phase of development of the Montenegrin economy, the ranking is mostly stable and moves around 70th place, with the exception of a better position in the indicators related to the Financial Market and Technological Readiness. As it is the case with other small countries, the Market Size indicator measures a low ranking.

Indicators that relate to the business sophistication and innovation are perhaps the biggest challenge, since their ranking is in the entire ten-year period in the lower part of the table. These indicators are important in order for the country to be classified into the highest development

group and therefore it is a message for decision-makers to put the focus of their policies on supporting innovation and creating an environment for the development of new entrepreneurial ideas.

Bearing in mind that there has been a change in the methodology, during the preparation of the latest Global Competitiveness Report, the data from the last Report are not comparable with the data presented in the reports published during the past 10 years. However, the World Economic Forum applied a new methodology to data that was available one year ago, and based on this, published the revised rankings, shown in [Table 1](#).

Table 1: Montenegro in Global Competitiveness Index: 2017-2018.

Basic characteristics	2018		2017	
	Points (from 0- 100)	Ranking (out of 140)	Points (from 0- 100)	Ranking (out of 135)
GCI	59.6 ↑	71	58.2	73
1. Institutions	54.7 ↑	63	54.2	61
2. Infrastructure	62.2 ↑	86	61.4	85
3. Application of ICT technologies	57.1 ↑	58	55.4	56
4. Macroeconomic stability	69.7 ↑	102	69.7	105
5. Health	84.8 ↑	55	84.4	54
6. Education and skills	68.1 ↑	52	66.1	55
7. Goods market	60.9 ↑	45	57.9	55
8. Labour market	67.5 ↑	25	65	30
9. Financial system	63.9 ↑	51	62.3	57
10. Market size	28.2 ↑	132	27.6	127
11. Business dynamics	63.4 ↑	50	62.1	50
12. Innovation capacity	34.9 ↑	74	32.3	85

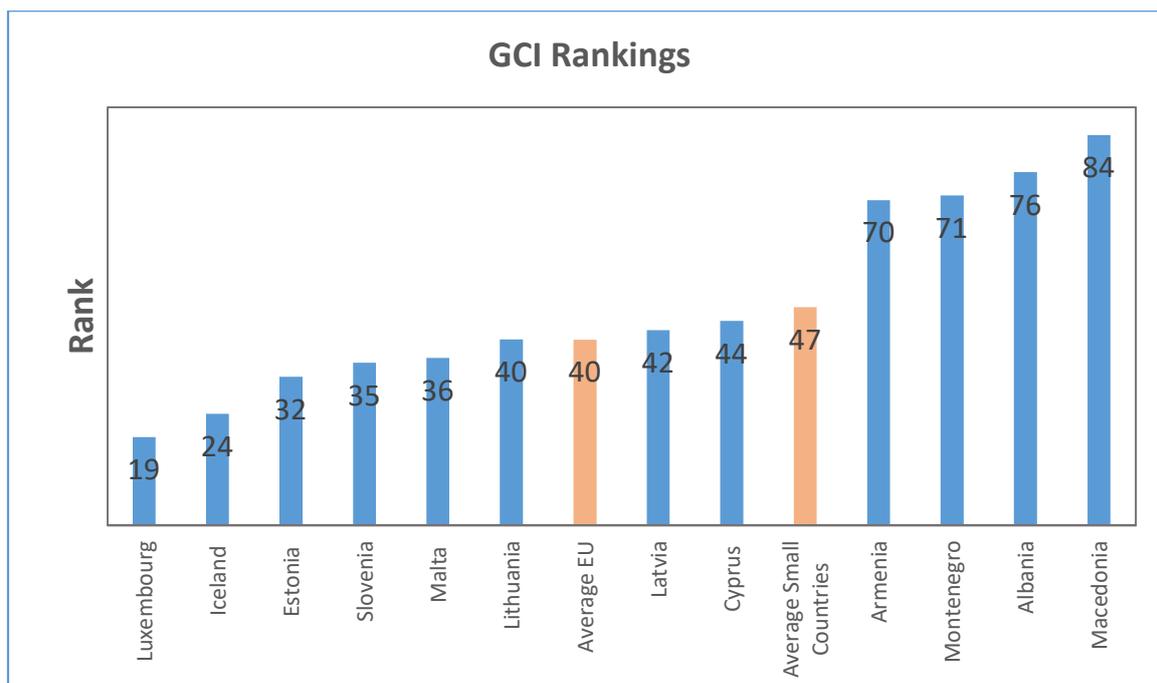
Source: GCI (2017 -2018).

