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Pursuant to Resolution 817 of the United Nations Security Council, the United Nations provisionally refers to the country for all its purposes as "the former Yugoslav Republic of Macedonia."
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EXECUTIVE SUMMARY

BACKGROUND
At the behest of the Government of Macedonia, the United Nations Development Program organised a Blue Ribbon Commission consisting of domestic and foreign experts to review the economic situation of the country and to provide a programme to accelerate the country’s growth, to alleviate unemployment and to prepare the country for entry into the European Union.

KEY GOALS OF THE REPORT

Members of the Macedonian Blue Ribbon Commission believe that in the ten year period following the implementation of the recommendations of this report, Macedonia will have made major progress toward the following objectives:

- The Macedonian economy will have experienced a period of sustained economic growth and created a substantial number of new jobs, cutting unemployment by at least one half. Poverty and inequality will have been sharply reduced, and the education, health and pension systems will have been reformed.

- The Macedonian economy will be fully integrated into the global economy. The share of exports in GDP will be significantly higher than it is now, there will be a substantially higher level of foreign direct investment in the country, on a per capita level comparable to other transition economies in the region, and the capital account will be fully liberalised.

- Macedonia will have considerably stronger, more efficient, and more credible institutions required for membership in the European Union.

- Macedonia’s government will carry out its functions efficiently. Corruption and overregulation will be significantly reduced, and the functioning of the legal system will approach European norms. Government functions will be depoliticised, and streamlined. Important government responsibilities will have been decentralised, with local governments adequately financed and able to provide key public services to meet the needs of their residents.

The key to the achievement of this vision lies in concrete steps needed to bring about dynamic and sustainable growth and in the implementation of a new wave of reforms in the key segments of the country’s economic and political system. These reforms are directed toward:

- increasing Macedonia’s integration into the global economy and moving the country toward membership in the European Union (EU);
- raising the dynamism of the private sector through tax reform, deregulation and privatisation and the creation of effective institutions combined with the elimination of institutions that are not providing sufficient social benefits;
- increasing the efficiency of the government’s functioning through fundamental changes in government operations, reforms in the functioning of the judiciary and the civil service, and the creation of effective methods of fiscal decentralisation.

KEY ASSUMPTIONS

Macedonia will affirm itself as a citizen-oriented, stable and democratic country. Regional political stability will contribute to favourable business climate and the Macedonian economy will not be faced with the sort of economic and political shocks observed during much of the transition period. We assume that the policies proposed in this Report will receive broad public support as well as the support of most, if not all, of

1The former Yugoslav Republic of Macedonia, hereinafter referred to as Macedonia.
Macedonia’s political parties and thus they will be consistently and intensively pursued by all governments over the next decade.

THREE MAJOR STRUCTURAL WEAKNESSES

In the 1990s, Macedonia implemented important first-generation reforms associated with macroeconomic transition. Reforms pertaining to price stability, price liberalisation, foreign trade liberalisation, and small privatisation were carried out with some success, but other reforms now require further efforts. The implementation of the so-called second-generation reforms, important for achieving dynamic and sustainable growth, has been slow and unsatisfactory. As a result, throughout the transition period, aggregate output growth in Macedonia has been insufficiently robust to overcome interruptions from external shocks, while the unemployment rate has remained exceptionally high. Therefore, structural and institutional reforms must play a key role in accelerating economic growth and creating new jobs. The Report identifies three major structural weaknesses that are responsible for Macedonia’s slow growth and high unemployment:

- Insufficient integration into the world economy (low globalisation), which limits the level of competition on the domestic market;
- Unfavourable business environment, which is characterised by an excessive regulatory and tax burden, insecure property rights, perceived corruption, poor corporate governance, etc., and which acts as an impediment to the creation of a dynamic and vibrant private sector, and
- Poorly functioning domestic institutions and excessive political influence in the economy, as seen by the instability in government policies, an institutionally weak civil service and ineffective judiciary, excessive connections between the interests of government officials and large companies, etc.

MAIN RECOMMENDATIONS OF THE BLUE RIBBON COMMISSION

Although the Blue Ribbon Commission Report follows a somewhat different structure, we present the main recommendations in seven broad areas:

- Preserving sound and credible macroeconomic policies
- Greater exposure of Macedonia to globalisation;
- Reducing the costs of doing business;
- Revisiting the role of the state;
- Building a trust in institutions,
- Preparing for EU accession, and
- Reforms aimed at securing future economic prosperity.

PRESERVING SOUND AND CREDIBLE MACROECONOMIC POLICIES

- Pursue a flexible macroeconomic policy of government budgets that are balanced over a medium-term time horizon
- Improve the planning and management of public expenditures
- Preserve the current exchange rate regime and prepare an exit strategy for abandoning the Denar-Euro peg in the longer term

GREATER EXPOSURE TO GLOBALISATION

Deepening trade integration

- Fully exploit export opportunities offered by the Free Trade Agreements (FTAs)
  - Negotiate reduction of non-tariff barriers imposed by regional trading partners
  - Provide for cumulative rules of origin
  - Expand FTAs to provide for easier trade in services
  - Harmonisation and unification of the regional free trade agreements
  - Establish effective mechanisms for trade dispute settlements
- Expand lending for exports, promote export insurance, reduce administrative barriers to foreign trade
- Reduce customs procedures and simplify and expedite formalities for firms

Blue Ribbon Report
engaged in international trade
- Invest in airport and other international transport infrastructures
- Reduce differences in effective tariff protection across sectors
- Ensure predictability, transparency and speed of border crossings
- Strengthen commercial diplomacy – promotion of trade, FDI and tourism

**Increasing the capital mobility**
- Rapid capital account liberalisation in the medium term
  - Encourage foreign competition in the banking system
  - Increase visibility of Macedonia on global capital markets
  - Gradually relax restrictions on outward portfolio investments

**Encouraging the knowledge transfers and spillovers**
- Increase student mobility
- Enhance participation of the academic community in international research networks

**CREATING A BUSINESS-FRIENDLY ENVIRONMENT**
- Reduce the tax burden on wages and business activity
- Visible (and frontal) anti-corruption campaign to reduce the “bribe tax” and shrink the “grey” sector of the economy
- Reduce the regulatory and administrative burden on business
  - Streamline and simplify regulations
  - Introduce regulatory impact assessments
- Improve access to financing through increased foreign competition, bank consolidation and enhanced bank supervision
- Modernise and complete the land cadastre
- Ensure strict law enforcement
  - Rapid resolution of contract and property disputes
  - Ensure level-playing field for companies
- Invest in the communications and transportation infrastructure

**REVISITING THE ROLE OF THE STATE**
- Privatise non-core government activities
- Reduce government regulation, stress the use of international standards, emphasise rules over the discretion of officials, and reduce administrative staff
- Constantly re-evaluate and widely publicise judicial reform
- Upgrade and specialise judicial expertise
- Resolve government claims against large companies
- Imposing hard budget constraints by the public enterprises

**BUILDING TRUST IN THE INSTITUTIONS**
- Visible results in combating corruption
- Protection of ownership rights and enforcements of contracts
- Introduction of merit-based personnel policy in the civil service
- Depolitisation of the administration
- Equitable representation in the public administration based on criteria of competence and political neutrality
- Introduction of performance management
- Strengthening transparency, accountability and control (external and internal audit) at all levels
- Encourage participatory budgeting and budget monitoring by citizens
- Easier access to justice: quicker, more efficient and simpler legal protection system
**PREPARING MACEDONIA FOR THE EUROPEAN UNION ACCESSION**
- Proper sequencing of the approximation of national legislation
- Strengthen regulatory bodies in EU context
- Preparation for management and administration of structural funds
- Negotiation of individual chapters of the Acquis
- Strengthening the role of the Parliament in directing and monitoring of the EU integration process

**SECURING THE FUTURE ECONOMIC PROSPERITY**
- Broaden access to primary and secondary education
- Dissemination of entrepreneurship culture from the primary education
- Large-scale formation of English language skills
- Management education
- Update state universities’ curricula and introduce mechanisms for quality assurance
Foreword

The Blue Ribbon Commission for Macedonia was formed in the spring of 2005 by the United Nations Development Programme (UNDP) in response to a request by the Government of Macedonia. Under the leadership of Kalman Miszei, then Assistant Administrator and Regional Director of the UNDP Regional Bureau for Europe and CIS, the UNDP has established Blue Ribbon Commissions in several other transition countries. The purpose of these Commissions was to produce “Blue Ribbon Reports,” which have achieved in each of them great success in terms of focusing on the key development concern, analysing it thoroughly, considering alternative policy solutions and then putting together a set of policy proposals that are given to the Government for consideration.

Common to them all is that they each address the most urgent reform needs of the country in question and then propose remedies to newly formed governments right at the outset of their mandate. While the focus in other countries, for instance, was on general governance problems and the need for reform of the state, the Macedonian Blue Ribbon Commission identified the situation of continued sluggish economic growth as the most pressing development problem in the country. For this reason, the topic Achieving Dynamic Economic Growth became the focus of the Report.

In our view, there are two features which make this report different to the many other reports prepared by International Organisations that also address key development concerns affecting a given country.

First, the timing chosen for the preparation and release of these reports is in advance of elections and soon after the new Government takes Office. This is in part due to a conviction that there is no better time for a government to take decisive steps toward a desired direction than at the beginning of its mandate. This was also the reason why the Blue Ribbon Report for Macedonia was set to be released into the public realm when the new Government – of whichever colours constituted – was fully assembled and ready to go.

Second is the independence of the members of the Commission as well as the consensual nature of their analyses and recommendations. The idea behind this formula is to find the most competent domestic and international experts to address the topic and then let them write, rewrite and edit the report. The period it took to produce the Macedonian Report has been filled with stimulating discussions, numerous choices and compromises, but also with a clear focus toward producing a report that can truly have an impact. Some would say it already has.

The Blue Ribbon Report we have in front of us is a synthesis of the thoughts of extremely knowledgeable people with one focus on all their minds: how to provide the best set of policies and incentives that would drive the Macedonian economy toward dynamic economic growth. Most of the members of the Blue Ribbon Commission are economists, some are lawyers; the majority have an academic background along with a practical political experience; many Commission members are either currently involved in the private sector or have been at some point, thus enjoying an in-depth understanding of the incentives needed for business to succeed in today’s global environment.

The process of preparing such a comprehensive report never occurs in vacuum. It is filled with extremely competent and committed people. The Macedonian Blue Ribbon Commission was co-chaired ably by Dr. Josef Brada and Dr. Taki Fiti, and consisted of the following members: Dr. Ksente Bogoev, Dr. Gligor Bishev, Dr. Vladimir Filipovski, Gazmend Kadriu, Dr. Gordan Kalajdziev, Dr. Vladimir Kandikjan, Dr. Gordan Kalajdziev, Dr. Srgjan Kerim, Dr. Mihail Petkovski, Dr. Goce Petreski, Dr. Trajko Slaveski, Dr. Marek Dabrowski, Dr. Vlado Dimovski, Dr. Zdenek Drabek, Dr. Karel Dyba, Dr. Paul Hare, Dr. Malgorzata Markiewicz, Dr. Kalman Mizsei, Dr. Marcus
Noland, Dr. Gabor Peteri, Dr. Ben Slay, Dr. Colin Talbot and Dr. Frederick Thompson. I would like to thank them for their commitment. I would also like to thank our own Norimasa Shimomura, Vesna Dzuteska-Bisheva, Lilian Kandikjan and particularly Ljupco Gjorgjinski who worked tirelessly until the Blue Ribbon Report was finally completed.

This Report, in short, is about a simple idea whose time has come: Macedonia to start experiencing dynamic and sustainable economic growth. It is, moreover, about how best to achieve that. The Blue Ribbon Report contains policy proposals that its commission members think are best suited to achieve this aim. It is now up to the future to retrospectively adjudicate their virtues, though the present may certainly bear witness that the preparation of these proposals was incredibly thorough.

Skopje, September ‘06
Maria Luisa Silva Mejias
UNDP Resident Representative
UN Resident Coordinator
Introduction by Team Leaders

The Blue Ribbon Commission for Macedonia was formed by the United Nations Development Programme (UNDP) in response to a request from the Prime Minister of Macedonia. In making this request, the Prime Minister reflected on the success that similar UNDP Blue Ribbon Commissions have had in influencing policy in other transition economies. While these countries, like Macedonia, have already received much advice from many sources, the strength of the Blue Ribbon Commissions comes from two unique features. The first is that they combine local experts with foreign experts, thus bringing together those who have a deep knowledge of local conditions, aspirations and obstacles to progress with those who have encountered similar problems and developed creative solutions in different settings around the world. The second strength is that each Blue Ribbon Commission, by reflecting on the country’s goals and aspirations, is free to decide for itself both the problems to be addressed and the policies appropriate to resolving those problems.

Given the record of these Commissions in meeting this objective, there was a legitimate expectation that a Blue Ribbon Commission for Macedonia could provide policy guidance that would help any Macedonian government to meet the most important economic desires of Macedonia’s citizens. These desires include faster economic growth, a reduction in unemployment, a deeper integration of Macedonia in the global economy through increased trade and foreign direct investment, a positive and effective role for the government in promoting the private sector and providing public services, and, above all, making the Republic of Macedonia a credible and attractive candidate for membership in the European Union.

Some members of the Commission met and consulted during the Summer and Autumn of 2005, and these consultations resulted in a draft report on Macedonia’s economic prospects and policy options. This draft served as the basis for intensive meetings of the entire Commission in January of 2006 in Skopje. During these meetings, various policy options and approaches were discussed with the objective of developing a coherent economic program that:

- had clear and measurable objectives so that progress in its implementation could be easily judged by the Macedonian public;
- was internally consistent so that the policies recommended were mutually supporting;
- addressed three key areas of concern – globalising the economy, promoting a business-friendly environment and making the government a partner, rather than an obstacle, to economic prosperity.

Once that overall strategy was agreed upon, existing chapters of the report were finalised and additional chapters were commissioned on topics that required more extensive analysis and policy recommendations deemed important to include in the Report.

In developing this Report, the members of the Commission acted as independent agents, and neither the Government of the Republic of Macedonia nor the UNDP sought to influence the recommendations contained in this report. Of course, individual members of the Commission did bring different viewpoints and approaches to their work, based on their individual experiences in economic policy making and analysis, whether in the Republic of Macedonia or in other countries. Thus, the degree of consensus that was achieved with respect to the final draft reflects the broad agreement reached from many different starting points about the problems facing the Macedonian economy and also about the ways in which the country’s economic future can best be secured.

As mentioned above, this Report and its recommendations are mainly for the purposes of the Government of the Republic of Macedonia. However, there could very well be a...
wider group of potential users of the Report, including the Parliament of the Republic of Macedonia and its various commissions, the business community, the academic community, and all the other institutions that must contribute to a more dynamic growth of Macedonia’s economy. Indeed, we encourage public discussion of the Report, because such discussion is the surest way of embedding pro-growth and pro-globalisation policies into the country’s political dialogue. While such public discussion may uncover additional ways of addressing Macedonia’s economic future, we believe that a sound and productive discussion of the report does have to be based on an understanding and acceptance of the weaknesses in Macedonia’s political and economic life that the report identifies. A denial of these weaknesses or an underestimation of their impact on the country’s prosperity will undermine the urgency with which these problems have to be addressed.

The members of the Commission are grateful to the UNDP for accepting the request of the Macedonian Government to have this report produced. The UNDP Office in Skopje did an excellent job of organising the work of the Commission and of securing the funding for it. The leadership and support of Mr. Frode Mauring and Ms. Maria Luisa Silva Mejias, the two UNDP Resident Representatives during the time in which the Commission was active, were critical for the success of the Commission’s work. The members of the Commission also wish to thank Mr. Norimasa Shimomura, Mrs. Vesna Dzuteska-Bisheva, Mr. Ljupco Gjorgjinski, and Ms. Lilian Kandikjan of the Skopje UNDP Office for their contributions in organising the funding and logistics of the Commission’s work as well as for the information, suggestions and research they provided during the course of the Report’s presentation. Finally, the members of the Commission wish to thank Dr. Ben Slay, Director of the UNDP Regional Centre in Bratislava for his support and encouragement during the course of this project and his staff for their valuable advice.

In writing this report, members of the Commission have sought to produce a document that is accessible to all, not just to specialists in economic policy. We have tried to present a realistic vision of what Macedonia can achieve in the next ten years, and we have provided a road map for the way ahead. What needs to be done is sufficiently compelling that any Macedonian government should be able to subscribe to nearly all of these recommendations, and citizens should be able to judge the extent to which the recommendations of this report are being implemented and the results that they achieve.

Skopje, September 2006

Josef Brada
Taki Fiti
I. Introduction

A. How to Achieve Dynamic and Sustainable Growth

Members of the Macedonian Blue Ribbon Commission expect that, ten years after this Report is published and its recommendations are effectively implemented, the Republic of Macedonia will have made significant progress in the key areas of its economic and social development:

- The Macedonian economy will have experienced a period of sustained economic growth and created a substantial number of new jobs, cutting unemployment by at least one half.
- The Macedonian economy will be fully integrated into the global economy. The share of exports in GDP will be significantly higher than it is now, there will be a substantially higher level of foreign direct investment in the country, on a per capita level comparable to other transition economies in the region, and the capital account will be fully liberalised.
- Macedonia will have considerably stronger, more efficient, and more credible institutions.
- Macedonia will affirm itself as a citizen-oriented, stable and democratic country. Macedonia’s government will carry out its functions efficiently. Corruption and over-regulation will be significantly reduced, and the functioning of the legal system will approach European norms. Government functions will be depoliticised and streamlined. Important government responsibilities will have been decentralised, with local governments adequately financed and able to provide key public services to meet the needs of their residents.
- Poverty and inequality will have been sharply reduced, and the education, health and pension systems will have been reformed.
- Macedonia will have adopted most of the measures and created most of the institutions required for membership in the European Union.

The key to the achievement of this vision lies in concrete steps needed to bring about dynamic and sustainable growth and in the implementation of a new wave of reforms in the key segments of the country’s economic and political system. These reforms are directed toward:

- Increasing Macedonia’s integration into the global economy and moving the country toward membership in the European Union (EU);
- Raising the dynamism of the private sector through tax reform, deregulation and privatisation and the creation of effective institutions combined with the elimination of institutions that are not providing sufficient social benefits;
- Increasing the efficiency of the government’s functioning through fundamental changes in government operations and in the tax system, reforms in the functioning of the judiciary and the civil service, and the creation of effective methods of fiscal decentralisation.
B. The Current Situation

The Republic of Macedonia has experienced almost fifteen years of transition since gaining its independence in September 1991. The transition process in the country started under very difficult circumstances. On one hand, macroeconomic conditions inherited from the former state were extremely unfavourable: negative GDP growth rates, a high inflation rate, a high unemployment rate and relatively high domestic and foreign debt. On the other hand, immediately following the gaining of independence, Macedonia was confronted with the problems relating to the international recognition of its entity, arising from the dispute over the country’s name with Greece. Various external shocks have plagued the country almost throughout the transition period - the UN embargo against FR Yugoslavia from the spring of 1992 to fall of 1995, the Greek unilateral embargo from February 1994 to September 1995, the Kosovo refugee crisis in 1999 and the six-month internal conflict in 2001.

Despite unfavourable initial conditions, Macedonia implemented important reforms in key segments of the economic system. Practically, first-generation reforms, although implemented with variable success, have been completed. In this respect, reforms pertaining to price stability, price liberalisation, foreign trade liberalisation, and small privatisation have been accomplished successfully, as is also confirmed by the EBRD transition indicators. Somewhat poorer are the assessment marks in relation to the large privatisation and banking sector reforms. More important is the fact that the effect of reforms is cumulative and mutually reinforcing, so that key weaknesses in some areas have offset the potentially positive effects of well-designed and effectively executed reforms in other areas of the economy. Moreover, implementation of the so-called second-generation reforms, important for achieving dynamic and sustainable growth, is slow and unsatisfactory. As a result, throughout the transition period, aggregate output growth in Macedonia has been insufficiently robust to overcome interruptions from external shocks, while the unemployment rate has remained exceptionally high. Hence, structural and institutional reforms must play a key role in accelerating economic growth and creating new jobs. The reforms of the highest priority must be directed toward the creation of a favourable business climate. These include the reform of the tax system, a decrease in regulation, the reduction of corruption, the promotion of entrepreneurship and labour market reform.

The Republic of Macedonia has also made important economic strides since its emergence as an independent state. It has created a functioning government that provides its citizens with vital services and an economic environment that is characterised by a high level of price stability. Partly as a result of these achievements, the European Union (EU) now sees Macedonia as a potential future member, granting it EU candidate status in December 2005. These achievements are a tribute to the country’s capacity to devise and implement sound economic policies, and they lend confidence to the expectation that the recommendations to be found in this report can be implemented in an expeditious and effective manner so as to move the Macedonian economy forward. Macedonia has enjoyed over 10 years of stable prices and a stable relationship between the Macedonian denar and the deutschmark and subsequently the euro. While this stability does represent an important achievement for economic policy, the growth of the Macedonian economy in terms of aggregate output and in terms of creating opportunities for increased employment has been unsatisfactory, whether weighed against the legitimate aspirations of the country’s population, against the performance of other transition economies or against what the Macedonian economy needs to accomplish to ensure successful entry into the EU. Until the past three years, real GDP has grown slowly, and measured unemployment has remained at high levels.
Figures 1 and 2 show Macedonia’s real GDP and its growth. Like other transition economies, Macedonia experienced a decline in aggregate output in the early 1990s followed by recovery, which, in Macedonia’s case, was impeded partly by exogenous forces as well as by structural shortcomings in the economy and in the ways in which reforms were carried out. As a result, the economy was not able to sustain consistent growth and high levels of job creation.
C. Three Structural Weaknesses of the Macedonian Economy

The shortcomings in the performance of the real sector of the Macedonian economy are strongly interconnected with three structural weaknesses that need to be overcome.

First, Macedonia is inadequately integrated into the world economy. This means that Macedonia does not benefit from the gains from trade and foreign direct investment to the degree that it needs to. Low globalisation limits the level of competition on the domestic market. Moreover, there is a strong correlation between a country’s globalisation and its ability to follow policies that promote growth and increase the incomes and economic freedom of its citizens.

Second, microeconomic forces and institutions that support a dynamic private sector that can adapt to emerging domestic and international market and technological developments and that can create new jobs and provide high incomes are absent or do not work well. Moreover, the country is not perceived in a favourable light by domestic and foreign observers. It is seen as a country that has problems with corruption, poor corporate governance and ethnic tensions and as a country that does not have a business-friendly environment.

Third, the involvement of the government in economic regulation and the application of the laws need improvement. The tax system needs to be revised to make it more transparent, easy to administer and to provide incentives that are consistent with Macedonia’s economic needs. The government’s ability to regulate the economy must be concentrated on those functions that are of greatest importance. The government now faces the challenges of the regional decentralisation of its activities and ensuring that the interests of political parties do not impede the effective functioning of the state administration and of the legal system.

1. Inadequate Globalisation

Macedonia, despite its small size, is an insufficiently globalised economy, whether measured in terms of its trade, its FDI or in its reliance on international standards and institutions to supplement domestic regulatory organs and institutions. For example, despite its small size, Macedonia’s export to GDP ratio is low in comparison to most transition economies, as Figure 3 shows; Macedonia’s participation in world trade is inadequate for its economic goals.

Similarly, the inflows of FDI into the country appreciably lag those achieved by many of the more successful transition economies, as Table 1 shows.

Table 1. FDI Inflows per capita for Transition Economies, 2000-2004.

<table>
<thead>
<tr>
<th>Country</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
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<tbody>
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<td>Albania</td>
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<td>68</td>
<td>44</td>
<td>58</td>
<td>37</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
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<td>27</td>
<td>37</td>
<td>37</td>
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</tr>
<tr>
<td>Bulgaria</td>
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2. The Microeconomic Foundations of Prosperity

Macedonian economic policy has created a stable macroeconomic environment that can serve as the basis for further development of the business sector, and the main barriers to growth are currently to be found in the microeconomic sphere. What Macedonia needs now is a series of more subtle and interconnected reforms that create a vibrant market economy, one that can create jobs, promote structural change and the creation of new firms and provide the flexibility for structural change that Macedonia will require in order to succeed on international markets and to adjust to the challenges of EU accession. Over the period of Macedonia’s statehood, new firm formation has not been dynamic, and the number of new jobs created has thus not been sufficient to reduce a level of unemployment that Macedonian society finds unacceptable. Structural change has largely been of the negative variety, with firms shutting down or downsizing their operations, but business expansion, and especially expansion into new lines of business, has not offset the job shedding that has occurred.

A key need is to improve the business climate so that it will be easy for entrepreneurs to start new businesses and also for existing businesses to alter their profiles. The government has attempted to introduce some measures for streamlining the process for starting firms, but additional measures need to be taken to accelerate new firm formation. The government should also review the regulatory and tax burden faced by firms of all sizes and make a credible commitment to reduce these barriers to entrepreneurship, both domestic and foreign. The private sector requires a functioning legal system, the rapid resolution of contract and property disputes, better and cheaper infrastructure, and relief from regulatory burdens. In particular, the tax burden on wages should be reduced.

The current financial system does not provide adequate support to the financing of new and existing businesses. Many of the reasons for this are structural, and a consolidation of existing small banks, the rapid entry of foreign banks and improved bank regulation are needed if the financial constraint on enterprise growth is to be overcome.

Macedonian agriculture has been under considerable competitive pressure from abroad, and such pressures will continue. The future of the system largely lies in the ability of Macedonian farmers to respond to these pressures and to restructure production toward a more focused output pattern that will be better integrated with the processing industries and also more export oriented. To this end, the government should provide assistance in the form of information about foreign markets and on phytosanitary and other regulations that need to be introduced if Macedonian food production is to penetrate European markets.

High unemployment is a major concern for most Macedonians. In part, the lack of job creation is due to barriers to entrepreneurship already discussed above. However, there are weaknesses in the Macedonian labour market that have to be addressed as well. One is the high taxes imposed on labour expenditures of businesses. These both discourage employers from hiring more workers and stimulate the growth of the grey economy. Macedonia’s unemployment statistics, as well as the viability of the legal sector, are compromised by the large size of unreported employment. Also distorting the unemployment statistics is the linking of registered unemployed status with the access to health care, and decoupling of this connection would be a positive step toward providing a truer picture of unemployment in Macedonia as well as rationalising the basis for providing health care to Macedonian citizens.

3. Limited State Capacity and the Political System

Third, the limited state capacity of Macedonia represents a serious barrier to development and growth. This problem needs to be addressed through deregulation and the early
adoption of international standards, especially the standards of the European Union. As a small country, Macedonia must recognize that the capacity of the state to intervene in the economy, to regulate economic activity and to create and support effective economic institutions is limited. This is in part due to limited resources, both human and financial, as well as to the fact that many of these government functions are characterised by important economies of scale and high fixed costs; in a small state, it is better to focus on doing fewer things well and to either outsource others to international organisations or foreign institutions or even to foreign private-sector providers. Moreover, regulation that is not consistent with international norms and standards represents an added cost for Macedonian firms seeking to sell their products and services on foreign markets, and such costs cannot easily be liquidated through sales on Macedonia’s limited domestic market.

The government in its role of public administrator, the civil service as the implementer of these administrative tasks, and the judiciary as special agent in the governance structure, are weak, while the political parties are too influential for the good of the country and its economic progress. The excessive influence of political parties on the staffing, composition and individual careers in the civil service and the judiciary, and possibly also on high-level positions in state-owned companies, the linking of party interests to those of certain large corporate supporters, political corruption and so on, create excessive instability in government policies and in the economic environment, and they hamper economic growth and needed reforms. The rules for financing political parties and election campaigns should be analysed and changed if the existing ones are found to encourage political corruption. The civil service and the judiciary need to be strengthened, their efficient functioning improved and their independence assured.

As a result of these shortcomings, some of the key functions of government are not carried out effectively. Among the most important are:

1. **Protecting citizens, their property and their right to use it as they see fit, and enforcing contracts.** The issue is whether the state can effectively impose the rule of law on economic activity. This depends, in part, on whether the right laws and regulations are in place, and, in part, on the ability of the government to administer the police, the courts and the regulatory authorities. There are grave defects in all of these requirements in the case of Macedonia, and their negative effect on economic development is clear throughout this report. Regulatory reform, promoting competition and effective corporate governance, completing privatisation and strengthening the functioning of the market mechanism are the keys to creating a dynamic private sector.

2. **Collecting taxes.** Given the existence of a large grey economy, variously estimated at 30-40% of GDP, there is room to increase tax collections while reducing the tax burden on legitimate economic activity. The tax system should be made more transparent and easier and less costly to administer. Moreover, the design of the tax system should reflect Macedonia’s economic needs: to increase employment, to shrink the size of the grey economy, to provide incentives for economic growth and to ensure microeconomic efficiency by maintaining low and relatively uniform tax rates on different economic activities and sources of income. There may be significant tax avoidance and fraud as well. This undermines respect for the law and places an undue burden on legal business activity, and it is a major barrier to foreign direct investment. Improvements in the tax system to simplify taxes and to make tax collection more transparent and simpler to administer are an urgent need.

3. **Provide public services.** In some respects, the provision of public services is good. The economic incentives to provide them
and to use them wisely are often lacking, and thus there is considerable waste in the delivery of such services. Decentralisation is both an opportunity to improve the delivery of such services as well as a major risk if it is done badly.

4. Regulate economic activity. Macedonia has built up many of the regulatory agencies that are to be found in a modern market economy. Given its size and capacity, it may have too many. Moreover, many do not function well, or function in a perfunctory way. Worst of all, some are simply the basis for corruption and rent seeking.

Thus, Macedonia should review all these agencies and abolish those that are of secondary importance or not functioning effectively. Under current conditions, regulation based on rules rather than on the discretion of regulatory authorities should be preferred to reduce the potential for corruption and the application of regulations in a discriminatory way. Emphasis should also be placed on making use of international organisations and norms to replace or supplement domestic regulatory bodies.

The implementation of government activity also depends on the division of tasks between the central government and local governments. Local governments should be able to implement their responsibilities with as much freedom as possible. They should be accountable for the results they achieve, but they must have the freedom and resources to pursue objectives in the way that they see fit.

Equally important are reforms aimed at establishing greater effectiveness of the government as an organ of administration. This involves reform of the judiciary to ensure an effective role for the courts in national governance, strengthening the rule of law in Macedonia, and achieving greater efficiency of the judicial system. Government administration, too, must be strengthened, so that the civil service will be an independent organ whose mission is to implement the policies of elected governments efficiently but not to be part of the party system. Moreover, Macedonia is committed to a significant decentralisation of government services, and this will be a task that will require the creation of new capacities at the local level as well as the ability of the central government to effectively devolve both responsibilities and resources to local governments.
D. Guideposts for the Way Ahead

1. Sound Macroeconomic Policies

The concept of accelerating growth we are proposing rests on three key pillars, globalisation, strengthening the microeconomic foundations of the private sector and improvements in the functioning of the government, whose elements are elaborated in detail in the individual parts of the Report. A prerequisite for these pillars to fully support economic progress is that their influence can be fully felt, and this can come about only in an environment of macroeconomic stability.

At the macroeconomic level, appropriate growth and efficiency-supporting economic policies need to be put into place. To date, Macedonia has achieved and maintained price and currency stability. However, both monetary and fiscal policies have had to be reactive, responding in short-term fashion to external shocks as well as to unforeseen domestic developments. Partly as the result of these external shocks, monetary policy has been tight, and fiscal policy has been marked by large swings in the budget balance. Consequently, it is difficult to perceive a functional relationship between the budget surplus or deficit and changes in aggregate output.

In the future, as Macedonia faces a more stable environment, greater attention will have to be given to the role of fiscal and monetary policy as mechanisms for the regulation of the economy and for creating the conditions for high and stable growth rather than as instruments that are used primarily to offset random economic and political shocks. Making the budget a stable instrument of economic policy will require greater administrative capacity on the part of state organs, both those charged with the collection of taxes and those that are responsible for state expenditures. Moreover, it is not only the budget surplus or deficit that matters for economic growth, but, as well, whether the tax structure and budgetary expenditures encourage the growth of economic activity or whether they impede it. Thus, tax reform must be an important part of fiscal policy.

Achieving the right fiscal and monetary policy mix will not be easy as the country faces new challenges, including fiscal decentralisation, reform of the pension system, the need for significant improvements in infrastructure, the eventual introduction of EU rules and institutions as well as the need to reform the tax system and the management of government expenditures.

Fiscal policy should be managed on the basis of the eventual need to conform to the so-called Maastricht Criteria, which will become increasingly important as Macedonia comes closer to EU membership. The implication is that a balanced budget should be pursued on a medium-term basis rather than on a yearly basis. Moreover, the size of the government sector must be constrained and the country’s domestic and external borrowing should not increase too rapidly. The government must find broader sources of revenue than payroll taxes and contributions because their currently high level has a strong negative impact on labour costs and the growth of the private sector. Such a change in the tax system will increase employment, help the private sector grow and increase export competitiveness. To the extent that budget deficits are planned, they can be financed, at least in part, by foreign borrowing (including Eurobonds), but expenditures should be used mainly for removing bottlenecks in infrastructure and for investments in education.

At the same time, the state’s capacity to manage such infrastructure expenditures effectively must be strengthened so that there are clear priorities on what needs to be built and that projects are finished in timely fashion and without major cost overruns. While it may be possible to develop such a capacity internally in the longer term, it may be useful to retain the services of an outside firm to review the country’s infrastructure, to recommend the most pressing needs and to oversee the initiation and timely completion of high-priority projects. Significant improvements to the telecommunications and air transport in-
The most critical need in terms of tax reform is to reduce the excessive taxes on the employment of labour and to make the tax system more transparent and efficient. By efficient we mean a tax system that is both easy and inexpensive to administer and also a tax system that does not encourage unwanted behaviour on the part of taxpayers. The current system needs to more fully incorporate these characteristics. We strongly recommend that in the next few years a flat tax be adopted. Because we lack the data needed to calculate tax rates and exemption limits that would make such a change in the tax system, in combination with the other changes that we propose, revenue neutral, we do not suggest a rate for this tax. Such a tax has been adopted with good results in a number of transition economies, and it offers clear advantages in terms of ease of administration and general neutrality between activities. Moreover, a major overhaul of the tax system in favour of such a tax will be seen as an important indicator of Macedonia’s willingness to undertake strong pro-growth reforms by both its citizens and by foreign investors. Subsequent to the reform of the tax system, the stability of tax rates should also become a policy objective in order to provide tax payers with a measure of certainty about their tax liabilities.

The tax base should also be broadened by eliminating exemptions that are often ad hoc and serve little purpose (such as the tax reduction for firms choosing to list their shares on the stock exchange) and by shrinking the size of the grey sector by reducing the tax rates on legal businesses, by liberalising labour laws and lowering wage taxes, and by both punitive measures and positive incentives to turn grey economy firms into legal ones. We do not believe that the tax system is a useful tool for social engineering, but if the tax system is to provide any incentives for certain types of economic activities, these incentives should be broad and growth-enhancing ones promoting saving, investment, the formation of small companies, and the acquisition of human capital rather than narrow firm- and sector-specific incentives.

Second, in the medium- and the long term, the effects of the quick and thorough implementation of the structural and institutional reforms of the second generation should be fully felt. The benefits of structural and institutional reforms are being felt even now, and additional results will be evident relatively soon – the process of restarting large companies is being completed, small industrial capacities are also being activated, the one-stop-shop system for foreign investors is being implemented, judicial system reforms are under way, the quality of government regulation is improving. These factors will contribute to the improvement of the investment climate and to the encouragement of domestic and foreign investors.

The key growth impetus must come from the private sector, as only the private sector can create wealth and jobs in the long term. Economic policy must therefore not only create an attractive macroeconomic environment to maintain the confidence of investors and entrepreneurs as well as of the international community, but microeconomic reforms must also clear the way for the private sector to flourish. To start businesses, to invest and to wind up business ventures must be both easy to do and at the same time assisted by institutions, laws and regulations that give market participants confidence in their ability to enter into contracts and ventures that will be subject to objective market criteria and protected by the efficient administration of justice.

2. EU Accession

Macedonia’s desire to become a member of the European Union (EU) is an objective that enjoys broad national consensus. This desire for EU membership thus must shape national policy, both foreign and domestic, the reform initiatives, and the economic agenda and business strategies. Macedonia’s EU aspiration provided the compass for the reforms
that were implemented in the transition process, and it still anchors the social agreement among virtually all Macedonian citizens.

It is important for this reason to review here what has been achieved and what is to come, bearing in mind that EU integration reaches into every aspect discussed in the Blue Ribbon Report. Economic growth is increasingly important for Macedonia for its own sake as well as for the country’s path toward the EU; equally important is the growth of its institutional and administrative capacity at all levels of government, from the local to the international. As discussed below, the main objectives and stepping stones in the next stages of Macedonia’s EU integration will be economic growth, economic and social opening to the EU and institutional preparedness.

An important milestone in Macedonia’s path toward EU membership was the signing of the Stabilisation and Association Agreement (SAA) in 2001. This agreement provided a strong motivation for the intensification of the adjustments necessary for the fulfilment of EU membership criteria. One positive outcome of the SAA was the establishment of an appropriate administrative structure and of an institutional framework for implementation of the Agreement as well as for monitoring of its implementation.

The next important step occurred in December 2005, when Macedonia achieved the status of a candidate country. This was an important political recognition of the progress and reforms achieved; however, an important reservation to this positive assessment of Macedonia’s progress is the fact that a date for negotiations has not been set because the country is not yet ready. The acquisition of candidate status does not mean fulfilment of the strict EU criteria for membership. In fact, Macedonia has only reached the point at which the complex process of negotiation about the individual chapters of the Acquis Communautaire and of fulfilment of the membership criteria, especially the economic ones, begins.

Fulfilment of the economic criteria for membership must be a top priority for Macedonia, not only in order to meet the standards of the EU, but also because they are crucial for Macedonia’s economic and social progress. Macedonia needs to fully develop a functioning market economy that will allow an even ground for competition and weed out all the oligarchic elements in the economy that stifle its overall growth. The Macedonian economy needs to be able to cope with the intense competitive pressures and market forces within the EU. Consequently, Macedonia needs to be aiming for where the EU economy will be at the end of the reporting period not where the EU economy is today.

The capacity of Macedonian institutions to effectively manage the requirements implied by EU membership and, before membership, the administration of processes such as the implementation of laws and the management of funds, needs to be strengthened. Answering the European Commission Questionnaire revealed that Macedonia has the potential to meet the administrative requirements of EU membership, but this potential cannot remain latent and needs to become the norm. Firm political commitment and leadership, not only management, is needed to prepare these institutions and the Macedonian economy for European integration. Municipalities need to be able to administer funds effectively and transparently. They need to be able to effectively interact with EU organs and to formulate sound and comprehensive policies. Public and civil servants from all levels of government need to be trained to work within European standards and processes, to effectively plan, budget and administer funds, to create projects and manage them ably and to be capable of being a positive and proactive member of the EU that can fully participate in European governance and in the formulation of EU policies. The role of Parliament will be essential in the process of creating these capabilities, in monitoring the implementation of EU-oriented policies and activities and especially in the process of negotiating accession.
The next step ahead is the negotiation process, which is both a great opportunity and a great threat. If Macedonia proceeds efficiently in this process, it will demonstrate to itself and to the world its institutional readiness for membership; if it fails to do so, its image as a modern state will suffer correspondingly. A successful negotiation will have important positive economic benefits and solidify a fragile national consensus; a negative outcome to the negotiation may nurture Euro scepticism and a general resistance to any further reform processes since these will be seen as having high costs and few benefits.

Macedonia will not be in a position to negotiate parallel chapters at the same time, as other countries have done; it will need to do so sequentially. This may slow the overall process. It is the view of this Commission that Macedonia need not rush this process, but, rather, it should strategically adopt segments of the Acquis if it is to its benefit to do so and leave those segments that may be hardest for its economy and society to internalise for last. Furthermore, it is very important that there be some continuity among Macedonia’s negotiators. They will also need to communicate intensively with the general public and explain the process so as to maintain the national consensus for EU membership. Consequently, the process of negotiating Macedonia’s entry into the EU must be as transparent as possible.

The time between achieving candidate status and the negotiations leading to future membership will be challenging, both politically and economically. While issues of political stability and interethnic dialogue have dominated the discussions between European and Macedonian politicians thus far, economics will dominate the next stage leading toward EU membership. Macedonia needs to undertake a major overhaul of its laws and institutions to prepare for EU membership. Such a large revision of laws, regulations and institutions should, in the long term, be beneficial. However, there will be transition costs, and considerable thought must be given to the phasing in of various EU-related laws and regulations. Consequently, Macedonia must create the capacity to weigh the costs and benefits of adopting specific EU laws and regulations at any given time and to develop a comprehensive plan for doing so. Preparing for EU membership will be a major task for the Macedonian government and society, as well as for the business sector. While the experience of other countries suggests that the pace with which changes are implemented may accelerate over time, it is critical that Macedonia have a clear roadmap of the process, one that identifies costs and benefits of adopting specific measures and weighs them against Macedonia’s ability to absorb such changes as well as their congruence with Macedonia’s economic strategy at any period of time.