The Index for 2018 in line with the new methodology shows that Montenegro records the best positions in the areas of: labour market, business dynamics, goods market, financial system and health. Of all indicators, the health sector recorded the best score of 84.8 points out of possible 100.

Montenegrin competitiveness compared to that of other small EU countries

The small states covered in this section are those with a population of about 3 million or less. Of the total number of countries analysed in the Global Competitiveness Report, 12 European countries fall into this category: Montenegro, Albania, Armenia, Cyprus, Estonia, Iceland, Latvia, Lithuania, Luxembourg, Macedonia, Malta and Slovenia. [Figure 1](#) shows the GCI score for 2018.

Figure 1: Global Competitiveness Index rankings of small European countries (2018).



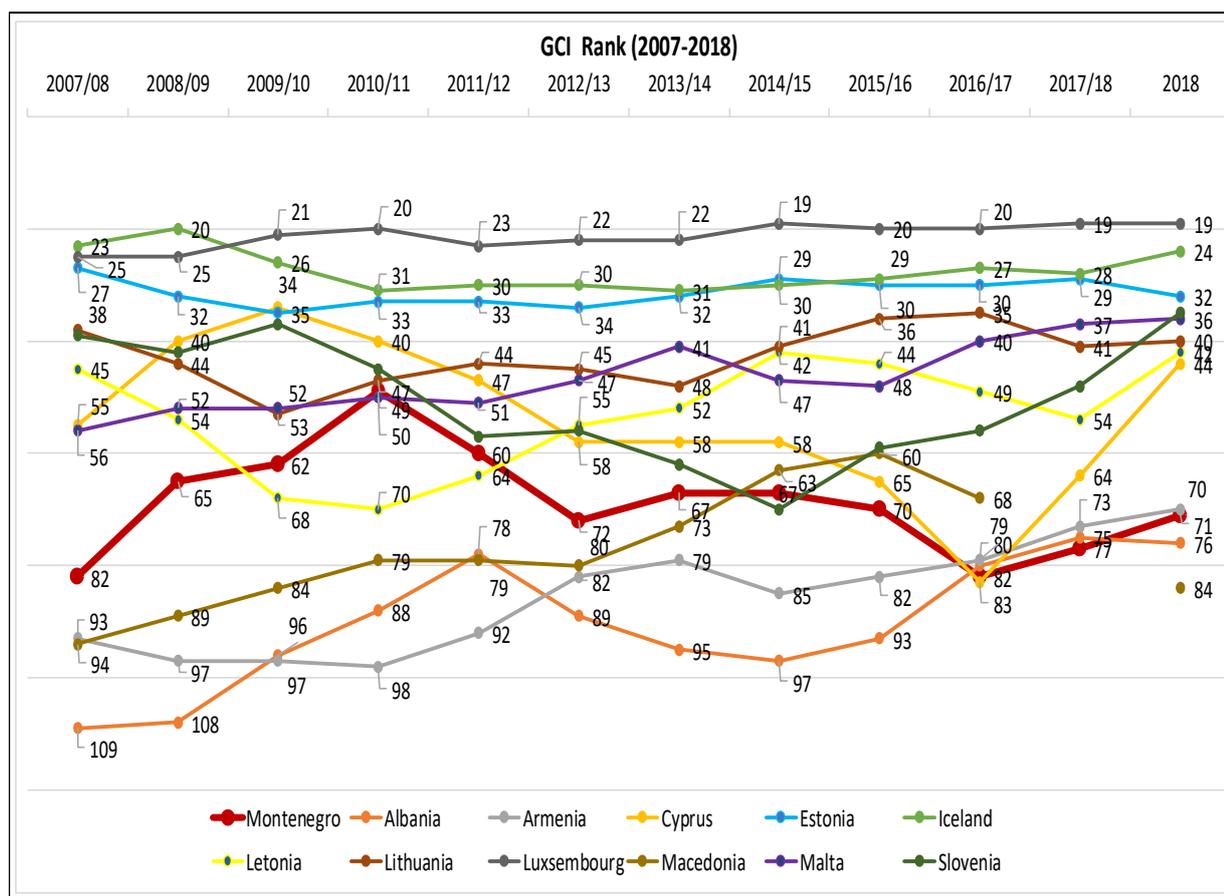
Source: GCI (2017 - 2018)