Macedonia has an enormous potential market open to it because of the free trade agreements (FTAs) it has signed, including the one with the European Union. Overall, the FTAs did not initially stimulate Macedonian exports very much, suggesting a weak supply response on the part of Macedonian exporters or ineffective implementation of the FTAs. In the past three years, exports to countries with which Macedonia has signed FTAs have shown greater dynamism, and these export gains must be consolidated and continued. Macedonian producers must pay greater attention to such factors as environmental standards, packaging, quality, marketing, management techniques and market study to prepare for the EU market.

It is hence worthy of mention that one of the elements of the pre-accession process is access to EU funds which will be channelled through the new Instrument for Pre-Accession Assistance (IPA). The main goal of the pre-accession funds is to prepare the institutions of future member countries for the management and administration of the much larger Structural Funds that the country will have access to once it becomes a member of the EU. Indeed, in order to obtain the pre-ac-
cession funds, the country needs to define its development and investment priorities for the medium-term, as well as clearly define and organise the institutional mechanisms for using the funds. The IPA funds will have a positive effect on economic growth through creation of a more attractive business climate by contributing to investments in infrastructure, institution-building, human resources, agriculture, competitiveness of firms, all with a consideration for balanced internal regional development.

Within the region, Macedonia has an advantage in bordering the EU, in the form of Greece, to the south. Indeed, the bulk of foreign investments that have come in the past years have been from Greece. However, the possibility of exporting to the rest of the EU is significantly hampered by the numerous borders that need to be crossed to reach the biggest part of the EU market. For this reason, it is in Macedonia’s interest that the rest of the Western Balkan countries also enter the EU as soon as possible, or alternatively, that the initiative toward a customs union for South East European (SEE) countries that seems to be prevalent now be intensified. The EU has a market of over 300 million people, but there is a market of sixty million customers within this region that also can be tapped if unification of sorts occurs regardless of, or as a prelude to, Macedonia’s entry into the EU; indeed, regional cooperation of increasing intensity is an important aspect of the Stabilisation and Association Agreement. An encouraging move in this direction is the recent political commitment to, and the start of in 2007, a single free trade agreement (FTA) for the countries of SEE.

Improvement of land and air communication must be Macedonia’s top priority. The airport is Macedonia’s gateway to the world and is in dire need of investments, which will come most easily if it is fully privatised. Except for Greece, all EU countries are a considerable distance from Macedonia, and air connections are critical for trade and business. Nevertheless, this does not undermine the importance of Corridors 8 and 10, for both Macedonia’s regional and European perspectives. Corridor 10 has a greater perspective of realisation and natural evolution, being also important to Greece. However, Corridor 8 will require more of a push by Albania, Macedonia and Bulgaria. Although corridors 8 and 10 were effectively taken off the European transport map, their importance is increasing as EU foreign policy progressively turns toward Asia. This, along with Macedonia’s candidacy, makes now a good time to press the issue to its conclusion.

The importance of diplomacy will be crucial in the EU integration process and its specificity needs due attention because the current diplomatic connections with EU partners will become governance relationships once membership is achieved. So, on the one hand, these need to be made very strong now, even as some Macedonian diplomatic and consular offices may need to be closed or reduced. Now is a good time to start thinking of these issues.

All reforms addressed in this Report are important for the convergence of the country to the EU and for full EU membership. Macedonia must accelerate its growth and help the economy become capable of creating new jobs. Therefore, the EU integration process, the process of reforms and that of creating an environment conducive to economic growth are intertwined. Macedonia needs to make best use of this great opportunity.

3. Reform Roadmap

Apart from a good reform program, equally important is its implementation strategy, including its proper sequencing. The experience of other countries demonstrates that fast and consistent reforms, well coordinated and properly implemented are more effective, less painful and bring their benefits quicker than do slow reforms that entail compromises on key issues. A clear commitment to complex policy and systemic changes backed by swift action where possible and a clear timetable
where more extensive study is needed prior to implementation help to build political momentum for change and take advantage of a political “window of opportunity”; give reforms and reformers greater credibility with both domestic constituencies and foreign governments, international agencies and foreign investors; and help to organise a pro-reform coalition and neutralize or compensate losers. They minimise the danger of having the reform process captured by its intermediate-term winners who may not be interested in the continuation of the reform to its intended conclusion.

A further lesson is that the most difficult and painful steps, especially those related to the rationalisation of welfare programs or the limiting of the privileges of influential social groups, must be taken at the very beginning when the support for the government and its reform program is the highest.

Complex institutional reforms such as public administration reforms, government decentralisation or reform of the judiciary, require more time and bring their fruits with a substantial time lag. This is the major difference between them and, for example, macroeconomic stabilisation or domestic or external liberalisation, which can and should be conducted in a shorter period of time and bring visible benefits sooner. However, the longer time span required by institutional reforms cannot serve as an excuse for abandoning or postponing them. On the contrary, they should be started early enough and conducted in the fastest possible way to be completed on time.

Macedonia has already completed the first stage of its transition process and does not need a radical stabilisation program or major changes in its macroeconomic policy. Most of the remaining reform agenda involves complex and time-consuming structural and institutional reforms that are of an urgency equal to that attached to stabilisation and liberalisation of markets in the early transition period, but which differ because the policies themselves are conceptually more complex and require a longer time to develop and implement properly and because the visible economic payoffs from such policy changes may be slower to reveal themselves. Fortunately, there are at least three important circumstances that can help to make this process easier in the case of Macedonia.

First, planning and implementation of a significant part of the proposed reform package has been already started: for example, the reform of the labour law, government decentralisation, judiciary reform, and, to lesser extent, public administration reform. These reforms need to be refined and their application must be accelerated, but there is not the need for a fundamental conceptual debate about their desirability or for a major political effort to initiate them.

Second, most of the required reforms will be very closely connected with the forthcoming EU accession process and EU membership negotiations, which will provide the government of Macedonia and Macedonian society with strong external incentives and a powerful anchor. The recently obtained EU candidate status should thus serve as a very positive stimulus to accelerate these reforms and create a pro-reform momentum.

Third, the last two years have seen some improvement in the previously disappointing economic growth record of Macedonia. There are also some signs of an acceleration of the growth of exports and increasing interest in Macedonia among foreign investors. Macedonia finally seems to be entering the phase of catching-up growth, which can reduce the social costs and social resistance to many proposed reforms, for example, to labour market and social reforms, and to help in social and political consolidation.

While the strategic goals of this Report concern a ten-year development perspective, i.e., a period most likely required to complete the EU accession process, the detailed reform work plan of the new government should
cover four years, the period of its constitutional mandate.

To demonstrate its reform commitment and build its reform credibility, the government of Macedonia should present publicly a complex program of economic and institutional change, and this document should contain not only major reform objectives and their directions but also a concrete timetable for their implementation, subject to subsequent periodical, for example, annual, reporting and updating. It is critical that the government’s reform program stress that the proposed program has two key features that must be understood and accepted by all elements of Macedonian society:

The first is that the program is closely linked to the country’s EU accession strategy, both in terms of making Macedonia a prosperous and dynamic economy whose economic performance will be stronger than that of other candidate countries, and in terms of making Macedonia a country that has fully implemented EU laws, regulations and directives into its daily life.

The second is that the reform program proposed here consists of interlocking elements all of which have to be implemented with equal thoroughness and within approximately the same time period. The reform proposed here is a complex program of mutually supportive measures, and it cannot be seen as a cafeteria from which politicians can accept some elements and reject others while expecting sound results.

As we suggested before, the reform process should start with the most unpopular and socially painful actions such as the continuation of labour market reform, including the issues of minimal wage and collective bargaining; increasing the retirement age and other measures aimed at decreasing the liabilities of the pay-as-you-go pension pillar; review of other social welfare programs; elimination of various group privileges; imposing hard-budget constraints and closing down loss-making publicly-owned enterprises; and undertaking major privatisation transactions followed up by the wide-scale privatisation program in many sectors including social services. Other measures that can be implemented quickly include the liberalisation of business formation; the improvement of conditions for foreign trade, including improved customs services, faster payments of rebates to exporters, speeding up border transit and facilitating the movement of goods and individuals internationally; and the development of a broad anti-corruption program with tangible objectives.

Many of the above objectives can be implemented, at least in part, through administrative measures and thus should begin as promptly as possible in the new government’s period of office. To the extent that legislation is required, a complex deregulation package including business registration, licensing, administrative permissions, the system of administrative inspections, etc., aiming generally to increase the ease of doing business in Macedonia and decreasing the business sector’s transaction and operational costs should be prepared and introduced within the first six months of the government’s mandate.

Forming a new government is also the best moment to reform and simplify its institutional structure and to reduce the excessive number of administrative staff. From the very beginning, the new government should also declare and adopt in practice a new merit-based personnel policy in public administration. While the institutions and the legislation to create a politically independent and merit-based civil service will take time and consultation with all elements of the political spectrum in Macedonia, the new government should avoid politically motivated dismissals and nominations and resist pressures from the political parties and business interest groups to promote their protégées. Only in this way can the stage be set for a civil service reform that will have broad and lasting support. The same should apply to state-owned
corporations and other public institutions. Even if the entire set of public administration and civil service reform measures cannot be elaborated and initiated immediately because many of them require conceptual debate, additional legislation and, sometimes, financial resources, this kind of visible change in personnel policy would signal the government's determination to introduce a new way of governing and increase its reform credibility. The government should press to implement new legislation creating an independent merit-based civil service by mid-2007.

Taking into consideration that tax reforms proposed in this Report, particularly the introduction of a flat personal income tax and changing the source of financing of the health care sector, require some preparatory work such as the simulation of their fiscal consequences, projecting fiscal compensatory measures, changing tax legislation, informing taxpayers and the technical preparation of tax administration to implement a new system, the realistic date of their launching seems to be January 1, 2008, which would require that fiscal analyses of these measures be completed by early 2007, and that the necessary legislation be enacted later in 2007. They should be implemented as a single package to minimise the number of necessary changes in tax legislation and to avoid a perception of instability in the tax system among taxpayers.

Parallel to tax and labour market reforms, the long-term institutional reforms such as those of the judiciary, that are already in train should be continued and, where possible, accelerated. While the government may wish to revisit the specific measures entailed in the existing reform programs through annual reviews or more formal analyses, halting or slowing these much needed reforms to review and redesign these badly-needed improvements in the functioning of social institutions would be a serious setback to Macedonia's progress. In those cases where reforms are needed but programs are not yet in place, it is critical that the government specify the desired objectives and the general means to address them immediately. In each case, clear reform objectives and a detailed road map and timetable of reform implementation should be publicly presented to avoid the subsequent dilution or reversal of the program or its capture by special interest groups. Such an approach can help to build pro-reform support and credibility for the government’s intentions and actions. It can also create positive expectations among the population and business community, including foreign investors and greatly improve the country’s international reputation.

Perhaps the most time-consuming reforms will be those involving fiscal decentralisation. While the legislative underpinnings are in place, the process requires considerable preparation on the part of both the central government and of municipalities. Moreover, there is considerable uncertainty about how well all the municipalities will be able to fulfil their new obligations. As a result, it is critical that the government stress the correctness of the principles that underpin the existing roadmap for fiscal decentralisation while remaining flexible in dealing with unexpected developments in the course of its implementation.

Most of the proposed structural and institutional reforms have a direct importance for the EU accession process and, for this reason, their detailed design should be harmonised with the Acquis Communautaire as much as possible to avoid second round modifications at a later date. Their timetable should be coordinated with either Macedonia’s already existing EU commitments, stemming, for example, from the SAA, or with the expected accession roadmap.

Compared to many of its Central and Eastern European neighbors, Macedonia is already delayed in its European integration process. The small size of the country, the fact that it will have to negotiate its accession alone, in contrast to the “collective” character of the 2004 Enlargement negotiations, plus the visible enlargement “fatigue” in Western Europe
seriously weakens Macedonia’s bargaining position. So it is very unlikely that any future government can obtain too many waivers and exemptions from the Acquis, no matter how good its negotiating skills may be. Too much bargaining will only delay the country’s EU accession. Macedonia cannot lose the window of opportunity opened by the recently obtained EU candidate status by delaying the most important structural and institutional reforms or diverting them in wrong direction. Instead, Macedonia must impose on itself the task of exceeding the readiness for EU membership achieved by the transition countries that have preceded it in gaining EU membership.

II. What is the Magnitude of the Task at Hand?

The members of the Commission do not believe that it is useful to set quantitative targets for Macedonia’s future economic performance. Nevertheless, in view of the public concern over slow growth, high unemployment and the need to integrate Macedonia more fully into the global economy, we do believe it to be useful for policymakers as well for Macedonian citizens to understand the implications of current economic performance as well as to have some conception of whether the goals of higher growth and greater globalisation are feasible and worthwhile.

For example, Figure 2 suggests that a growth rate of real GDP of 4% would be feasible for Macedonia under the current economic system because such a growth rate has been obtained on several occasions, including the past several years. Table 2 provides a simple projection of what would happen to the Macedonian economy in the future if such performance could be sustained. With real GDP growth of 4% per annum and no structural changes and a 2% growth in labour productivity, Macedonians will enjoy a higher standard of living, but this will be undermined by several structural shortcomings.

The first is that Macedonia’s balance of trade deficit will continue to grow, potentially to unsustainable size. Second, even if the labour force remains constant, the decline in unemployment will be modest, not falling below 20% in the next 10 years.

Table 2. Baseline Economic Scenario.

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal consumption</td>
<td>216.44</td>
<td>261.21</td>
<td>317.80</td>
<td>386.65</td>
<td>4.0%</td>
</tr>
<tr>
<td>Public consumption</td>
<td>55.12</td>
<td>67.74</td>
<td>86.85</td>
<td>105.24</td>
<td>4.0%</td>
</tr>
<tr>
<td>Investment</td>
<td>10.94</td>
<td>11.83</td>
<td>12.89</td>
<td>13.94</td>
<td>4.0%</td>
</tr>
<tr>
<td>Exports</td>
<td>10.33</td>
<td>13.79</td>
<td>16.04</td>
<td>19.95</td>
<td>4.0%</td>
</tr>
<tr>
<td>Imports</td>
<td>103.33</td>
<td>202.86</td>
<td>266.83</td>
<td>380.39</td>
<td>4.0%</td>
</tr>
<tr>
<td>Total</td>
<td>260.00</td>
<td>335.31</td>
<td>407.96</td>
<td>569.34</td>
<td>4.0%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>29.95</td>
<td>37.89</td>
<td>46.10</td>
<td>56.09</td>
<td>4.0%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>39.75</td>
<td>50.30</td>
<td>61.19</td>
<td>74.45</td>
<td>4.0%</td>
</tr>
<tr>
<td>Utilities</td>
<td>11.13</td>
<td>14.08</td>
<td>17.13</td>
<td>20.85</td>
<td>4.0%</td>
</tr>
<tr>
<td>Construction</td>
<td>14.64</td>
<td>19.78</td>
<td>22.85</td>
<td>27.80</td>
<td>4.0%</td>
</tr>
<tr>
<td>Trade</td>
<td>66.64</td>
<td>45.60</td>
<td>55.48</td>
<td>67.50</td>
<td>4.0%</td>
</tr>
<tr>
<td>Other services</td>
<td>133.30</td>
<td>168.66</td>
<td>205.20</td>
<td>260.66</td>
<td>4.0%</td>
</tr>
</tbody>
</table>

Table 2. Baseline Economic Scenario.

<table>
<thead>
<tr>
<th>Employment (thousands)</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>97.60</td>
<td>96.42</td>
<td>106.46</td>
<td>119.52</td>
<td>2.0%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>116.30</td>
<td>130.67</td>
<td>143.99</td>
<td>156.67</td>
<td>2.0%</td>
</tr>
<tr>
<td>Utilities</td>
<td>15.80</td>
<td>17.75</td>
<td>19.56</td>
<td>21.56</td>
<td>2.0%</td>
</tr>
<tr>
<td>Construction</td>
<td>26.50</td>
<td>41.01</td>
<td>45.19</td>
<td>49.80</td>
<td>2.0%</td>
</tr>
<tr>
<td>Trade</td>
<td>74.20</td>
<td>85.37</td>
<td>91.87</td>
<td>101.24</td>
<td>2.0%</td>
</tr>
<tr>
<td>Other services</td>
<td>192.60</td>
<td>216.40</td>
<td>238.46</td>
<td>262.78</td>
<td>2.0%</td>
</tr>
<tr>
<td>Total</td>
<td>523.00</td>
<td>567.63</td>
<td>647.34</td>
<td>713.56</td>
<td>2.0%</td>
</tr>
</tbody>
</table>

| Active labour force           | 632.00| 852.00| 1022.00| 1302.00| 0.00%      |
| Unemployment (thousands)      | 209.00| 244.37| 284.46| 338.44| 37.14%     |
| Unemployment (% of active labour) | 29.37%| 22.17%| 18.41%| 14.24%| 29.37%     |

A strategy that accelerated growth of output by some 2% over the baseline 4% growth rate and that accelerated Macedonia’s globalisation by increasing the growth of exports so that they would be 60% of GDP by 2015 could achieve results that appreciably improve Macedonia’s economic situation. In Table 3 we assume that exports, generated by manufacturing, agriculture and trade, grow sufficiently fast so that they account for 60% of GDP by 2015. In this situation, incomes would be higher than in the foregoing scenario, but, more important, even if the labour force is assumed to grow rather than remaining stagnant, unemployment falls sharply and exports and imports would effectively be in balance.
Table 3. Increased Globalisation Scenario.

These, of course, are simple projections, and we do not mean to represent them as comprehensive models of the Macedonian economy, in part because they embody rather mechanical assumptions, for example, about the relationship between the level of output and the level of employment. Rather, our objective is to show that such a change in the performance of the Macedonian economy can, over time, generate a qualitatively more favourable set of outcomes than that implied by the baseline scenario. The more optimistic of our scenarios does, however, rest on the three pillars for economic progress we set out above. It embodies a greater globalisation of the Macedonian economy, explicitly through a faster growth of exports and implicitly because such growth to some extent presupposes an increase in foreign direct investment (FDI). The latter, as well as increased dynamism of the domestic economy, require better functioning institutions as well as a supportive business climate, both requiring government policies in support of a the micro-foundations of the economy. Finally, employment gains will also require tax reform as well as labour market reform to make hiring additional workers appealing to private sector firms.

III. Adjustment of the External Sector

We have previously pointed out Macedonia’s under-globalisation, which is both a barrier to the country’s economic progress and to its structural and economic reform. This under-globalisation is manifested in Macedonia’s relatively low trade-to-GDP ratio, by the low volume of FDI and by the low level of Macedonia’s integration in global capital markets. In turn, the low level of foreign trade is a major contributor to, as well as the result of, the lack of competitiveness of Macedonian products, the passivity of Macedonian firms and their ineffective corporate governance and the lack of responsiveness of Macedonian firms to opportunities on foreign markets. Among the manifestations of this interaction between globalisation and the performance of the domestic economy are:

1. Monopolisation of the domestic market makes exporting look unprofitable to many Macedonian firms because of the lack of competitive pressure on the domestic market. Moreover, their profits are not competed away by imports because import channels themselves are often monopolised.

2. Macedonia has export capacities in products that face severe competition on international markets – textiles, shoes, etc. Yet, for products for which global demand is now booming, e.g., steel, there appears to be little dynamism beyond bringing some capacity on stream via FDI.

3. Macedonian products do not appear to face extensive foreign barriers – the EU provides preferential access to its market and Macedonia has concluded free trade agreements (FTAs) with many neighbouring countries. As these FTAs were put into place, there was little or no “supply response” on the part of Macedonian exporters. It could be that these agreements failed to match Macedonia’s export poten-
tials or this could be evidence that Macedonian firms lack the incentives or the ability to expand their sales abroad and thus would not respond to other export incentives like devaluation either. Macedonian managers may not be aware of international opportunities or sufficiently well versed in international business.

Of the many concrete measures that the government can implement to help to promote Macedonia’s globalisation, we prefer those measures that reduce barriers to trade, including tariffs and administrative barriers, and barriers created by lack of information because these will, in the end, also strengthen the microeconomic basis for Macedonia’s global competitiveness, on which its prosperity must rest. We see measures designed to provide direct government aid to export activities as both inconsistent with Macedonia’s international obligations and likely to create problems by creating further opportunities for corruption and favouritism, thus actually weakening Macedonia’s competitiveness on world markets.

1. Current Status of Policies Affecting the External Sector

The policies affecting the external sector have been radically changed over time. In general terms, the broad elements of Macedonia’s trade policy are liberal, allowing foreign goods *de jure* fairly unrestricted access into the Macedonian market. Macedonia does not provide any serious import restrictions. Tariffs are on average quite low – the World Bank reports that Macedonia’s average tariff rate in 2004 was 8.1 percent, quotas have been eliminated with some exceptions, licensing procedures streamlined. The country has been a Member of the WTO since 4 April 2003. On the surface, trade policy does not seem to constitute a major impediment to the foreign trade performance.

Nevertheless, the level of Macedonia’s integration in the global economy is very low for its size, and this signals serious problems in the conduct of economic policy and in the performance of institutions important for international trade. These problems are discussed in the following sections, which also offer various recommendations for their solutions. All recommendations are intended to improve trade performance directly through changes in trade policy or indirectly through other policy measures that have strong linkages to trade.

It should be noted at the outset that the major constraint on the performance of the external sector does not appear to have an origin in the conduct of trade policy. The origin of the difficulties appears to be microeconomic and to lie in the operations of domestic firms and markets, the problematic nature of other economic policies and poorly functioning domestic institutions. These are discussed at length elsewhere in the Report, but here we remind the reader of this important connection.

Nonetheless, the discussion that follows below will raise issues from those areas in order to highlight their linkages to the performance of the external sector. Future development of the external sector will depend critically on political stability in the region. Regional political stability is necessary for further cooperation with neighbouring states with which Macedonia will have to negotiate more comprehensive and far-reaching measures to enhance its trade relations and economic cooperation. For example, Macedonia’s most important trading partners are its neighbours to the North, which take about a quarter of Macedonia’s exports. About one half of those exports are directed towards the Kosovo market. It is clear, therefore, that the prospects for a successful export drive depend to a significant degree on good neighbouring relations with these countries. Thus Macedonian foreign policy and its commercial policy component must both be actively directed at promoting regional initiatives that reduce tensions and promote commerce with its neighbours.
2. Policy and Institutional Recommendations

Given the progress made by the authorities in liberalising the external sector there are relatively few outstanding issues to be addressed that relate to that sector alone. Nevertheless, some areas of policy concern still remain and will need the attention of the Macedonian government. The following discussion is divided into three broad categories of outstanding issues – (1) those affecting the access of Macedonian exporters to external markets, (2) those affecting domestic incentives and institutions that are critical for enhancing the role of the external sector and (3) outstanding issues of trade policy per se. Even though the market access issues relate to measures that are to some extent under the control of foreign governments, they can be addressed by Macedonian authorities through negotiations with their foreign partners.

A. Market Access.

Macedonia’s exports depend, inter alia, on the ease with which exporters can access foreign markets. At the present time, most of Macedonia’s main trading partners provide fairly liberal access to Macedonian exporters, but some barriers still exist. Many of those restrictions will be further liberalised or completely removed under the terms of the existing regional agreements. The remaining barriers should be targeted by the government as issues for further negotiations – either in the WTO or through regional arrangements. Indeed, because Macedonia’s underglobalisation is a characteristic that it shares with many of its neighbours (see Figure 3), creative solutions for regional trade liberalisation proposed by Macedonia should be favourably received by its neighbours.

The remaining barriers against Macedonian exports affect trade both in goods and in services. The following three groups of barriers should be singled out as constituting a particularly serious constraint on exports – (1) non-tariff barriers such as sanitary and phytosanitary (SPS) regulations and technical regulations imposed by importing countries as well as by other operating rules, and (2) the treatment of “sensitive” products and (3) a variety of restrictions imposed on trade in services, and (4) the degree of cooperation with Macedonia’s important trading partners.

The restrictiveness of SPS regulations is extremely serious for Macedonian exporters because they affect the country’s agriculture, which has significant export potential, and because of difficulties faced by exporters in complying with such regulations. The latter is partly a question of costs of compliance and partly a matter of inadequate knowledge and technical facilities. It is the latter that the Macedonian authorities should improve, and, to do so, they should seek the necessary technical and financial support from external donors and trading partners such as the European Union.

Access to foreign markets has been also complicated in the past by the introduction of customs administration in the independent states neighbouring Macedonia. Even if those countries were to administer their customs in the most efficient way, customs administration always adds to the costs of trade. It is, therefore, in the interest of all parties concerned to ensure that customs administration officials fully cooperate in order to facilitate exchange of goods. The most sensible step is to ensure that procedures be harmonised as closely as possible in order to ensure compliance with the WTO and the EU rules, and Macedonia should take the lead in developing regional agreements on such procedures.

The second set of issues concerns the scope of liberalisation in markets of export interest to Macedonia. The access to those markets is typically adversely affected by restrictions on imports of so-called sensitive products. That is the case even when trade flows are regulated by free trade agreements. FTAs typically include provisions for sensitive products whose trade is often limited by export quotas. Unfortunately, the sensitive products are also
often products of considerable interest to many exporting countries. Macedonia, too, has been subject to such restrictions, and it is, therefore, extremely important that these restrictions be removed as quickly as possible.

The third area of concern is the access of Macedonian service providers to foreign markets. Macedonia has been a traditional exporter of such services as construction and transport – two markets that continue to be heavily protected abroad. Macedonian diplomacy must therefore seek multilateral solutions to this problem.

Many of these issues are already addressed in the existing FTAs that Macedonia has negotiated. However, there are considerable differences among the FTAs signed bilaterally by Macedonia with other countries and by the latter countries among themselves. There are also some serious shortcomings in these FTAs. First, the FTA initiatives have primarily taken the form of bilateral agreements. While such arrangements are a step towards market opening, their bilateral nature is quite risky and potentially damaging. This is because the bilateral FTAs together with the Stability and Association Agreement (SAA) with the EU will most likely create a “hub-and-spoke” relationship with the EU in which the major beneficiaries would be EU firms. Moreover, the existing differences among the bilateral FTAs are large enough to significantly limit the potential gains from the increased size of the market for foreign businesses and investors. The proposed harmonisation and unification of the regional FTAs should thus be a priority for Macedonia. The harmonisation should cover areas such as customs administration and rules of origin. Specific proposals are made in the text below. In addition, it would be highly desirable to include rules concerning competition, provisions for state aid and for mergers and acquisitions.

The FTAs have been quite successful in removing tariff and quota restrictions on the exports of Macedonia to its FTA partners. However, the current FTAs are heavily tilted towards liberalising trade in goods while services have not been opened up to the same extent. This is unfortunate given the historical ties among the countries in the region. The authorities should, therefore, consider expanding the scope of existing regional agreements to the area of services. Moreover, the Macedonian government should ensure that domestic laws and regulations do not discourage domestic firms from establishing strategic alliances with foreign partners whenever there are opportunities to do so.

A final comment concerns the implementation of the existing FTAs. The business community in the region has often complained about problems of non-compliance with the terms of the FTAs. This clearly indicates that there is a need for the establishment of an effective mechanism for the resolution of trade conflicts. The existing provisions for dispute settlements should be reviewed and changed if necessary. Mechanisms used by other FTAs, such as NAFTA, could serve as a model. The alternative for members of FTAs who are also WTO Members is fairly straightforward – these countries can use the existing WTO mechanism for dispute resolution. Whatever measures are taken, they must include training of lawyers in international trade law.

B. Domestic Policies Affecting Trade

Trade performance of countries depends on factors that can be grouped into three classes – macroeconomic conditions such as inflation, external debt or current account imbalance, structural factors such as poor infrastructure, inflexible labour markets or problems of financial sector, shortage of skilled labour and so on. Trade policy and institutions are typically included in this group of structural policies. It is clear that, ultimately, all of these factors are closely connected and should be considered by the authorities whenever they seek to enhance the role of external sector. Both macroeconomic policy and various elements of structural policies are discussed in detail elsewhere in the Report. This section will
only address the macroeconomic and structural issues in so far as it is necessary to highlight the important linkages with trade performance and policy.

1. Exchange Rate and Domestic Prices.

Economic growth in small countries such as Macedonia is critically dependent on the growth of exports and the active participation of the external sector in the mobilisation of resources for economic growth. However, the present role of the external sector is below its potential as evidenced by the relatively low share of exports and imports in GDP. It is clear that the share must increase if economic growth is to accelerate and reach a higher sustainable level.

In order to stimulate the growth of the external sector of the economy, it is essential that domestic incentives to export and to compete with foreign firms are not distorted. Unfortunately, there are strong indications that the competitiveness of domestic firms is generally very low. The current account has been under pressure, even though the trade gap has been partially offset by labour remittances. The production base is extremely narrow, which exposes the country to market fluctuations. The low trade-GDP ratio noted above reflects problems of low competitiveness of Macedonian industry and service providers across the board. Total exports increased by only 38 percent during the ten year period between 1995 and 2004. There were only three commodity groups that actually expanded, iron and steel, clothing and re-exported fuels. The country has been a net importer of most commodity groups, and its competitive position as measured by indices of “revealed comparative advantage” has been steadily deteriorating. Most importantly, labour productivity and the real effective exchange rate have declined in recent years, in contrast to developments in neighbouring countries.

These trends could be in part explained by relatively high costs of doing business in Macedonia. For example, the level of real interest rates has been high, payroll taxes on labour are also quite high, and there are many bureaucratic burdens on firms. All of these high costs point to the fact that the ability of domestic firms to compete on foreign markets is seriously impeded.

On the other hand, the rapid growth of imports relative to exports seems to reflect an expanding domestic demand and strong incentives for domestic firms to produce for the domestic market and not for export. Even though exports have been adversely affected by disruptions of production, there are indications that the incentives to export are lacking in view of the poorly functioning trade-related institutions.

Some observers, incorrectly in our view, have attributed Macedonia’s poor export performance to the management of the exchange rate, arguing that a devaluation of the Denar is necessary. In the case of Macedonia, a strong case can be made against a devaluation of the exchange rate under present circumstances and in favour of mechanisms that would provide for the realization of a more outward-oriented strategy based on higher productivity on the part of Macedonian producers. This is in part due to the fact that devaluation would have only a short-term effect on exports until domestic prices and wages adjusted upward, and it would thus delay the implementation of more fundamental economic reforms that are critical to Macedonia’s long term export success.

Moreover, the current exchange rate regime and its objective of maintaining a stable exchange rate are consistent with the government’s over-arching objective of achieving and maintaining financial, macroeconomic and political stability. The management of the exchange rate thus cannot be seen as the key obstacle to Macedonia’s internationalisation, but the need for designing an exit strategy from the current de facto pegged exchange
rate must not be downplayed in the medium term as Macedonia prepares its strategy for entry into the Euro Zone. This strategy will be dictated by the speed of convergence towards the economic performance of the European Union.

In conclusion, the long term international competitiveness of domestic firms can only be achieved through sufficient flexibility of domestic prices and an increased level of microeconomic efficiency that would raise real productivity in the “tradables” sector. The latter will require that domestic product and factor markets are sufficiently flexible which, in turn, will call for a reform of the system of payroll taxes and other fiscal levies that affect businesses.

2. Stimulating New Exports and Import Competing Industries - Role of Structural Policies.

The success of Macedonia’s outward oriented strategy will depend on the supply response of the economy. However, this response is currently subject to major structural impediments. The production structure in Macedonia is extremely narrow, which leads to a high concentration of exports and to dependence on a few export commodities. Extremely narrow production and export structures are a major developmental problem and constraint. It is clear that expansion of the external sector will only be possible through a greater diversification and increased investment in the manufacturing sector and in services.

However, these changes cannot be achieved by direct government intervention (policies of “picking winners”) but by entrepreneurs who are taking business risks and are guided by market forces. In brief, such changes will only take place in an environment in which markets are not subject to serious distortions and are supported by strong institutions. Economic diversification will not take place by government fiat and the role of industrial policies should be minimised. Instead, the authorities should put their emphasis on creating the right business environment and by encouraging new entries into markets, both from incumbent firms seeking to diversify their output and from newcomers, by eliminating all barriers to entry.

In addition, the supply response will depend on the ability of the government to address three additional structural problems – the structure of incentives generated by the existing system of taxes and tariffs; problems of physical infrastructure; and problems of corporate governance, the efficiency of the judiciary and of property rights.

(i) Market Entry and Business Environment.

Entry into new foreign markets is dependent on the overall business environment and policies to encourage the establishment of firms, the competition among firms, and the ease with which banks can support new production activities. The easier the terms of setting up and conducting business, the stronger will be incentives for entrepreneurs to enter new markets. Policies needed to create an environment conducive to good business must also include measures to facilitate exit from markets. Otherwise, business activities will slow down due to unresolved commercial disputes, increased indebtedness of firms, deteriorating balance sheets of banks and of other creditors and, in general, high costs of doing business.

This will call for an overhaul of the existing system of licensing trading rights (see section 3.2 below), creating incentives for businesses to leave the grey economy and join the formal economy, and strengthening the bankruptcy code. These policy areas are discussed in more detail elsewhere in this Report. It should be sufficient to note at this point, however, that a strong link exists between business environment and structural constraints in the Macedonian economy on the one hand and the relatively narrow production base, low trade – GDP ratio and relatively slow economic growth on the other.
Incentives to trade are also dependent on the level and structure of indirect taxes and tariffs. While the level of tariff protection is not very high by international standards, the existing tariff schedule provides different effective protection to different sectors and firms. Macedonia has the highest dispersion of tariff rates in the region. Such dispersion of tariff rates seriously distorts trade and is a source of corruption. In the long run, tariff protection should be similar across sectors and ideally as low as possible. In the medium term, changes in the tariff schedules should fully take into account the need for harmonisation with the European Union, targeting all sectors of the economy.

In the short run, the government should consider a rationalisation of its VAT system. The system should not discourage production activities of sectors that have a strong export potential. For example, VAT rates on agricultural products are relatively high, which discourages domestic production and processing of agricultural products as well as investment in these activities. In reviewing the VAT rates, the government should take care not to discriminate between activities at different stages of processing.

Expansion of existing trade and the development of new trade activities depend crucially on a well functioning and efficient infrastructure. The successful economies of South East Asia have benefited from highly efficient telecommunications, modern facilities for transport - railway, road, airport- and efficient and honest customs administration. The authorities should address key issues of infrastructure and related services – customs administration and other elements of trade facilitation, financial services, telecommunications, tourism and business services and transport services. Both the issues of physical infrastructure and of selected services are discussed further below.

Another issue of the Customs Law concerns rules of origin, which can be a major source of protection of domestic industries as well as an impediment to exports. These restrictive effects apply particularly to countries with free trade agreements in order to avoid diversion of trade due to different level of external protection among the participating countries. The problem is particularly serious for Macedonia, which has signed several such agreements. The empirical evidence suggests that there are large gains to be made from expansion of trade with other Balkan countries. A solution to the problem is to seek closer cooperation in trade policy by more closely harmonizing external tariff and trade policy instruments with countries in those regional trading arrangements. Another important measure is to provide for cumulative rules of origin, which would facilitate the exchange of goods across the region.

Macedonia is a member of most relevant international bodies involved in the coordination of activities dealing with technical standards, quality control, metrology and accreditation. While the legal provisions of technical standards and regulations seem to be in place, the enforcement of those standards continues to be problematic and costly, particularly where...
those problems affect exports. The inspection services should therefore be considerably improved, and the government should enhance the services through training of inspectors. The government should seek financial assistance from the EU and technical expertise from the new members of the EU to provide the training, to introduce the best practices and to provide the local staff with the essential equipment. The WTO could also provide assistance in the implementation of the provisions of the TBT Agreement. Alternatively, Macedonia may wish to contract out some or all of these administrative tasks to a foreign private service provider.

(iii) Sanitary and Phytosanitary (SPS) Measures. Similar comments as those noted with regard to technical standards apply to the SPS measures. Macedonia has signed major international agreements concerning sanitary and phytosanitary measures, it has adopted the relevant legislation, but the enforcement of strict SPS standards is not effective, it is costly, and it constitutes a major constraint for exporters. The solutions to this problem are similar to those proposed in the case of technical standards – external assistance from the EU to install the best SPS practices in the country through advice in loco and to finance the essential equipment. The WTO could provide assistance with regard to Macedonia’s compliance with the SPS provisions of the WTO agreements.

(iv) Export Financing. The traditional lending practices in Macedonia constitute a major constraint for export promotion. They are heavily biased towards collateral-based lending, which limits the scope of banks’ operations to lending towards incumbents and makes new entry into export markets extremely difficult, especially for small firms, and discourages project and investment lending. Foreign banks and other financial institutions with experience in project lending should be encouraged to enter the domestic market. The government should also facilitate the entry of factoring firms, which play an important role in export financing. The government should also provide further support to the banking sector to help the latter expand lending for exports. This will require possibly two steps – the provision of guarantees for pre-export financing and the establishment of hybrid lines of credit for foreign banks or foreign buyers. The institution that could provide these resources and the service already exists, the MBDP, but the bank’s operations will have to be strengthened by injecting new capital and through training.

The government would also be well advised to follow the current negotiations in the WTO, which will most likely introduce rules and limits on export credits and other trade financing instruments. Finally, the government should also help to introduce export insurance into the market. This may require first an assessment of the existing impediments to the establishments export insurance by private providers and should be accompanied by proposals to remove these bottlenecks.

Refunding of the VAT to exporters lags seriously, and, given the level of interest rates, is a major cost to Macedonian firms who export a significant part of their output. The government should commit itself to making refund payments on exports within 30 days after which unpaid exporters would receive interest on overdue refunds at the going market rate of interest.

(v) Trade Promotion. Trade promotion will also be critical to develop the external sector. A system that would help identify new export opportunities and open up new export markets for Macedonian exporters is needed. This calls for an active role of Macedonian embassies, which should shift their emphasis towards such commercial activities. It will be also extremely important to considerably strengthen the teams of trade negotiators – in the WTO and with Macedonia’s trading partners – in order to obtain concessions in areas that constitute serious barriers to Macedonian exports. Finally, it is important that business
associations and the Chambers of Commerce play an increased role in the provision of information about export opportunities and markets.

(vi) Trade Agreements. Like the rest of the region, Macedonia regulates its trade through bilateral free trade agreements. As noted above, it is important that these agreements are superseded by a single free trade agreement with the country’s neighbours. The agreements should keep the range of “sensitive” products to a minimum, and, given the ambition to join the European Union in the future, they should seek to harmonise the tariff and non-tariff structures with those of the EU.

2. Trade Facilitation.

The trade exposure of the Macedonian economy can be enhanced by government measures that facilitate trade. The Macedonian government is fully aware that it can play an extremely positive role in facilitating trade, and it has already adopted various measures to that effect. It should also consider the following measures, which are the “best practices” based on the experience of other countries.

(i) Duty drawbacks. Any tax levied on imports acts as a tax on exports and thus on their competitiveness. The more direct is the use of imports in the production of “exportables”, the stronger is the adverse effect on exports. Countries that impose tariffs on imported inputs are, therefore, well advised to allow exporters to purchase imported inputs free of duties. The practice is known as duty drawbacks, and it is recommended that the policy of duty drawbacks be adopted by the Macedonian authorities.

The duty drawback system should be as simple as possible and preferably automatic and without conditions. The drawbacks for temporary imports are very expensive (especially for small shippers) since they involve bank guarantees. The general policy of duty drawbacks should only be applied in the case of duties on imports of raw materials and other intermediate products but not in the case of imports of capital equipment. The government should refund money expeditiously and set a time limit of maximum 30 days. Late payments should carry an interest charge at the going market rate. Given the close ties of Macedonia with the EU, the procedures should be harmonised as closely as possible with those of the EU.

(ii) Publication of trade regulations. Transparency of government policies can be of enormous value. It helps provide for a level playing field and thus encourages fair and efficient competition. It creates opportunities for new entrants into the market and helps, therefore, increase competition and create new markets. Last but not least, transparency is an effective tool for fighting corruption.

Transparency implies that government regulations concerning trade are effectively publicised. The effectiveness depends, inter alia, on the scope of such information, and the authorities should, therefore, make sure that they have properly defined the scope. They should also consider different methods of publication in order to ensure the most effective and efficient method of disseminating this information. Currently, the technical and SPS standards are not easily found by domestic firms. Transparency will be enhanced through the establishment of “enquiry points”. Such information must be clearly displayed on official government websites, in both Macedonian and English. Their location should be discussed and agreed between the government and private sector representatives.

(iii) Fees and charges. It is a frequent practice of governments to levy various fees and charges on foreign trade transactions. While in theory such practices may be fully rational, their usefulness in practice is highly questionable. They increase costs of doing business and thus affect the competitiveness of firms, and they are rarely a useful source of govern-
ment revenue, but they do act as a brake on international trade, especially for small firms. Moreover, the practice is frequently another source of corruption. As a general policy, it is, therefore, advisable that the authorities either reduce the practice of charging fees and levies to the absolute minimum or, better, eliminate the practice altogether.

Fees and charges of the banking sector also tend to be very high. Charges for bank guarantees and for letters of credit – two important financial instruments in international trade – are seen as particularly expensive by Macedonian exporters. Increased competition in the market would help to reduce these charges, but the authorities should also review banking regulations to ensure that they are not a contributor to these high costs.

(iv) Release of goods. Foreign trade transactions also depend on the efficient release of goods into the market. It is known that the release of goods constitutes a major problem under current Macedonian conditions, and that the physical inspection of exports is excessive and too frequent. It is recommended that Macedonian customs officials adopt an alternative system of inspection based on statistical techniques that could be developed with the assistance of outside experts. A program of “trusted shipper” and of cooperation with freight forwarders should be implemented. It may also be useful to note that efficient release of goods typically involves practices based on the proper, transparent and widely used classification of goods, generally acceptable principles of customs valuation, and a system that avoids an excessive use of guarantees such as bonds and sureties.