Montenegro occupies the 71st position and is ranked better only with respect to Albania (76) and Macedonia (84). The latter is the worst ranked small country in Europe. The best ranked small European country is Luxembourg (19). Apart from Montenegro, Albania (76) and Armenia (70) occupy positions in the lower part of the table, while Iceland (24) is in the top 25 in the overall ranking of the GCI. Luxembourg's competitiveness is highly ranked due to an extraordinary performance in in the areas of macroeconomic stability, the market for goods and the financial system. The lowest ranking is recorded in the area of market size, which also applies to the other small countries due to their natural conditions. The Icelandic economy also boasts macroeconomic stability and a strong position in terms of other indicators including the application of ICT, skills and the labour market and well-regulated health services. As with Luxembourg, the worst rated area is market size.

A more careful analysis of the competitiveness of small European countries shows that market size is a limitation for a number of indicators, and hence for the overall position in the global competitiveness ranking. In other indicators, there is no common denominator of good or bad characteristics of small economies. The economy of each of these countries has its own specific features and the same reforms may lead to different results. This is also logical, given that each country has a different political, social and economic environment and that for these reasons global movements affect them differently.

Analyzing trends in competitiveness ranking over the last ten years, small European countries fall into two groups. The first group of countries, whose rank is more or less constant, includes Luxembourg, Iceland, Estonia, Malta and Lithuania. The position of these countries on the scale of global competitiveness in the previous decade was consistently better than 50. Luxembourg, Iceland and Estonia have also kept their position continuously above the 32nd position.

Figure 2: Rankings of small European countries on the GCI: 2007-2018.



Source: GCI (2018)

The second group of countries consists of those whose position has changed significantly over time. Thus, Slovenia is characterised by a constant decline in ranking after the global economic crisis, until 2014, when recovery occurred. Cyprus shares the experience of Slovenia after the global crisis, with the difference that the downward trend has continued until the sharp fall in 2016, after which there was an improvement of as many as 38 positions. Latvian rankings have the character of classical cyclical movements, where cycles last for about three years. For the remaining non-EU member states, the situation is more atypical compared to the EU member states. Albania is characterized by cyclical movement, which does not start with a downward trend after the global crisis, but on the contrary, the peak comes in 2011, followed by a downward trend that has already been interrupted by recovery in the past three years. The Macedonian trend is completely different from all other countries, as there is a constant increase in ranking, starting from 2007, with the atypical situation that the data for 2016 does not exist, after which the first time there was a significant decline in the rating. In Armenia, the trend

most resembles that of Latvia, which shows cyclical movement. Also, there are no big oscillations in the rankings, because the rankings over time range from 70th to 90th place.

Montenegro has some of the characteristics of all the 12 observed countries. In the first few years, the reaction to the crisis did not result in a reduction of competitiveness, but was followed by the improvement of the position until 2010. After this, there was a sharp decline until 2012 when stagnation occurred until 2015, followed by a fall, which returned the country back to its position in 2007, and a slight recovery in the last report. In this context, Montenegro has the most pronounced volatility; changes cannot be attributed to the classical cyclical character and not just an upward or downward trend, while there are also sharp changes in positions.