(v) Documentation. It is, of course, evident that foreign trade transactions must be accompanied by proper documentation. However, it is also essential that the relevant and accompanying documentation not be “excessive” and that the requirements for documentation be, therefore, minimised. Prior publication of documentation requirements is also necessary. A single national focal point should be established to facilitate the information gathering process.

(vi) Tariff classification. The tariff classification system used most frequently by countries – the Harmonised System – is the general standard used by all WTO Members. However, the system is undergoing almost permanent revisions to reflect changes in international trade and improvements in the methods of classification. Countries may also differ in the level of disaggregation of their trade and tariff data. There is a wide-ranging agreement among WTO Members in the on-going WTO negotiations on trade facilitation to adopt whatever revisions the technical experts recommend. It is, therefore, highly advisable that the Macedonian authorities follow these negotiations very closely and make sure that their tariff classification system is up-to-date.

(vii) Border crossing. Border crossing can be a critical bottleneck in international trade. The evidence from other countries shows that costs incurred in delays at borders, costly administrative procedures and the costs of corruption can exceed the costs of tariff barriers by multiple factors. The dissolution of the former Yugoslavia has made the question of efficient border crossing particularly important. For example, it has been shown in research for the United States and Canada, two countries with almost completely “free” trade, that trade between Canadian provinces is 2200% larger than between Canadian provinces and US states of similar distance and size, meaning that national borders continue to be a major barrier to trade. These findings suggest that the Macedonian authorities must take especially radical steps to offset the effect of new borders on international trade.

The general policy advice to all governments is to ensure that the administration of border crossings is governed by three fundamental principles – predictability, transparency and speed. The insistence on efficient border crossings is crucial in Macedonia which is an active transit country. In addition, some border crossing of Macedonia can be made diffi-
cult by inundations and will require maintenance investments. Their efficiency could be increased by considering increasing the number of crossing points and by expanding their capacity, and by moving some inspections and other control activities away from the customs checkpoints to avoid overcrowding. Inspections should be random rather than total. Moreover, key customs facilities should operate 24 hours each day. It should also be noted that corresponding improvements will be required of neighbouring countries, so Macedonian policy must be directed at creating regional cooperation in the improvement of border facilities and increases in their number. Visa regulations should also be facilitated both for foreigners arriving to Macedonia and for Macedonian citizens on business abroad.

(viii) Licensing and Auditing. The current system of licenses, permits and certificates is seen by many in the business community as being in need of an overhaul. The system can be burdensome and excessive and thus costly, adversely affecting the competitiveness of firms in Macedonia. Trading is extremely concentrated, and the entry into the sector has proved to be difficult.

The government should, therefore, review the current situation, streamline and simplify the procedures to ensure that the licensing requirements are kept to the absolute minimum. Simplified procedures for SMEs are required. Establishment of a separate unit within one single ministry charged with the task of issuing trade licenses, permits and certificates should be considered.

With regard to auditing standards, firms are still required to prepare two sets of financial statements corresponding to domestic accounting standards and to IAS/IFRS international standards. This is clearly a requirement that increases costs of doing business and should be eliminated as soon as possible. The sole use of international standards should be a matter of priority as soon as practicable, and it is a conditio sine qua non for firms involved in international business.

3. Promoting Trade in Services

The service sector of Macedonia must represent a major source of future economic growth as well as a source of expansion of the external sector. At present, the sector remains relatively undeveloped, and its contribution to foreign trade is small. Its expansion is vital because the efficient delivery of various services is needed to support the activities of the manufacturing and agricultural sectors and to create additional income-generating activities. This section provides suggestions concerning the development of the services sector, a process in which the government should play a promoting role by facilitating the process.

Domestic banks should be able to compete for deposits from neighbouring states or for domestic deposits which may otherwise end up in bank accounts abroad. With the expansion of foreign investment in the country, domestic banks should be able to attract the business of foreign firms that would otherwise be served by foreign banks. The authorities should review their bank regulations and consider the time path for the adoption of Basel 2 Rules. Remaining restrictions on the access of foreign investors into the banking sector should be removed. Measures to strengthen bank supervision will also have to be adopted.

Tourism is a service sector with a considerable trade potential. At present, tourist services are not well developed, which is reflected in a low participation of major hotel chains in the Macedonian market. All efforts should, therefore, be made to attract those chains to invest in the country. Development of tourism also requires good airline and airport services, reliable and efficient foreign currency operations and facilities, and tourist guide services. The authorities should upgrade and reconstruct the airport facilities, possibly through a contract with a foreign airport service provider. The tourist market should be opened to foreign tour operators, in part by enforcing full foreign currency lib-
eralisation on current account transactions. The government should expand English language training in the tourist sector and organise “road shows” abroad to promote Macedonian tourism. Above all, the government should design a well thought out strategy to develop tourism in the country that would identify major infrastructure investment projects and guide all other decisions concerning investments, identify different segments of tourist infrastructure that need to be developed, specify conditions for market access and so on. Embassies should play a very active role in promoting tourism in Macedonia.

The authorities could also consider expansion of medical services for foreigners. Such services have become a major source of income and foreign currency earnings in countries such as Hungary and the Czech Republic, and the potential also exists in Macedonia. Demand for medical services is high in the EU and Switzerland and the services are often provided abroad on the grounds of far lower costs and high quality service. This is particularly the case for dentistry, plastic surgery and spa services. The Macedonian authorities should ensure that high quality skills continue to be offered in the country and that doctors and nurses are not tempted to leave for better opportunities abroad and that they have access to modern medical equipment. Innovative approaches will be required to provide credit financing and operations of the services providers. The authorities should harmonise qualification requirements for health service provision as closely as possible with those of the EU.

Business services are another activity of considerable potential for Macedonia. There are many global companies that are seeking to obtain access to low cost back-office corporate activities abroad. Such activities include accounting services, call centres, design activities, IT support etc. In order to attract foreign firms for those activities it will be necessary to offer a pool of well trained and foreign language speaking personnel, first rate telecommunication facilities and, in the case of activities such as accounting, qualification standards that meet the requirements of foreign firms. The government policies to attract such a foreign interest should be “bound” in the schedules of Macedonia in the WTO to make the policies not only fully transparent but “binding”, i.e. predictable and reliable. Labour laws may need to be adjusted to meet the needs of some of these activities, such as call centres and back office service providers to operate around the clock and every day.

Transport services are another promising sector. Macedonia is a cross-road (transit) country and could be a major “hub” for other markets. At the same time, Macedonia is dependent on the transport services of other countries, but the mutual dependence with neighbouring countries should facilitate negotiations on access to common road, rail and port market services. Transport services could be enhanced without major investment, at least initially, by streamlining customs administration to facilitate cross-border movements of goods and expanding the scope for cabotage.

The development of auditing services is important for another reason - to allow easier integration of Macedonian firms into global markets. Access of domestic firms to first-class services of reputable auditing firms is critical to enhance their credibility and build trust with their business partners. No credible listing on foreign stock markets will be possible without audit of those firms. Major mergers and acquisitions will also require audit of Macedonian firms whether they are being acquired by foreign firms or they are acquiring firms abroad.

One sector that has been historically fairly successful in exporting its services is construction. However, exports of construction services have dropped over time, reflecting changes in the traditional markets such as Central Europe. A revitalisation of exports of construction services will require a major effort on the part of the government and the in-
dustry. Marketing of construction services will have to receive a priority. Construction firms should not be constrained by restrictions of the Central Bank concerning outflows of foreign currency. Otherwise, the firms would be unable to finance their services abroad.

4. Foreign Investment Promotion
There is arguably no better, faster and more effective way of increasing the participation of Macedonia in global markets than through foreign investment in the Macedonian economy. Foreign direct investment (FDI) has played an extremely important and positive role in the economic progress of countries such as China and other South East Asian nations, Chile, Czech Republic, Hungary, Poland, the Baltic States and many others. FDI typically brings the host country’s firms to foreign markets, helps increase the competitiveness of domestic firms, expands exports and establishes import competing industries. At present, Macedonia is a country with one of the smallest inflows of FDI among all transition countries.

Macedonia certainly offers a variety of factors of potential interest to foreign firms, and it is only a matter of creating the correct policies and institutions so that foreign firms will “notice” Macedonia on the map of attractive markets. Sectors such as tobacco, wine production, banking and other financial services, iron and steel, chemicals, textiles and clothing as well as non-ferrous metals – all sectors with a large weight in the Macedonian economy but also experiencing considerable difficulties – can be interesting for foreign investors.

Governments are often tempted to “fine-tune” various domestic policies to attract FDI by introducing policies that provide favourable incentives on a preferential basis to foreign firms. Such policies are a mistake that originates in the lack of understanding of the motivations of highly competitive foreign firms. Clearly, a country has to offer a business opportunity to foreign investors such as the size of its market, low labour costs, qualified labour, access to other markets, natural resources, etc. In other words, the market has to offer a business opportunity that is profitable and based purely on commercial interest. Some, if not all, of these factors are present in every country. What matters most on the list of fundamental determinants of FDI are: macroeconomic, financial and political stability; respect for property rights; well functioning courts; and a business-friendly administrative environment. Financial incentives also matter, of course, and the government should ensure that its tax regime is competitive in relation to those of other countries. However, financial incentives provided on a discriminatory basis, i.e., offering special incentives to foreign investors, may only matter if some of the above fundamental factors are not present in the host country and when the country is forced to compete with other FDI-seeking countries.

The government could consider those measures to encourage FDI that have proved successful in other countries. First, the list of permissions required by the authorities from foreign investors to have their businesses established in Macedonia should be kept to a minimum. Complex bureaucratic regulations are costly and tend to be a strong disincentive to invest in the country concerned, not only because they make entry costly and time consuming but also because they are a signal to the foreign investor of long-term problems of doing business in the country. As part of these reforms, eliminating barriers to the ability of foreign investors to purchase land for their business activities is important, and laws should be in place to ensure that investors’ ability to acquire real estate is not abridged or made more difficult than it would be for a domestic buyer.

Second, information about investment opportunities in the host country can effectively be provided by a foreign investment promotion agency, and such an agency has recently been established. In making its activities effective, it is critical to ensure that the agency operates
with at least two key objectives: the agency should be an important source of information and advice to potential foreign investors about investment opportunities and conditions in Macedonia, and it should also act as a very effective “one-stop-shop” to help foreign investors in processing the administrative requirements for establishment. Ideally, such agencies should always be independent, i.e., outside the formal government structures, or semi-independent institutions in order to avoid government interference in project selection and promotion. Furthermore, the agency statutes should provide for transparent incentives to reward the agency and its staff in cases of successful FDI transactions. In reviewing the activities of the agency, the founders should draw on the experience of other successful agencies of this kind in other countries such as Thailand or the Czech Republic, and they could also consult with experts in the FIAS/World Bank.

Third, Macedonia is an economy with the potential to attract foreign investment. However, its market is extremely small, and it will be attractive to foreign investors only if it is seen as a part of a large and integrated regional market. It is for this reason that Macedonian authorities should strive to intensify their cooperation with other countries in the region. The first step in that direction would be a harmonisation of the FTAs that the country has already signed with its neighbours.

Fourth, as beautiful as the country may be, and as well-educated and industrious as its citizens may be, Macedonia is not well known abroad and its image is sometimes confused or marred by association with ethnic strife, political instability or corruption. The country would, therefore, greatly benefit from a clever “country branding”. The government should hire an experienced public relations firm with strong credentials to establish Macedonia as a country that is attractive to foreign businesses and tourists by promoting a clear and attractive message regarding Macedonia’s attractive features to foreigners.

Fifth, under the current rules, Macedonia currently levies taxes on foreign companies and their profits repatriated to their home countries. This may lead to double taxation of those companies’ incomes which, in turn, is a strong disincentive for foreign investors to invest in Macedonia. The solution to this problem is double taxation treaties that the government should sign with Macedonia’s current and potential important foreign investor countries without delay.

Finally, foreign investors require business conditions that are based on transparency, the rule of law, and contract enforcement. An obvious barrier to FDI inflows to Macedonia is the perception that Macedonia suffers from corruption and an anti-business climate. Macedonia needs to fight corruption, but the popular global rankings of corruption that guide many businesses in their investment decisions may be a lagging indicator of reality. Macedonia needs a visible anti-corruption campaign. There is advice available from international organisations such as the World Bank on how to do this and Macedonia should also publicly declare a goal to improve its international rankings in this respect – to rank in the top 50% of all countries in 5 years and in the top 25% in 15 years. Moreover, both privatisation and corporate governance reforms should be designed with a view to finding foreign investors.

Above all, foreign investors need to see a government strategy for growth and development that is backed by investment in education and greater availability of infrastructure (e.g., reducing the high costs of telecommunications), and protection of foreign investors from local predation.

D. The Capital Account

Finally, Macedonia is not very open on the capital account, and we encourage the government to move toward full capital account liberalisation within three to five years. It is impossible for Macedonia to achieve its
growth targets based on domestic savings and capital formation alone. Moreover, the lack of entry of foreign banks into Macedonia is one of the causes of, as well as the obvious remedy for, the relatively undeveloped state of the banking system and of the high interest rates that prevail in Macedonia. Thus, the undeveloped state of the banking system cannot be an excuse for keeping out foreign competition. Elimination of foreign currency restrictions will also allow Macedonian firms and financial institutions to tap cheaper sources of credit and to access markets for risk capital. In general, the elimination of foreign exchange restrictions is desirable on efficiency grounds.

Nor will limiting Macedonian citizens to investing only in domestic assets encourage saving or direct it to the best investments. Rather it will encourage capital flight and offshoring of assets. Macedonia thus needs to liberalise outward capital outflows. While such outward flows may reduce the amount of money available for investment domestically in the short run, the opportunity to invest abroad can increase domestic saving. Moreover, there may now be considerable unmeasured capital flight out of Macedonia, and this capital would be repatriated if the opportunity to return it to Macedonia and then to move it abroad again legally exists. Clearly, the ability of foreign direct investors to move funds out of Macedonia should be as liberal as possible; generally, such investors are more likely to be influenced by the overall liberalisation of outflows rather than to special regimes that affect only foreign direct investors.

In addition, Macedonia needs to be better known on global capital markets. Its visibility will benefit from some borrowing by the government on the Eurobond market to establish the country’s financial “reputation;” in the course of privatising large firms, the government should consider seeking listings on foreign exchanges for the shares of these companies. This will increase Macedonia’s visibility in global financial markets, attract capital and FDI, and also strengthen corporate governance.

In the short run, however, the government must balance the efficiency considerations against those of financial stability. The latter is typically conditioned by a certain degree of financial depth, effective financial oversight, reasonable level of currency reserves, a track record of financial stability, and other factors. While Macedonia has already made a considerable progress in those directions, the opening of the capital account cannot be immediate, but should be as rapid as possible. The government should immediately allow FDI inflows and those foreign currency outflows that are essential for their operations in the meaning of Article XI of GATT. The government should also consider a gradual relaxation of restrictions on outward long-term portfolio investment and, subject to punitive taxation, short-term and highly speculative portfolio investment.

In the years to come, the Macedonian economy will become increasingly integrated in the world economy and will be more intensively exposed to globalisation and liberalisation. As a result, the balance of payments deficit may become a constraint on accelerating growth and development policy may need to be directed towards strengthening the external position and export stimulation. Given Macedonia’s aspirations for EU integration and the need to achieve faster growth than the more advanced transition countries, Macedonia will be forced to minimise the use of external trade protection and to radically open its economy. Care should be taken to avoid the introduction of distortionary tariffs and the use of non-tariff barriers. Rather Macedonia should maintain low and relatively flat tariffs. The intensification of Macedonia’s integration in the global economy is critical for its economic success, and, given the emphasis on EU accession, it is clearly the centrepiece of the country’s hopes for the future.
IV. Structural Reforms for Microeconomic Efficiency

Macedonia has made significant progress in creating a market economy and the institutions needed to sustain it. Nevertheless, in some important aspects, economic performance has been unsatisfactory, and most Macedonians are deeply concerned about the country’s ability to provide for a better economic future for themselves and for their children. In particular, they view high unemployment as a critical economic issue. Macedonia has recently changed its fundamental labour legislation, and it is also taking important steps forward in privatisation, regulatory reform, improvements in the functioning of the judiciary, etc. Moreover, many additional changes will have to be made in the near future to make the country a viable candidate for EU membership. Microeconomic reforms, meaning reforms that promote the efficient functioning of markets, that bring the discipline of competition to firms and to their managers, and that underpin and reduce the costs of business transactions are the key to creating wealth and prosperity.

Given Macedonia’s current situation and its economic and social objectives, these microeconomic reforms must be bold, widespread and undertaken with a vigour and thoroughness that surpasses efforts previously seen in other successful transition economies. Prosperity will only come to Macedonia if it can raise the productivity of workers, of capital and of natural resources located within its borders. While social, macroeconomic and political stability and the rule of law are prerequisites for productivity gains, in themselves they cannot create prosperity. Gains in incomes and wealth are only brought about by individuals’ decisions to invest, to start new businesses, to liquidate existing ones or to alter their activities, and, on the part of both workers and managers, to change jobs. Decisions about investments and business strategy must be driven by the desire of firms to create value for their owners in a competitive environment. If firms seek only to survive or are protected from competition, if their owners seek to preserve what they have rather than to aggressively compete for more, then they will opt for defensive strategies, seeking government aid, trying to preserve their value, product mix and markets rather than responding to new developments. Similarly, workers naturally fear the severe consequences of losing their jobs in an environment of high unemployment, and, as a result, labour mobility is limited, thereby reducing the ability of the economy to develop in new and more productive directions.

Given Macedonia’s size, microeconomic decisions must reflect and respond to global trends, and many of these decisions will be made by foreign firms doing business in the country as well as by Macedonian firms doing business overseas. Thus, globalisation and microeconomic reform are deeply interconnected.

A. Improving Macedonia’s Business Climate

From international experience across many countries we already know a great deal about the factors that make for a good business environment and, within that, a favourable environment for productive investment. Assessing the quality of a business environment can be done in two principal ways, namely: (a) by studying the processes and practices concerning business conditions in a given country, and then comparing these with best practice, by which we mean the typical environmental conditions prevailing in countries considered to have a very good business environment; and (b) by studying the outcomes in terms of indicators such as the rate of new business formation, the stock and size distribution of businesses, rates of business investment, and so on, and again comparing these indicators with international best practice. A careful review of both (a) and (b) is needed in order to move forward to the design of more effective business sector policies for Macedonia.
It is important to stress at this point that in making the comparisons referred to in regard to both (a) and (b), the most relevant comparison is not really that with Macedonia’s own past situation and policies, with respect to which there has undoubtedly been some notable improvement over the past decade or so; rather, it is with other, more successful economies in the region and in the world. In our view, the people of Macedonia cannot enjoy sustained growth and rising living standards without much stronger and more active participation in the world economy, both through trade and through FDI inflows and eventually FDI outflows as well. To succeed at this, the country needs business conditions that are well above average by world standards; nothing else will do.

1. Processes and practices

EBRD (2005) reports on the most recent Business Environment and Enterprise Performance Survey (BEEPS) of the transition economies; this surveyed 9500 firms across 26 transition economies plus Turkey, with comparative data obtained for a selection of mature market economies. The latest BEEPS study follows on similar exercises carried out in 1999 and 2002, so there is now enough data to identify some clear trends. The surveys cover both business processes, discussed here, and some performance measures, discussed below.

The business environment is assessed using seven main categories. These are: business regulation, labour market conditions, taxation, institutions and property rights, infrastructure, finance, and finally the macroeconomic environment. In regard to all of these, the three BEEPS studies show steady improvement on average across the transition economies, though the 2005 survey also reveals that for every indicator, except for labour market regulation, the mature market economies remain ahead of the transition economy average. Interestingly, new private firms and recently privatised firms generally report more severe constraints on their business practices than do firms that remain state-owned, presumably because the latter still enjoy close personal links with political elites that help them bypass regulation and evade the consequences of competition. In South Eastern Europe (SEE), new private and recently privatised firms also find themselves having to pay a higher “bribe tax” than do the remaining state-owned firms.

Overall, then, we find an improving picture, but still with a long way to go. This is especially so for the small SEE countries such as Macedonia, because previous surveys showed that their business environments were rated substantially behind those of the leading Central and Eastern European (CEE) countries, and they were only a little better than the average of the CIS.

These observations are reinforced by a recent World Bank study of international trading patterns of the transition economies that notes the substantial opening up that has occurred in all transition economies in the past decade and a half, with formal trade barriers like tariffs and conventional NTBs mostly down to quite low levels except in parts of the CIS. However, in terms of trade patterns, the entire region is exhibiting a tendency to split into two groups, with the CEE countries at one pole, largely trading within the EU and with developed market economies, increasingly trading in high-value-added goods and services involving much innovation and investment. At the other pole stand the CIS countries, increasingly engaging in commodity trade, such as oil and gas, and in trade with each other or even disengaging from the world economy. The resulting trade patterns are not especially conducive to innovation and productivity enhancement, so they are not very favourable for longer term growth.

In between these two poles are the SEE countries, with Macedonia currently closer to the CIS pole in its trading practices and patterns. In order to change this situation and shift Macedonia more towards the CEE group, much deeper reforms are needed to further enhance the business environment.
2. Outcomes

Concerning outcomes in terms of business performance, the picture painted by the latest BEEPS survey as reported in EBRD (2005) is more mixed. However, a few common features emerge from the survey, and are worth noting here. Specifically, foreign-owned firms generally have both significantly higher sales per worker and higher total factor productivity than do state-owned firms, recently privatised firms with domestic owners, and new private firms. In general, firms in the CEE countries have much higher efficiency levels than those in the SEE region, showing that a competitive environment spurs firms to improve efficiency more rapidly and that the overall business environment significantly affects performance at the firm level. These findings therefore reinforce what we said above.

The other outcome data that are of great interest are those on the size distribution of firms and their total numbers. Unfortunately, recent information on this is quite scanty, but we refer here to some comparative data for the year 2000 published in Falcetti et al. (2003). This is reported in Table 4.

Studies of the United States, the United Kingdom and other mature market economies suggest that it would be normal to expect a well functioning economy to have in the order of 50-60 SMEs per 1000 inhabitants, and this expectation is confirmed by the data for the Czech Republic and Poland in the above table; Hungary and Slovakia, though performing well in many ways, have lower figures in the table. Macedonia in 2000 was reported to have only about a third the number of SMEs that it would have if it were to compare to the former two Central European countries, and this seems to provide quite strong evidence that the business environment is far less favourable and encouraging than it needs to be. Macedonia has made significant strides in facilitating business start ups since the data for Table 4 were compiled, but, as yet, the results, while positive, have not created a critical mass of new firms. In the remainder of this section, we examine areas where additional improvements should be sought.

Table 4. Number of Enterprises in South-eastern Europe (2000)

<table>
<thead>
<tr>
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<th>All SMEs (including micro)</th>
<th>Micro only</th>
<th>Large</th>
<th>SMEs per 1000 inhabitants</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEE</td>
<td></td>
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<tr>
<td>Albania</td>
<td>56,442</td>
<td>55,143</td>
<td>76</td>
<td>16.5</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
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<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>234,231</td>
<td>207,643</td>
<td>741</td>
<td>27.6</td>
</tr>
<tr>
<td>Croatia</td>
<td>39,807</td>
<td>47,368</td>
<td>529</td>
<td>13.7</td>
</tr>
<tr>
<td>Macedonia</td>
<td>27,938</td>
<td>25,985</td>
<td>194</td>
<td>34.0</td>
</tr>
<tr>
<td>Moldova</td>
<td>35,898</td>
<td>35,138</td>
<td>2,925</td>
<td>5.2</td>
</tr>
<tr>
<td>Romania</td>
<td>300,073</td>
<td>270,043</td>
<td>1,991</td>
<td>13.4</td>
</tr>
<tr>
<td>Serbia and Montenegro</td>
<td>46,207</td>
<td>n/a</td>
<td>1,072</td>
<td>8.0</td>
</tr>
<tr>
<td>CEE-Visegrad</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>476,990</td>
<td>830,601</td>
<td>1,671</td>
<td>151</td>
</tr>
<tr>
<td>Hungary</td>
<td>275,671</td>
<td>249,388</td>
<td>1,030</td>
<td>27.4</td>
</tr>
<tr>
<td>Poland</td>
<td>1,792,982</td>
<td>n/a</td>
<td>3,071</td>
<td>45.6</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>403,330</td>
<td>40,662</td>
<td>610</td>
<td>11.2</td>
</tr>
</tbody>
</table>

Note: According to the old European Union (EU) definition, an SME is defined as an enterprise with less than 250 employees, and a micro-enterprise is one with 1-9 employees. These definitions have recently been revised by the EU to incorporate annual turnover limits, but these are not used here. “Large” enterprises in Moldova are those with more than 50 employees, and most are therefore medium-sized according to the EU definition. Source: EBRD survey of national authorities; table taken from Falcetti et al. (2003).

B. Restructuring of the Enterprise Sector

1. Mobilizing Existing Capacities

During the early period of transition in the Republic of Macedonia, as in other countries in the region, a decline in industry’s share of value added in GDP was evident. Although the decline has to some extent been reversed (see Figure 4), the effects of this decline, in terms of idle industrial plants and facilities, continue to serve as a drag on the economy. The large number of inactive manufacturing capacities, in which large amounts of capital had been invested in the past, indicates either...
a non-rational use of the available resources or the fact that these assets no longer have any economic value to anyone. There is a need for quick reactivation and modernisation of all those enterprises, or their parts, that have prospects to work successfully under market principles. Those that cannot be sold or even given away clearly have no economic value, and they should be scrapped expeditiously. This program must be executed quickly, through a program of tenders by domestic or foreign buyers. Assets that do not find a buyer quickly should be liquidated, and local governments should be allowed to sell or lease the land on which they stand.

Figure 4. Share of industry in total value added (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Value Added (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>35.5</td>
</tr>
<tr>
<td>1991</td>
<td>28.8</td>
</tr>
<tr>
<td>1992</td>
<td>26.3</td>
</tr>
<tr>
<td>1993</td>
<td>24.9</td>
</tr>
<tr>
<td>1994</td>
<td>22.5</td>
</tr>
<tr>
<td>1995</td>
<td>21.9</td>
</tr>
<tr>
<td>1996</td>
<td>22.7</td>
</tr>
<tr>
<td>1997</td>
<td>24.9</td>
</tr>
<tr>
<td>1998</td>
<td>26.2</td>
</tr>
<tr>
<td>1999</td>
<td>26.2</td>
</tr>
<tr>
<td>2000</td>
<td>28</td>
</tr>
<tr>
<td>2001</td>
<td>29.2</td>
</tr>
<tr>
<td>2002</td>
<td>28.1</td>
</tr>
<tr>
<td>2003</td>
<td>28.6</td>
</tr>
<tr>
<td>2004</td>
<td>27.2</td>
</tr>
<tr>
<td>2005</td>
<td>28</td>
</tr>
</tbody>
</table>

Source: State Statistical Office

There is a need to quickly resolve the status of the claims of the Government against large companies on all grounds (outstanding liabilities towards the Electric Power Company of Macedonia, the Macedonian Railway Company, the Public Revenue Office, the Agency for Bank Rehabilitation, and the Agency for Commodity Reserves) so that these companies, in a transparent way, could then be offered for sale to interested foreign and domestic investors. The government should provide for simple tenders that do not force investors to make complex promises about their future plans; correspondingly, the government should not enter into any agreements that involve commitments to subsidised sales of electricity or other services, tax benefits, etc., to buyers of such firms. In the firms with a predominant state share or even a significant minority state share in their ownership structure, the Government has both an obligation and the responsibility actively to seek potential investors.

The reforms in the judiciary are crucial for the protection of ownership rights and for increased efficiency of the contracts, thus encouraging firms to invest productively. However, the reforms of the judiciary are projected on a medium-term basis. In the meantime, the judicial authorities should be required to quickly solve outstanding disputes in the firms related to ownership rights. The Government, of course, has no right to suggest to the courts what the outcomes of the disputes should be, but it does have the right and the responsibility to ask the courts to solve them quickly because significant capital assets are idle until then. The government should also enact clarifying legislation, which would help resolve at least some of these cases.

The same should be done with small firms. There is a need to speed up the procedures for restarting firms by conceding them under favourable conditions to interested entrepreneurs. Considering the fact that local government units and local authorities are given certain economic competencies and responsibilities, we suggest that legal possibilities should be examined for transferring state ownership of the facilities to the local government units. These units can then be actively involved in the process of restarting the facilities on their territory. The advantages of such a practice are reflected in the fact that local authorities are better acquainted with the local situation, and they can come to acceptable solutions faster, and contacts between potential investors and local authorities can be established faster and in a simpler manner. A strong preference in this system of selling firms should be for cash sales, even at lower prices, in preference to deferred payments even at a higher price, and strict time limits should be placed on selling all assets. Those not sold will be returned to the State for disposition.
Amendments to the Law on Bankruptcy that particularly focus on increasing creditors’ protection and reducing the deadlines considerably – that is, the duration of bankruptcy proceedings – are good solutions that should be applied consistently. It is essential, also, to provide training for the trustees and court staff for the purposes of implementing the new legal solutions efficiently.

In the public enterprises that have been accumulating losses on a continuous basis and where the problems of “soft budget constraints” (the losses are ultimately borne by the budget) and “moral hazard” (if losses are covered this year, they will also be covered next year) are present, the government should immediately proceed with a triage. Clearly not all public enterprises are running at a loss because managers are doing a bad job – they may be, but often it is the policies imposed on these firms (high employment, keeping prices low, providing loss-making services/goods to the public) that lead to losses. The government should identify those firms that can be privatised and sold, perhaps after a cleanup of arrears, preferably to outside owners rather than to workers or existing managers. Those that cannot be sold should be shut down; and those that provide indispensable public services but at a loss should be given a clear subsidy – either a lump sum or per unit of output.

For the latter firms, the establishment of the institution “management contracts on the basis of public announcement” would be useful. We suggest that such management contracts be introduced in public enterprises. Hence, we would particularly like to underline that managerial agreements must not primarily protect the interests of managers of public enterprises - in case of their replacement after privatisation is completed. On the contrary, they should act according to the logic of incentives and rewards in cases of improved performance of public enterprises, and penalties, e.g., replacement of managers, when the anticipated results are not achieved.

Macedonia is a small country with limited resources. Its production structure (mines, ferrous and non-ferrous metallurgy facilities etc.) highlights the risk of environmental degradation. Therefore, it is very important to enforce the prescribed environmental standards and to bring those standards into line with those of the EU. Doing so now will give Macedonia and its products a positive image in EU markets, and it will ensure that investments being made now are not rendered inefficient when Macedonia joins the EU. There is also a need for further advancement of the environmental standards in the direction of internalization of the externalities – so that the costs are borne by the polluters. In modern market economies, there are two main types of governmental regulation of the environmental pollution: direct government control (the maximum allowed quantity of harmful substances that an enterprise may discharge into the environment is prescribed by law), and taxes for the discharge of harmful substances that are paid by the polluters. Research in this field expresses a preference for taxes that act as incentives for the economic entities to reduce their pollution, i.e., to reduce the degradation of the environment.

2. Improvement of Corporate Governance

The improvement of corporate governance is particularly important for better performance of firms and for private sector development. The 2004 Law on Trading Companies removed a large number of barriers to the efficiency of corporate governance. It is necessary to speed up the process of completion of the legislation in this area according to the best international practices. In this context, it is of particular importance that the EU directives on transparency be incorporated in the Law on Securities. This would improve the quality of provision of information to the shareholders and the general public about the performance of the firms and the quality of their managers, which is essential for increased efficiency of the capital market. The
adoption of the Code of Conduct in the area of corporate governance will act in this direction. The consistent enforcement of the legislation concerning the rights of the shareholders is also important, because it helps investors to be more informed about the performance of the firms.

3. Support for Small and Medium Size Enterprises

Given the great importance of the small and medium enterprises for job creation, the effective use of local resources, increases in the supply of goods and services, and for ensuring the sustainability of development, they should be supported mainly with the new measures and instruments that are currently applied in other market economies. The government has reduced barriers to forming and registering new companies. The efficacy of this law should be closely monitored, and needed adjustments should be enacted quickly.

The Agency for Support of Entrepreneurship, the regional centres, the business incubators and the local authorities should participate in promoting business networks for connecting small businesses with complementary programs including supplier networks, access to bank credit, etc. at the local and regional level. There is a need for caution in the establishment of new institutions for the direct support of SMEs and entrepreneurship. Worldwide experiences have confirmed that increased participation in the entrepreneurship process can be ensured through other forms such as student internships, temporary engagement of graduates, experts and local consultants on concrete projects, etc.

Experiences of developed countries confirm that the dissemination of entrepreneurship culture must be a well thought out process that includes young people from an early age – as early as primary school. Therefore, we suggest that the Ministry of Economy, in cooperation with the Ministry of Education and the State Universities in the country, should introduce business disciplines in the curricula (and not only in economics or business faculties, but much more widely), as well as add these topics to the curricula of the secondary schools.

C. Increasing the Efficiency of the Financial System

A dynamic investment climate and the ability of firms to finance their growth and their expansion to new activities as well as the ability to finance newly-formed firms requires an efficient financial system, one that provides sufficient funds for growing businesses and that can also avoid channelling funds to failing firms. The availability of such financing appears to be a major barrier to Macedonia’s economic progress. Barth et al rank Macedonia 74th out of 121 countries, on a par with Kenya and Pakistan, in a global capital access index that seeks to measure the ease with which new and existing firms can access needed capital. Neither small size nor being a transition economy is a bar to scoring well in this ranking; Estonia ranks 21st, the Czech Republic 32nd. Moreover, Macedonia is tied with countries such as Germany and Japan for 22nd place in terms of “macroeconomic stability”, one of the subcomponents of the overall index. However, Macedonia does very poorly relative to its overall ranking in some other sub-indexes such as “economic institutions”, by which the authors mean contract enforcement, property rights, lenders’ and borrowers’ rights and the efficiency of the bankruptcy process, judicial independence and efficiency, etc. and in “banking institutions”, meaning the strength and efficiency of the banking system. These findings are consistent with the views of the Macedonian business and financial community, and they suggest that improvements in the financial system and its supporting institutions are needed if economic progress is to accelerate.

1. Improving Financial Intermediation by the Banking Sector

Given Macedonia’s economic needs and structure, the banking system is likely to play
a very large part in the financing of Macedonian firms and farms. A well-functioning system that can attract both domestic savings as well as foreign funds is a critical need, and policies to create such a system must be implemented quickly and thoroughly.

By the standards of other transition economies, the role of the Macedonian banking sector in financing the business sector is low, and lending rates as well as interest rate spreads appear to be quite high, suggesting poor financial intermediation by the banking system. While some observers attribute these high interest rates to monetary policy, we believe that they also reflect to a greater or lesser extent all or some of the following factors:

1. The structure of the banking system, including weak governance of banks, lack of competition, the existence of weak banks, and ownership of banks by other firms.

2. The financial situation of many borrowing firms is not good. The state of corporate governance in borrowing firms often makes owners willing to borrow in order to keep their firms afloat and to avoid possible changes in their ownership structure. Many firms are also financially troubled, making lending risky, especially if bankruptcy procedures are not effectively implemented. Lending to weak firms not only misdirects funds to sectors of low productivity, it also starves more dynamic firms of needed funds.

3. Macedonia is a partially Euroised economy. Some financial transactions are denominated in Euros, others in Denars, and some Denar loans carry currency clauses protecting the lender against Denar devaluation. The level of Euroisation is close to the level of other small and open economies. Neither ending the Euroisation of deposits and loans nor moving toward full Euroisation of the Macedonian economy appear to be realistic options in the intermediate term although, of course, this issue must be tackled at the final stages of the adoption of Euro. Therefore, the current arrangements and their contribution to high interest rate spreads will have to be accepted, and other means, such as improving competition in the banking sector, will have to be used to lower interest rates.

The reform processes in the banking sector should, in the future, be directed towards remedying these weaknesses. There should be further intensification of effective competition in the banking sector by encouraging the entry of quality foreign banks, which will result in a wider variety of banking services and more competition. In this context, the legal restriction against opening branches of foreign banks in the country until 1 January 2008 should be abolished. The Macedonian banking market should be open on very liberal conditions (in terms of acquiring the rights to operate on the territory of the Republic of Macedonia) to any bank that is domiciled in a country with bank regulation a priori deemed acceptable to Macedonian regulators and whose size or capitalization meets a pre-determined and uniform standard set either by Macedonian legislation or by the regulatory authority. At a minimum, this should allow the nearly free entry of large and medium-sized banks from the EU, the US, and many OECD countries. Also, the ability of Macedonian banks to seek deposits overseas should be enhanced, especially because of the large number of Macedonians working outside the country.

There should be a much faster process of consolidation of the banking sector by encouraging mergers and acquisitions among the existing banks. Capital requirements should be raised either by legislation or by the regulatory authorities as a way of promoting consolidation as well as of improving the quality of banks. This would reduce the risks associated with the presence of a fairly large group of very small banks. Regulators should also focus on the quality of bank owners, and firms in obvious financial difficulty should be forced to divest their holdings of bank shares and to give up their representation on bank boards. These measures should also have a positive impact on the inflow of FDI into the banking sector, as small banks that cannot
raise their capital would thus become available for sale, and low-quality owners forced to divest their shares would have to sell them to new owners.

It is also necessary to further improve the quality of credit analysis and the monitoring of loans in order to increase the efficiency of the allocation of bank loans by the inclusion of new, financially healthier borrowers, especially from the sector of small and medium firms. This would be supported by the use of the loan registry established within the central bank, which will provide information necessary in the credit analysis not only for the banks, but also for other non-banking financial institutions (leasing and factoring companies), as well as for the development of credit ratings during a possible issue of corporate bonds on the capital market. The registry should also provide information about creditors’ tax and utility payments or arrears. Therefore, all the regulatory aspects of the use of the credit registry need to be developed.

Improvements are needed in the corporate governance of banks in terms of strictly limiting the loan exposure of banks to related persons (legal and natural) because lending to related parties raises conflicts of interest between the bank as the “owner” of a firm, and its role as lender to the same firm. The issue is even more complicated when the firms themselves hold shares of their own banks. Such cross shareholdings are not uncommon in some countries, where banks hold shares in the larger firms, especially in countries where stock markets are weak or non-existent or developed late.

Some countries have found the resulting conglomerates a successful vehicle for promoting high investment and rapid development. Japan and later Korea are examples of such a successful relationship between firms and banks. However, there are far more countries where such nepotistic relationships between banks and firms have not fostered growth at all. They have simply enabled bad firms to survive. Russia comes to mind, as does quite a number of developing countries in South America and elsewhere in South East Europe (e.g., Bosnia, Moldova, and Serbia). What seems to be important for economic success in these contexts is a combination of competition within each conglomerate due to the operation of a sort of internal capital market, with weaker firms denied funding; competition between conglomerates; and a strong orientation in the whole system, including from the political elite, towards growth and development. It is at present doubtful whether all of these conditions hold for Macedonia.

This regulation on related lending should be implemented in conjunction with new regulations strengthening the independence of banks’ Boards of Directors, improving the systems of internal control and promoting the role of the risk management bodies. If Macedonia chooses not to ban all related lending (which may be difficult to do in practice), we would recommend that, at the least, strict limits be placed on the amount of such lending and that the regulatory authorities and banks’ Boards of Directors, and especially independent directors, have the means and incentives to monitor such lending.

There is a need for strengthening the rights of creditors and the responsibilities of the bankruptcy managers with new amendments to the Bankruptcy Law. In addition, in the Law for Collateral, further definitions should be made as to the issues regarding the foreclosure of collateral by the creditor, the priority of claims of the creditors etc.

In the future, bank supervision in the Republic of Macedonia will be confronted with the important challenge of implementation of the new international supervision standards, known under the general name of the Second Basel Agreement. These standards are, above all, relevant for developed banking systems, and they are quite complex and sophisticated in their methodological framework. Their relevance for Macedonia will grow with the pace of technological modernisation, includ-
ing progress in information technology and in electronic banking, of the Macedonian banks and the pace with which they will be enlarging their activities involving financial instruments on the capital market. The new Basel standards will also introduce a new approach to the supervision of, inter alia, the “traditional” and, for Macedonia, still the most relevant type of risk, credit risk.

All these steps, including increased foreign competition, reducing operating costs, and the increasing the deposit base of the banks should contribute, as they did in other transition countries, to a decrease in the general level of interest rates and margins and to a better allocation of funds among firms.

2. Development of the Debt and Equity Markets

Even in the most developed market economies, much of the investment by private business is funded from retained earnings, including, of course, depreciation allowances, with many small businesses also getting initial financial support from family, friends and business associates. Issuing bonds and new shares is therefore not the only means of financing investment. As a result, the great bulk of stock market transactions involve redistributing existing financial assets rather than issuing new ones to raise capital for expansion.

The development of an equity market in Macedonia is problematic. On the one hand, the country is small, so such a market is subject to high costs and unable to capture economies of scale. The structure of shareholding, mainly in the hands of insiders or residual shares held by the government, does not offer an ownership structure that is conducive to the liquidity of such a market. Most important, the market signals received so far are that Macedonian firms see insufficient benefits from listing their shares on the Macedonian stock exchange, and this suggests that the resources expended on the creation and functioning of the stock market might have been more usefully expended on other institutions or reforms. Indeed, the government has chosen to provide significant tax breaks to induce firms to list their shares on the stock exchange, and the tepid response of the firms to these financial subsidies is a clear signal of the limited benefits they perceive. We deplore such “targeted” tax measures.