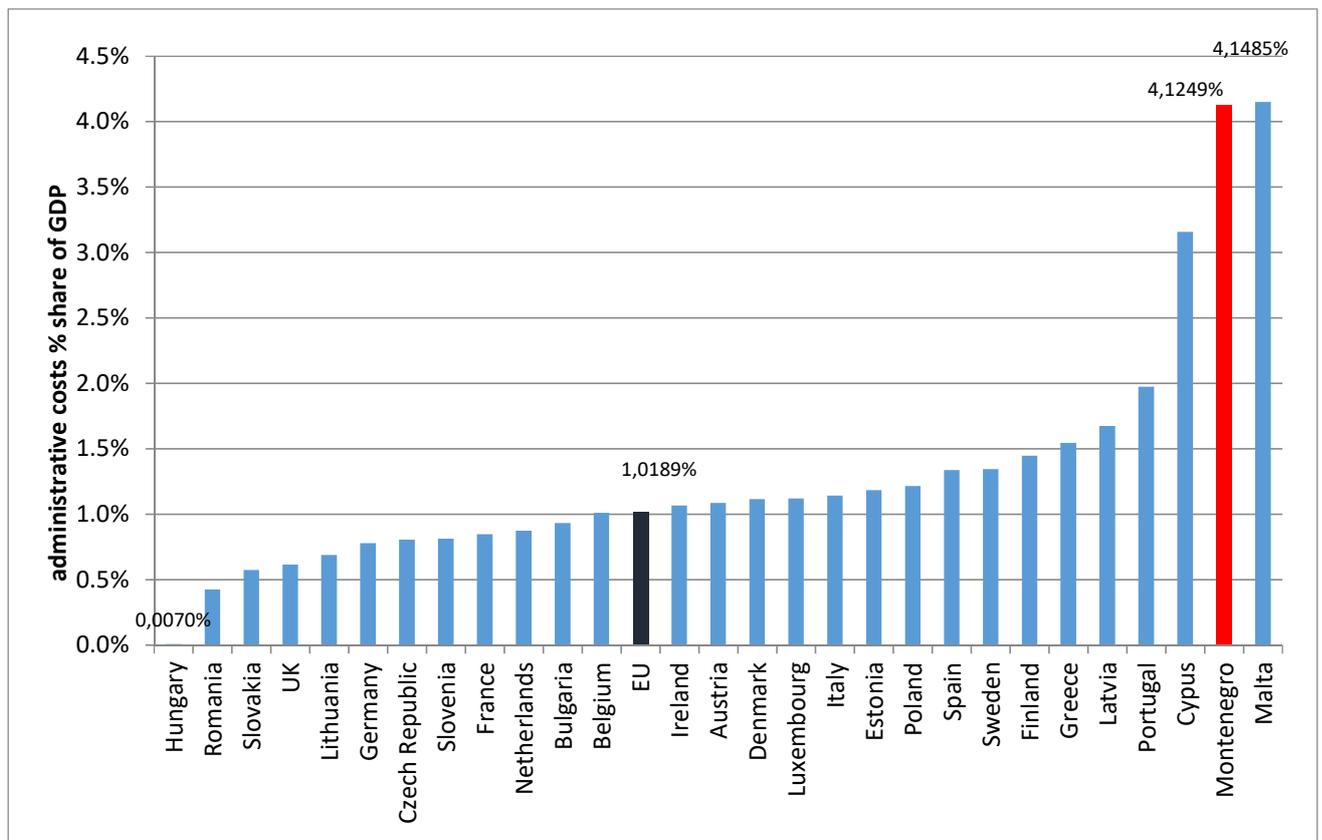
How can such movements be explained in the assessment of the competitiveness of the observed group of countries? Abrupt changes in competitiveness assessments or inability to preserve continuity can be a consequence of the lack of consistency in economic reforms, political stability, or insufficient administrative capacity for implementing required reforms of the economic system leading to competitiveness. Also, high volatility can be a consequence of exogenous shocks that small economies are by nature more affected by than large ones. Interestingly, among the ten most competitive countries in the world, six are not members of the European Union (Switzerland, USA, Singapore, Hong Kong, UK, Japan) and the best placed small country is Luxembourg, an EU member, in 19th place.

How can this data be interpreted? Did the EU regulations and administrative costs have an impact on the competitiveness of small countries considered given that such countries typically face far greater challenges in applying EU regulations than large countries.

In small countries, administrative costs tend to be relatively higher than is the case in large countries, mostly due to the fact that overhead costs cannot be downscaled in proportion to the population. Small economies also have a smaller absorption capacity for implementing EU regulations compared to large countries, which is negatively reflected through the higher cost burden. Research suggests that the situation in Montenegro is similar, and indeed is even more unfavourable, taking into account the characteristics of the economy, as shown in [Figure 3](#)).

Montenegro has a ratio of total administrative costs to GDP similar to Cyprus and Malta: the countries with the highest cost burden of GDP in the EU. They are also small states. Such data further suggests the challenge of small countries to adequately absorb EU regulations.

Figure 3: Comparative overview of total administrative costs in EU Member States and Montenegro, both as a percentage of GDP.



Source: Bošković (2017).

Challenges and opportunities of a small economy

Montenegro faces challenges characteristic of small countries, notably high dependence on international economic trends and consequently a high degree of exposure to external shocks, inability to influence the movement of prices in the international market, economies of scale constraints, and limited institutional capacity.