Nevertheless, we acknowledge the ultimate value of the liquidity of shares for shareholders, but we would encourage the Macedonian government to consider less costly ways of achieving this, for example by allowing commercial banks to make a market for key securities. The issue of insufficient liquidity of the securities market could be dealt with indirectly in the medium term by encouraging the process of integrating the Macedonian Stock Exchange (MSE) into international capital markets. The first possibility would be that the MSE becomes a part (a subsidiary) of a major European stock exchange, something similar to what has happened with stock exchanges in the Baltic countries. In this case, the Macedonian Exchange could still retain its legal personality as a domestic institution. The second option would be for the MSE to link to regional markets – a “joint trading platform” possibly led by the Slovenian and/or Greek stock market. In principle, both options could allow, even under the existing foreign exchange regulations, for Macedonian residents to invest in foreign securities, and could also enlarge the pool of liquidity for trading in Macedonian securities. It is obvious, however, that the first option would achieve both of these results faster. However, either option is only likely to be viable in the distant future.

Until a more permanent solution is found to the foregoing problem, strengthening of the regulation of the market for securities must follow the changes in international regulation standards within the IOSCO and of the relevant EU directives. Moreover, it will be of key importance to ensure that the Securities and Exchange Commission, as a regulatory and supervisory body of the securities market, is both independent and competent. It is also of
importance to increase the quality of financial reporting and auditing, which serves the purpose of increasing the information efficiency of the securities market. Insisting on the disclosure of information, which is embedded in the regulations adopted by the Securities and Exchange Commission and the Macedonian Stock Exchange, is not enough, because the publicly available information will be of limited use to the investors in securities without good audits of financial reports. Progress is also needed in the application of international accounting standards. Currently two sets of financial accounts are reported, one according to Macedonian standards and the other based on international standards. Also, the Audit law of 2005 requires an effective enforcement mechanism.

Both government bills and bonds have been issued and the development of the government bonds market is important for the development of the market for corporate bonds: in general, the government bonds market is a benchmark for the rest of the bond market, both with regard to the setting of prices and yields and to the institutional arrangements (for example, for settling transactions, etc.). The experience of other transition countries is that government bonds tend to crowd out lending to firms, and thus we would encourage caution in determining the volume of government securities placed on the domestic market. Some such bonds are useful, providing a solid asset for investors, but too large an issue could starve the business sector of funds. Treasury bills and bonds have been released, and progress has also been made on the regulatory framework in this area. The pension reform will create a need for bond issues as a regular instrument for financing pension expenditures. In this context, the issue of the first sovereign Euro-bond of the Republic of Macedonia should have a certain demonstration effect.

The bonds issued by local authorities could also be a viable instrument on the market. However, a prerequisite for issuing “municipal” bonds is the consolidation of outstanding debts of local authorities, i.e., compiling and reporting correct information about the true level of municipalities’ debts, and, afterwards, developing a credit rating of the potential issuers of such bonds. We discuss the conditions for issuing such bonds at greater length in the chapter on fiscal decentralisation.

3. Reforms of the Pension System

The “first leg” of the pension system is the pay-as-you-go component financed by government revenues. The government needs to consider reforms to this system because it will increasingly come under pressure as payments are diverted to the “second leg”. In particular, the government should reconsider the retirement age and examine whether it should be mandatory.

From the aspect of the financial system, i.e., the capital market, a new type of financial institution, privately managed fully funded pension funds, has emerged for the first time with the pension reform. These, in fact, are the first investment funds in the Republic of Macedonia. By their institutional form, the pension funds are defined by the law as open-ended investment funds managed by companies established to manage pension funds. In this way, a new “industry” within the financial sector has emerged: the industry for managing financial assets. The key to the good functioning of this industry is regulation that is both legally well established and effective. It is of particular importance that the regulatory body carries out effective price regulation with regard to the fees (commissions) that will be charged by the pension companies, given the fact that in the initial stages there are only two pension fund management companies, creating an insufficiently competitive market.

The limits imposed on the classes of financial assets in which the funds may invest, which is a standard type of regulation for pension funds, are included in the Law, whereas the details are elaborated in the secondary legislation of the Agency, as the regulatory body.
In the future, depending on the development of the national capital market, as well as on the possible measures for further liberalisation of the capital account of the balance of payments, there will be a need to reconsider the limits for certain classes of assets, especially with regard to the investment in foreign financial assets (see Box 1.)

Another important issue is the corporate governance of pension funds, i.e., pension companies. On the one hand, the regulation addresses in an adequate manner issues such as the separation of the funds of the members of the Fund from the funds of the company; execution of the function of “custodian of assets” for investing the money of the Fund in securities of persons related with the company; the obligation to provide for external audit, etc. In the future, account should be taken of the most recent regulatory standards in this area, such as the principles of corporate governance of pension funds developed by the OECD. The existing legislation assigns numerous and important functions and powers to the Agency for the supervision of the capital-financed pension insurance. Therefore, it is of critical importance that the Agency have institutional independence vis-à-vis the executive branch of the government, appropriate human resource capacity, credibility and transparency of its operations.

Box 1. The Organisation of Pension Funds: A Problem Caused by Insufficient Globalisation

The current organisation and functioning of the new private pension funds throws into sharp relief some of the problems that Macedonia faces in creating institutions in a small and insufficiently globalised economy and the need for creative solutions to these problems. First of all, any such pension fund is characterised by important economies of scale. Even limiting the number of entrants into this industry to two may already result in too small a fund manager size and result in high operating costs. In fact, the fees of the Macedonian funds, 1.8%, are higher than the fees of similar funds in other transition countries, in some cases by quite a wide margin: Czech Republic, 1%; Hungary, 0.6-0.7%; Latvia, 1.1% and Poland, 0.54%. Second, by restricting the funds to investing no more than 20% of their assets abroad, for example in the bonds of foreign governments or in the shares of major global companies, the funds are severely limited in their choice of assets, resulting in a portfolio that is very inefficient in terms of risk and return. What might be seen as a prudential regulation in a large country with a well-developed capital market thus becomes, in the Macedonian case, a mechanism for raising costs and lowering returns to participants in these funds. The entire organisation of this part of the pension system should be reconsidered by the government as soon as the relevant legislation and contracts allow, and the lifting of limits on investment in foreign securities should be an integral part of the liberalisation of the capital account of the balance of payments.
D. Creation of a Favourable Investment Climate

A favourable investment climate has a strong influence on the motivation of the firms to engage in productive investments, to create jobs and to expand their capacities. The investment climate focuses on the issues of institutions, rule of law, stability of policies, administrative barriers, corruption, infrastructure, taxation, financing of businesses, policies for attraction of foreign investments etc. Hence, the creation of a favourable investment and business climate is a process that cannot be implemented unless it covers all interrelated segments of the business environment. Given that investments are based on future expectations, the ability of governments to maintain stability and credibility of their policies are key elements in the creation of a favourable climate for investments.

Good protection of ownership rights, the efficiency of the enforcements of contracts and the rule of law in general are the first precondition for the creation of a favourable business climate because they have the strongest influence on the motivation of the firms to invest productively. This shows how important the implementation of a comprehensive, competently drafted and quality managed reform of the court system is.

High-quality, readily available and inexpensive infrastructure has a strong impact on the cost of doing business and is one of the basic conditions for mobilizing domestic resources, for attracting foreign investments and for increasing the economy’s efficiency. Therefore, in the forthcoming period it is necessary to make special efforts to improve the communications and transportation systems of Macedonia, to reduce the costs of these services, and to support the process of rehabilitation, enlargement and modernisation of the local infrastructure and utility services. To this end, it is necessary to use all possible financial sources: the state budget, the Road Fund, credits from international financial institutions, concessions etc. In the areas of telecommunications, energy and transportation services, further liberalisation is necessary, for example through the entry of a new operator in fixed telephony, entry of the private sector into the generation and distribution of electricity, etc., as well as raising of the quality and efficiency of the regulations, as preconditions for price decreases to the benefit of businesses and citizens.

Corruption increases the costs and the risks of doing business, deters both domestic and foreign investors and harms the international reputation of the country. Therefore, it is necessary to deal with corruption in a frontal and broad manner by: introducing an efficient judicial system; creating rule-based and non-arbitrary regulations; re-assessing the discretionary rights of government officials; implementing the one-stop-shop system in as many spheres of regulation as possible; strengthening the position and independence of bodies fighting corruption; increasing the transparency of public procurement; confronting the practice of politicising important economic decisions, etc. In this respect, the political will of the government to address this evil is a crucial precondition for the elimination of corruption, and a strong and credible commitment to a quantifiable goal is essential. In addition to a developing, implementing and publicising a broad anti-corruption program, the government should set concrete targets for achieving a major improvement in the country’s rankings in well-know international indexes of corruption as suggested earlier in this Report.

E. Institutions for the Support and Regulation of Markets

Modern analyses of economic growth attribute differences in the level of economic development and in the speed and sustainability of economic growth between national economies as reflecting the quality, efficiency and credibility of their institutions.

The following four types of institutions are particularly important for the processes of economic growth and development:
1.) Market-creating institutions, such as the judicial system, which protect ownership rights, ensure the execution of contracts and the rule of law in general and have crucial importance for encouraging productive investments.

2.) Market-regulating institutions such as agencies, commissions and other regulatory bodies in the areas of telecommunications, energy, transport, environmental pollution, finance, anti-trust commissions, etc., that mitigate market failures;

3.) Market-stabilizing institutions, including the Ministry of Finance and the National Bank as the most important macroeconomic institutions. Their credibility is most directly associated with their ability to maintain price stability and to implement macroeconomic policies that will support the growth and the creation of jobs;

4.) Market-legitimizing institutions, including pension funds, schemes for support in case of unemployment, health funds, etc. Among other institutions, we particularly emphasise the importance of the State Statistical Office and the Cadastre. The Cadastre's records and their completion is a priority need because it is directly associated with effective investors' and citizens' real estate ownership rights.

1. Judicial Reforms
Macedonia’s court system is overburdened, inefficient in processing cases and regarded as corrupt. As such, it is a major barrier to the development of the economy. Reforms are under way and these need to be pressed with vigour, to be constantly evaluated and publicised, not only among legal specialists but also the public at large.

The goal of the reform in terms of organisation is to adjust and restructure the judicial bodies and services according to rational criteria. Changes in the organisation of the courts should adjust the number of courts and their jurisdiction according to an efficiency criterion. There is a need for a more adequate regulation of the internal organisation of the courts and of the established management and control mechanisms, along with a consistent enforcement of management standards in the judiciary.

In regard to court procedures, reforms must provide easier access to justice, free court proceedings from unnecessary procedural formalities and create a more efficient and unbiased system of legal protection. Judicial procedures need to be revised to expedite the resolution of cases. Furthermore, in the area of criminal justice, the slow course of the proceedings can be removed by defining priorities in the penal policy, simplifying the regular court proceedings, applying summary proceedings and out-of-court settlement.

The measures for improving the efficiency in the settlement of disputes in the area of property and contractual law are related to three levels. At the dispute prevention level, it is necessary to encourage the participation of trained individuals (lawyers, legal advisers) in the phase of negotiations for concluding contracts, with a view to stipulating clearly the rights and obligations, thus avoiding later possible disputes. At the dispute settlement level, there should be much greater possibilities for alternative methods for settling disputes. At the execution level, a huge load can be taken off the courts by transferring the competency for the execution system to enforcement officers – private persons with public authorisation in that area.

Judges must exhibit the expertise, independence and impartiality that every person justifiably expects from the judiciary as a whole and from every individual judge entrusted with the protection of his/her rights. Judicial expertise needs to be upgraded. Judges should have one or several specialties in law, and cases in those specialties should be assigned to them. Advancement and retention of judges should be based on merit according to these criteria.

Judicial reform, nevertheless, is not the only mechanism that can contribute to the creation
of a favourable legal climate for economic development of the country. As mentioned elsewhere in the report, measures need to be taken to clearly define the system of registration of real estate and to ensure its efficiency and transparency. Additional measures need to be taken to improve the functioning of the registers for registration of pledge rights. Measures should also be taken to improve the legal framework related to foreign investments in terms of improving the system for registration of trading companies.

2. Market-regulating Institutions
Regulatory institutions mitigate so-called market failures. The lack of tradition of such market regulation by the state and the inexperience of Macedonian institutions in this area is a serious handicap for Macedonia that needs to be addressed. In doing this, it is especially important that these institutions establish themselves from the very beginning as autonomous and independent institutions. Given Macedonia’s desire to join the EU, the regulatory framework should be consistent with EU practice, and we strongly recommend that staff form Macedonian regulatory agencies be given significant opportunities to work at or to visit counterpart agencies in EU countries.

The domain of electronic communications and radio broadcasting is key to creating a sound business infrastructure, and particular attention needs to be paid to developing a regulatory framework that will support the development of this sector. A single regulatory agency should be established in accordance with the practices in EU countries, the competencies of which will include, *inter alia*, the adoption of a list of universal services, tenders for obtaining concessions in mobile telephony, specification of the conditions for linking telecommunication networks, etc.

Given Macedonia’s limited resources to staff regulatory agencies, we strongly recommend that ways be developed to make use of foreign, and especially EU, regulatory procedures and that, where feasible, foreign or international regulatory institutions be used to provide regulatory oversight.

F. Agriculture

Agricultural output has stagnated in the transition period despite Macedonia’s potential in this sector. Agriculture in Macedonia will increasingly and unavoidably face greater foreign competition in the future. Even though it is a sector that has significant potential thanks to the increased globalisation of agricultural trade, this potential can be realised if and only if government policies and structural changes in agriculture can enable Macedonian farmers and processors of agricultural outputs to increase their productivity and increasingly meet EU and world standards for quality, phytosanitary standards, etc. The effective performance of the agrarian sector, just like that of industry, requires macroeconomic stability and a business friendly environment. Hence, the recommendations for improving the overall business climate in Macedonia developed elsewhere in this report are critical for accelerating the growth and improving the competitiveness of the Macedonian agricultural sector as well. In this section we address the sector-specific policies and institutional improvements necessary for strengthening the ability of Macedonian agriculture to effectively meet the needs of the domestic market and to compete on global food markets in certain products as well.

1. Market and Institutional Improvements
Needed improvements in the functioning of the markets for agricultural inputs and outputs and of the institutions that support these markets include:

The Market for Land. A key barrier to the prosperity and progress of the agrarian sector is that it is dominated by small family farms and by small and medium-sized food processing facilities. The efficient functioning of the land market is the only feasible way to resolve the major structural problem of the sector – the excessive division of
privately-owned agricultural land. In Macedonia, the average farm has 2.5 hectares divided into 6 non-contiguous plots. Such a pattern of land holdings constitutes a major barrier to efficiency and to the introduction of modern technologies.

It is vitally important that Macedonia develop a market for agricultural land that encourages the rational use of land by permitting the consolidation of agricultural plots, the expansion of successful farms, and the exit from agriculture of land owners who do not wish to work their land. The market for private agricultural land, which accounts for about 80% of the total, is overly segmented while the lease market for state-owned land is dysfunctional. The Macedonian cadastral land registration system is in the process of modernisation, with updating of maps and the introduction of new data storage technologies as well as verification of current land titles. This work, which is fundamental for the efficient operation of the land market, needs to be accelerated by employing additional budgetary and donor resources. The sale of agricultural land to foreign persons, both legal and natural, should be permitted as soon as the revision of the land cadastre is complete. This liberalisation can promote the modernisation of agriculture by foreign investors, and increase the price of land, thus enabling farmers to raise funds for the modernisation of their equipment and buildings and for the expansion of their land holdings.

Accelerating the consolidation of private land also requires changes in inheritance legislation as well as improvements in the collection of the land property tax. The existing tax regime for agriculture land has brought the cost of land ownership to almost zero, and it thus eliminates an important incentive for the numerous landowners who have migrated to the cities and abroad to lease or sell the agricultural land that they do not use. Employing public resources for setting up a national agricultural land market information system is also justified under the existing circumstances. Updating and enforcement of spatial plans is another important government function that facilitates the transparent functioning of the land market.

As far as state-owned land is concerned, the government needs to rethink its current policy of land leasing as the only mechanism for disposing of state such land. Less than a decade after the existing policy was introduced, there is clear evidence that a single disposal method, and the criteria used for awarding lease contracts, have not generated the desired outcomes. Much of the leased land remains idle due to the ban on leased parcel subdivision and sub-leaseing and to the non-enforcement of the lease contracts. There is considerable international evidence that the gradual sale of state-owned land and reliance on the market to determine economically feasible farm size is a superior model for directing land into its best use. Therefore, Macedonia needs to revise the Agricultural Land Law by building on the best international land regulation practices and strengthening the capacity of the institutions for land management and administration.

The Market for Agricultural Labour. The agricultural sector continues to provide employment, though not in a very productive manner, to a significant portion of the labour force. The contraction of employment opportunities in the other sectors of the economy brought about early in the transition was partially mitigated by the agricultural sector, which is now plagued by underutilised labour that only deepens rural poverty by creating an illusion of employment without sufficient income. This surplus labour and market uncertainties have pushed many commercial family farms into semi-subsistence farming. Thus the overall economic recovery and job creation in the other sectors of the Macedonian economy are crucial for the absorption of the underutilised labour in rural areas.

It should be noted, however, that, despite the perceived low opportunity cost of unskilled agricultural labour, there are some labour-intensive types of agricultural production that experience labour shortages during the peak
farming season. There is recent evidence that labour mobility across the national borders in the region is increasing, and many seasonal workers find summer agricultural jobs in EU member states. Thus, the pressures for raising productivity and profitability in Macedonian agriculture and creating higher paying jobs are increasing as a result of regional labour market integration.

In the given circumstances, the best course for government policy is to improve the services that promote rural non-agricultural activities by encouraging entrepreneurship through education and training, i.e., improving the employability of the idle agricultural labour force by developing and implementing re-training programs relevant to the needs of the expanding private sector. The government also needs to address issues of rural poverty. We believe that the better way to address rural poverty lies in direct financial support to the rural poor rather than in subsidies to agricultural production. The latter would tie the rural poor to agricultural activities, even if these were not viable in the long run or did not require as large labour inputs as was the case in the past, while the former would provide more effective support for less money while encouraging the natural movement of labour to other, more productive, activities.

The Market for Intermediate Inputs and Technology. Although agricultural inputs are generally available in the rural areas, this market is overly regulated for a country of the size of Macedonia where very few inputs are produced domestically. The cumbersome and time consuming registration requirements for plant and animal genetic material as well as for plant protection agents and veterinary drugs contribute to: (i) higher prices due to the substantial compliance costs that are ultimately passed on to the consumers; (ii) postponed penetration of new technologies because of the delayed availability of the inputs that are necessary for the adoption of those technologies; (iii) limited interest among multinational firms to register their new products for sale on the Macedonian market. Quality control is also a concern, and farmers frequently complain about product forgery. Therefore, this market would benefit tremendously from less regulation, and Macedonia’s EU membership ambitions provide an excellent opportunity to adopt a “me too” policy of applying EU standards and approvals even before acquiring member state status. Given that there are large regions within the EU member states that have similar agro-environmental conditions as Macedonia, this policy is relatively simple and easy to implement because it is based on the rationale that “agricultural inputs that are good for the EU are good for Macedonia as well”. This would require regulatory action for the transposition of the EU’s plant/animal genetic, plant protection agents and veterinary drugs registries into the domestic legislation as well as the creation of new types of enforcement capacity that would be focused primarily on preventing labelling fraud. The early adoption of such policy would level the playing field, as far as the agriculture inputs and input-based new technologies are concerned, for Macedonian farmers relative to their competitors from the EU member states.

Macedonia’s agro-processing capacity must be upgraded. Foreign direct investment in this sector should be encouraged, not necessarily by financial stimuli, but rather by commercial diplomacy and publicity as well as though public education of farmers to enable them to meet the demands of modern processing facilities. To this end, the government needs to reduce barriers to the activities of private farmers, of cooperatives and other voluntary organisations for post-harvest collection of produce and of marketing associations for processing and distributing them.

The Market for Rural Credit. Despite the weaknesses of the banking sector that are described in this report and the severe contraction of agriculture credit post independence, recent government-backed donor programs have increased rural lending. USAID-sponsored micro-credit institutions using advanced micro-credit techniques have
expanded their operations and have acquired the legal status of a financial intermediary under the Macedonian Banking Act. Their rural lending portfolios are increasing and show admirable repayment rates. An IFAD financed micro- and small-agriculture credit facility based on loan refinancing principles, where commercial banks bear the full lending risk and have access to matching capital under favourable terms for agriculture credit, has attracted the interest of the biggest Macedonian banks and facilitated substantial commercial capital co-financing of small- and medium-sized agriculture investments.