One of the most serious challenges of small economies is limited human talent. The number of quality people determines the amount of ideas and innovative projects that can be implemented. Montenegro has 620,000 inhabitants, out of which 272,500 represent the economically active population, and with negative demographic trends (the birth rate and natural growth rate are falling). Emigration, usually affecting the brightest and ablest, exacerbates this problem. An additional challenge in this context is the aging of the population. Most Western European countries share this challenge; but its consequences are significantly more visible in small economies.

Small countries often find it difficult to attract the best talent and it is difficult to keep the ones that are attracted for a long time.

Limited human capacities lead to challenges in the labour market. Large, especially infrastructural projects cannot be implemented with the domestic workforce. Investments lead to an increase in demand for labour, which leads to a rise in the cost of labour and/or sometimes with inadequate qualifications and ability. All this represents a limitation and can lead to a reduction in competitiveness. That is why small countries are under the challenge of a need for the foreign labour.

However, a larger inflow of foreign labour may, in a short term, change the demographic structure of a society in a small country, and this can lead to social and political uncertainties. It is a subject of debate as to whether the small European countries can deal with this problem on their own.

Apart from these challenges, in the case of the Montenegrin economy, labour legislation is inadequate and very rigid. A legal framework that involves complicated administrative procedures, inflexible requirements in terms of employment and the dismissal of workers, and duration of the labour contracts create additional threats to the competitiveness of the economy.

The fact that limited human capacities lead to a slow process of educational system reforms, exacerbate the Montenegrin labour market situation.

In a small system, personal connections, cronyism, state capture by interest groups, and political corruption tend to be commonly found. Policies are often directed towards satisfying sectarian interests and not general ones, and this will eventually lead to negative selection and poor incentives. State consumption and state regulation will grow for the purposes that are not in the interest of long-term sustainable growth and competitiveness. Even if society develops economically, and this development is not accompanied by the strengthening of institutions and a political system that is ready to accept this development, it will lead to instability. In such circumstances, in small systems, especially those without historically founded institutions, it is not easy to build an institutional framework for long-term sustainable growth.

In a small system, the costs of political order and the provision of public goods are relatively higher and more burdensome for the citizens and the economy. As has been argued above, the Montenegrin economy is heavily burdened with administrative costs. It has been estimated that over 4% of gross domestic product is spent by companies to comply with regulatory requirements (Bošković, 2017). This is mostly due to the small size of the economy and the lack of administrative capacities, which lead to constraints on the ability to adequately and more efficiently absorb regulation.

In small economies, large capital projects tend to be relatively expensive, and therefore not economically viable due to the problem of their financing. For example, Montenegro has long delayed the construction of its highway. According to estimates, this project would cost about €2 billion, which is about half of Montenegro's GDP, raising questions about the sustainability of such a project. In addition, the implementation of this project has sparked considerable discussion with international financial institutions and the European Commission, in the light of the choice of partner selected (Chinese company), the contracted amount and method of financing. This serves as an example of how small countries not only face the challenge of relatively expensive infrastructural projects, but also political challenges that arise from integration process which could limit their choices in the process of choosing partner or financing method.

Another matter that weakens small economies is that they often have a higher risk profile, due to a lack of economic diversification and, depending on the state of financial markets, may have a lower credit rating, leading to pressure on public debt, implying a smaller fiscal space.

Conclusion

Small countries face serious challenges in building a competitive economy. The most common constraints affecting competitiveness relate to the small domestic market, a high degree of exposure to external economic shocks, administrative and institutional problems resulting mostly from relatively high overhead costs and limited human resources, and inadequate infrastructural development, again associated with high overhead costs.

Yet, in spite of these downsides, many small countries succeed economically, and it is in this regard that we have referred to the example of Luxembourg. Due to free trade agreements, relatively free movement of people, availability of transferable technologies, good economic governance and appropriate institutional frameworks, small countries like Luxembourg can generate high income per capita for their citizens and promote economic growth. Smallness is not necessarily a constraint to development.

Montenegro needs to strengthen its economic governance, invest in institutional and infrastructural development, and put in place effective regulatory frameworks. In such an environment, Montenegrin business is likely to flourish and the economy will progress, ushering in prosperity to its citizens. Such an environment should also encourage talented individuals to create, produce and innovate, thereby fostering entrepreneurship and thus improving the competitiveness position of the economy of Montenegro.

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