An important contributing factor to the success of these rural credit schemes is the existence of subsidised business advisory services that help farmers and rural entrepreneurs prepare business plans and loan applications. Thus, simultaneously with improving the overall competition on the credit market and consolidating the banking sector, the government needs to expand and/or replicate the existing rural credit success stories in a way that does not distort the credit market and channels funds for investments to rural areas. A well functioning rural credit market is also one of the major preconditions for Macedonian farmers to be able to meet the strict pre/co-financing requirements of the IPARD investment grants scheme that will become available to Macedonian rural residents by the end of 2007.

Information for Policy Making. Informed policy decisions need to be based on reliable up-to-date information about the economic and financial performance of the sector as well as about its resource base and structure. Much of the currently available information about the agrarian sector dates from 1981 when the last agricultural census was carried out. Therefore, all branches of government as well as foreign donors need to support the current efforts of the Macedonian Office of Statistics to secure funding for a new census. The new census is an excellent opportunity inter alia for setting the stage for the development of an EU compliant Farm Registry and Farm Accountancy Data Network as well as for providing the necessary inputs for drafting a viable Rural Development Strategy and the associated plans that are important prerequisites for the timely absorption and equitable allocation of the EU funding through the Instrument for Pre-Accession Assistance (IPA) - Rural Development (RD) grants pillar.

2. Macedonian agriculture in a global setting. Globalisation has, and will continue to have, a major influence on Macedonia’s agricultural sector. All Macedonian governments since independence have drafted agriculture strategy documents whose overarching objective was achieving self-sufficiency in food production. The efforts to translate such an isolationist objective into concrete agricultural policies are particularly troublesome in the light of SAA and WTO agreements and lead to ad hoc government interventions to mitigate the increasing trade gaps for particular food products, with milk and cereals being two egregious examples.

Hence, both in keeping with our recommendations for the greater globalisation of the Macedonian economy and with the need to formulate a realistic agricultural policy, Macedonian policymakers need to abandon the goal of food production self-sufficiency and embrace a more realistic goal of making Macedonia a “net agricultural exporter” while maintaining the environmental sustainability of the agriculture resource base. Thus, Macedonia needs to carry out a fundamental realignment of its national agricultural policies and support programs toward helping farmers to produce commodities using efficient technologies that they feel will be most advantageous from a market perspective, for traders to move goods in the expectation of profits unconstrained by uncertainty about government intervention, and for consumers to be able to buy food at the lowest prices, whether from foreign or domestic sources.

Such policy adjustments are long overdue given Macedonia’s commitments to reduce trade barriers under the SAA and WTO
agreements as well as the forthcoming expansion of CEFTA, and future EU membership. By acquiring EU candidate status, Macedonia became eligible to receive investment grants for rural development under the IPA program, and creating the administrative capacities for making effective use of these funds is an important task for the government. The introduction of EU and international standards regarding the origin, quality, health testing, and other components of food products, fresh and processed, will become increasingly important. Without their effective implementation, Macedonian market- and export-oriented agricultural surpluses have no real and sustainable prospects.

G. Labour Market Reforms
The persistently high level of unemployment in Macedonia is a major source of concern and the cause of serious social problems. Consequently, unemployment has become a central issue. The unemployment statistics appear to be unreliable despite some attempts to improve the efficiency of collecting and disseminating the unemployment figures. According to the National Human Development Report (2004), the unemployment rate was almost 37%, while other characteristics of unemployment include the following related figures: young people (15-30 year old) account for more than 40% of the unemployed, the long-term unemployment rate is above 30%, those who finished 3-4 years of secondary school account for 55% of the unemployed, and female activity rates are much lower than those of the men.

The analyses of unemployment in Macedonia suggest some obvious factors that contribute to the high unemployment rate: the decline of some sectors of economic activity combined with a lack of dynamism in the emergence of new sectors; a low export-intensive economy; a low level of foreign direct investment; a large informal economy; inefficient labour market policies and rigid labour legislation; and weak law enforcement.

From the data available it is clear that Macedonia has very low rates of job creation, destruction, and turnover compared to other transition countries at a similar level of development. This reflects the shortcomings in the supply of financing for new activities and structural, economic and regulatory barriers to new business creation. Job creation and destruction rates were around 1% per annum, which is well below the average level in most transition economies. These rates suggest that, while it may be possible to improve the unemployment situation somewhat through labour market measures, the true solution to Macedonia’s unemployment problems must come from the creation of a more dynamic private sector.

The data show that the private sector did a better of job creation than the public sector, even though more jobs in the private sector were destroyed than created. Furthermore, the highest level of job creation is in small and medium enterprises. One of the crucial conclusions from the analysis of job creation is that it is concentrated in the private sector. Job creation is the highest in services, such as education, real estate, and hotel and restaurant businesses as well as in wholesaling, retailing, motor vehicle repair, etc.

Macedonia has seen continuous increases of nominal wages over the period 1996-2004, primarily due to the increase in the share of the private sector in employment and the limitation on the increase of wages in the public sector imposed by the Law on Wages. Net wages paid out in 2004 showed an increase of 4%. Macedonia also shows relatively high sectoral and regional wage differentials due to the high level of centralisation of industry and its labour demand. In Macedonia, the law requires that firms pay wages that are at least 65% of the average wage in their sector. This seems to help neither firms nor workers and does lead to inefficiencies. Macedonia might be better served with a minimum wage law covering all workers, but one that provides for a minimum wage of somewhat less than 65% of the national average wage. Given the high unemployment rates among young
workers, a high minimum wage could be an important barrier to the creation of entry level jobs.

The large size of the informal economy gives the wrong signal to labour allocation and undermines the legal system. Some estimates show that almost one-third of the labour force depends on the informal economy, including seasonal work, temporary work and part-time jobs. The wages in the informal economy are relatively low and in some cases this helps businesses to survive since they reduce the “formal costs” of labour (see the discussion on the tax wedge). Also, the informal sector is detrimental to the young population and entrepreneurs because they develop an “evasion philosophy”. Thus, for many, the informal economy has become a normal way of doing business, and it is tolerated by the local authorities and, in some cases, even by the state authorities.

The labour market situation is in a way the “residual” of all other policies and their failures or inefficiencies, for example, because the low level of law enforcement and inefficient tax collection have a direct impact on the size of the informal economy. Thus, the labour market situation can be indirectly improved by many measures proposed in other parts of this Report. However, labour market measures introduced in this section can also have a direct impact on labour supply and labour demand. Moreover, some of these measures can help to introduce a more transparent situation onto the labour market.

Labour statistics need major improvement: It is necessary to establish a good system for registration of the unemployed through the statistical office and the Employment Agency. So far, the Agency has begun various activities that will increase the reliability of the labour data. The proper data collection, dissemination, and use are also crucial for adequate and justified allocation of the unemployment funds. An important measure that is needed is the introduction of basic health care for all citizens in order to discourage the registration as unemployed of persons working in the informal sector or by other citizens for the sole purpose of obtaining access to health care services.

The wage-setting process should be clarified. Wage policy should be established through collective bargaining, primarily, at the company level, unless there are compelling reasons for a broader agreement. The principle of wage-setting should follow the established European formula that real wage increases should lag by at least one percentage point behind productivity increases.

One of the central problems of the current wage policy is also the tax wedge that has a direct impact both on the cost competitiveness and on the scale of the informal economy. To increase competitiveness – particularly of the manufacturing sector - the taxes on labour wages should be reduced, although this is a measure that has to be introduced within the framework of the introduction of the flat tax and a reform of the provision and funding of health care.

Institutional capacities have increased but are not yet sufficient. Labour market institutions’ capacity should be expanded. First, the national employment agency should play a major role in promoting and operating active labour market measures. The agency should strengthen its technical, organisational, and staffing capabilities. It may be useful to establish job-points, disseminate information about employment opportunities, and other related activities. In 2005 the National Employment Agency (NEA) initiated a comprehensive plan for reducing unemployment with 27 detailed measures, including specific instruments for unemployed youth. The effectiveness of these measures should be evaluated on an ongoing basis.

Beside the National Employment Agency there are 15 licensed private employment agencies. Their role as mediators has improved in the last years, but they can have an even bigger role on the labour market through the establishment of temporary employment agencies, etc.
Labour legislation has been modernised but still has some serious drawbacks. The new Law on Labour Relations covers a number of basic principles, European directives and ILO conventions, including the provisions of the European Social Charter. The legislation has improved flexibility on the labour market including the working time provision and the information for workers on individual conditions. There are some provisions that do not meet the requirements of the Acquis, such as appropriate protection of workers in the case of the insolvency of the employer. The enforcement of the Law will be difficult due to the judicial system’s unfamiliarity with its provisions.

Active labour market policy: Employment policy in Macedonia is being transformed into a set of active labour market measures aiming at promoting the creation of new job opportunities, at activating jobless people, and introducing human resource management. Active measures should be put together as part of the national employment strategy, which should be the key document governing employment in the country for the next five years and should emphasise active measures rather than passive ones such as unemployment benefits. Active policy measures should also include European directives and prepare Macedonia for the use of the European Social Fund (ESF), particularly for strengthening the administrative capacity for management, implementation, and monitoring of active labour market policies. Also, active measures should target some special groups with particularly high unemployment rates such as disabled persons, young persons, and women. Active labour market measures should also play an important role in diminishing regional differences in unemployment levels.

The informal sector is very detrimental to business values. Informal activity accounts for 35-40% of GDP, if not more. It undermines the revenue base of the Government, creates unfair competition, and distorts official indicators, thus causing the incorrect expenditure of government funds, e.g., on social benefits. The reduction of the informal economy should be based on a mix of measures:

- Reduction of the tax burden on labour and business activity and simplification of tax regimes;
- Simplification of the legal and administrative regimes by reducing time and cost for registering new business/obtaining permits and licenses, etc;
- Making property registration and land titling procedures easier and simplifying the procedures required to register property as collateral;
- Addressing corruption on all levels;
- Ensuring strict law enforcement (i.e., harsher penalties for the lawbreakers, although an amnesty might be considered for those who register their businesses within a certain period of time (maximum 6 months));
- Establishment of a national-level commission with private sector representation to give advice on policies toward the grey economy;
- Enhancing access to capital by easing banking regulations, etc.

Moreover, there are some other measures that should complement labour market policies:

- Management education is one of the key instruments for a major shift not only in the labour market but also in the economy as a whole. The possibilities include changing school curricula, the establishment of new business schools, introduction of new business courses etc.;
- Introduction of best practice in human resource management and taking a broader view of labour to more fully embody the concept of human capital and its development would create a more competitive environment and greater knowledge transfer. Particularly, the idea of identifying and publicising “national champions” in human resource practices is intriguing as it would help overcome the “average is ...
good enough” principle which is now widespread throughout the economy.

Because there are regions with particularly high unemployment rates, it is necessary to deal with unemployment through a regional approach as well. The problem of income insecurity should be solved through measures targeting the most vulnerable groups of unemployed, while complying with the defined criteria for receiving welfare, which would provide a more equitable distribution of social transfers. In doing this, targeted measures need to be prepared, especially at the local level.

Notwithstanding the fact that the budget for public expenditures is tight, a certain amount of public work could contribute to a reduction of unemployment among the most vulnerable groups and among the long-term unemployed through temporary jobs, especially for the recipients of welfare benefits of working age.
V. Making the Government of Macedonia a Partner in Economic Growth

Macedonia’s government cannot, by itself create prosperity or solve pressing economic problems. It can, however, by improving its functioning and the support it provides to the private sector through the provision of government services, make a major impact on economic performance and on the lives of Macedonian citizens.

A. Public Administration and the Political Process

Public administration reform is a difficult and complex process. It presupposes qualitative changes in several segments that have to go in parallel and that are often contradictory. First, there is a need for rationalisation of the administration via consistent implementation of the already adopted medium-term fiscal strategy agreed with the IMF, which offers solutions in terms of reconsidering the number of employees and their utilisation and improving efficiency through functional analyses of the most important budget users, through more courageous use of the method of full privatisation or privatisation of the business in the budgetary institutions that are appropriate for such an approach – for example kindergartens, some institutions in the area of culture, some institutions addressed in the project for structural adjustment of certain budget users etc.

Second, the enforcement of the principle of equitable representation of Macedonia’s ethnic communities requires the selection of competent staff from diverse backgrounds. Departure from the practice of government employment dictated by political parties is needed as it is detrimental to the effective functioning of public administration, because, instead of following the logic of competence and professionalism, it follows the logic of political and pre-election manipulations.

Third, the increase in the efficiency and in the capacity for action of public administration requires above all that more room be provided for the employment and promotion of competent staff through natural attrition and through a more courageous rationalisation of public administration. Remuneration and promotion in administration must be determined by an objective merit system, and over time it is necessary to ensure convergence of the remuneration in public administration to that in the private sector, which will ultimately result in an increase of the reputation and prestige of civil service employment. If all political parties have to rely on the same civil service personnel to implement their policy programs, Macedonia can have a good civil service, but if parties can easily rely on their own appointees to implement polices, then the civil service will be inefficient, demoralised and corrupt.

It is of importance also to depoliticise the administration, i.e., to separate the temporary political policy-making positions from the permanent administrative staff whose job it is to implement these policies. Thus only the Minister and two Deputy Ministers in any ministry may be political appointees; the remainder should be civil service staff. The conditions of the civil service should be codified so that:

1.) Entry into and promotion in the civil service is on merit.
2.) There is a civil service commission established to:
   • ensure the independence of the civil servants from political pressure;
   • independently verify claims of corruption or abuse of power by civil servants;
   • investigate on its own initiative corruption or malfeasance by civil servants.

The civil service commission should have two members elected by members of the civil service and a member each from every political party that has seats in the Parliament.

B. Making Public Administration Effective

1. The Evolving Concept of Public Administration
In addition to changing how the civil service is organised and interacts with the political system, Macedonia needs to change its concept of public administration.

For public administration and services to flourish in Macedonia, they need a degree of trust and legitimacy for using their resources, processes, and services to create beneficial social outcomes for society. They have to demonstrate they are creating public value for citizens, just as private companies have to demonstrate the creation of private value to their shareholders and investors. Public value is not just an economic concept – it is also about the overall contribution to society in economic, social and political terms that public administration and services make.

Trust in government and its institutions is very low in Macedonia, where almost 52% of citizens have no confidence at all in government. Therefore, the concept that the public administration and services are creating a public value for citizens presents a shift from how the public administration is viewed by the public today, with the corrupt seen as normal, as well as a shift in the functioning of the civil and public servants themselves, who continue to view themselves as mastering instead of serving the public. After introduction of the market economy, the Macedonian civil service needed to develop itself along the lines of performance management. Unfortunately, all processes remained within the classical framework of bureaucratic, hierarchical, periodic reporting, where budgeting control remained the major method of control.

Guided by its aspiration to join the EU, the country has to articulate a clear vision of how the public administration and public services will benefit society, create public value and build capacity to equal not only the current quality of public administration across the EU member states, but to meet expected future service requirements as well.

Much of this vision already exists in various explicit and implicit approaches to the reform and development of public administration and services. The public administration reform is comprehensively outlined in the Strategy for Public Administration Reform adopted in 1999 establishing the following basic principles of the new public administration system: rule of law, transparency, competence, stability, accountability, predictability, equal treatment, efficiency, and ethicality. Whilst these are sound principles, they do not entirely cover the main administrative principles required by the EU in the process of accession: reliability, predictability, accountability, transparency, efficiency and effectiveness.

2. Public Value from Public Administration and Public Services

Public administration and public services add value when they help to make life better for everyone. They do this not just by providing collective goods and services, but also because people value the way in which these are provided. Citizens value not just the public services but the “procedural” aspects of how they are delivered – especially participation, fairness, equity and probity. Markets also only function efficiently in states where the rule of law and other supports provided by the state, such as regulation, work efficiently and are generally accepted.

Different democracies have adopted differing ideas about how big the public sector should be, although nowhere is it insubstantial; about how centralised and decentralised or how local or national public administration and services should be; about the exact contours of the public services and what can and should be provided by voluntary or market means; about how much they should be based on law or not; and so on. But there are some broad areas of commonality in democratic approaches to public administration and services. They are expected to demonstrate:

- their political neutrality, legitimacy and accountability to democratic government and the people, and to seek the trust and cooperation of the citizens;
that they properly, fairly and without corruption manage public resources;
that their processes are fair and equitable, open to scrutiny and challenge, and efficient in the use of resources to deliver services;
that the services they deliver are of the correct volume, of high quality, are fair and equitable and responsive to the real needs and concerns of citizens;
and that these services lead to real and lasting benefits to society as a whole greater than could be achieved by any other means such as private or voluntary provision.

If public administration and services can satisfy these criteria, they add real value to society. The model that forms the framework of this section here has the following features as its main principles:
1. a greater focus on results and value for money;
2. devolution of authority and enhanced flexibility;
3. strengthened accountability and control;
4. a client-and-service orientation;
5. strengthened capacity for developing strategy and policy;
6. introduction of competition and other market elements; and
7. changed relationships with other levels of government.

C. Building Blocks of Public Value

1. Trust and Legitimacy
Public Administration and Public Services need to demonstrate political neutrality, legitimacy and accountability to democratic government and the people and to seek the trust and cooperation of the citizens. The current state of public administration reform in Macedonia is characterised by a high degree of formalisation of democratic institutional arrangements and attempts at technical improvement but a low degree of change management and an absence of a clearly articulated vision of the role of public and civil services in Macedonian society.

The transition period has been marked by a high level of unemployment, increasing the pressure on the government to create new jobs in the public sector while in a constant struggle for power and citizens’ votes, and to recruit party loyalists to these jobs. As a result, public sector employment is used as a tool of patronage leading to an overstaffed, inefficient public sector and a civil service that is loyal to party officials and programs. The current system of civil service provides incentives for such behaviour because it is a predominantly position-based system. It is open for entry at all levels, except the highest managerial level, to persons outside the administration. Promotion within this system does not follow rules of automatism or seniority, as in the career systems adopted by many Central European countries, but allows new employment procedures and open competition with applicants coming from within and outside the administration.

Accountability is lacking in this system. The Law of the Civil Service does not mention accountability (Law on Civil Service, Official Gazette no.59/2000, no.112/2000, no.34/2001). The only persons in the whole civil service who are held accountable to the Parliament for their work are the Director and Deputy Director of the Civil Servants’ Agency. The remaining civil servants are personally responsible only to the Minister or the Head of the public body. This situation makes a great hierarchy out of the Macedonian civil service system, contrary to the principles employed in the EU member states, such as devolution of authority and enhanced flexibility, coupled with strengthened accountability and control.

In Macedonia, strategic planning, policy analysis and impact assessments are not, as yet, a generally accepted practice. The introduction of performance measurement of the civil service has started recently and is conducted on an annual basis. The introduction of the institutions of the Ombudsman, state audit, the internal audit, and the new procedures in public procurement sets a solid basis for significant improvements of the operation
of the civil service and for increasing its legitimacy. The process of decentralisation is also seen as one of the ways to meet the needs and expectations of local satisfaction in the democratic government. However, the system has not provided for tools to monitor and measure public satisfaction in the values received from public services.

Given the above diagnosis, we would propose that the following additional initiatives be implemented:

- Amend recruitment procedures to create a competent and politically neutral administration.
- Move to a career-based civil and public service system through comprehensive career development planning to increase professionalism and provide for effective leadership.
- Strengthen accountability and control at all levels of the civil service system. Measures such as the ‘employee of the year’, or ‘public service unit or department of the year’ would promote professionalism and introduce competition among civil and public servants.
- Set clear goals and objectives for the civil and public service in all sectors and provide concrete methods for measuring progress toward goals and enable early warning if there are problems in achieving objectives.
- Introduce procedures and tools to allow for citizens’ monitoring of civil and public service performance.

2. Public Value and Resources
Public administration and public services need to demonstrate that they properly, fairly and without corruption manage public resources. Given that 90% of Macedonians believe that the government, police, customs and courts are corrupt, individual legal initiatives, such as the Law on Prevention of Corruption and the Law on Free Access to Information, are to be applauded, as they inject anticorruption behaviours into the Macedonian public sector. However, none of this will really take root unless there is a major leadership and cultural change program across the civil and public services, starting from the top. Anticorruption measures do not require new laws limiting the work of the public sector, but rather practical steps to remove away some of the incentives and opportunities for corrupt behaviour of the civil or public service.

In respect to proper and honest management of public resources, a prominent problem in Macedonia is the management of public finances. Therefore, the country should establish an effective and transparent mechanism through which available public resources are allocated in a manner that promotes economic growth and reduces poverty. The public expenditure review is such a mechanism. The national budget in Macedonia is currently prepared on an annual basis, taking into account only the revenues and expenditures anticipated to occur in the coming year. This provides a basis only for short-term planning and thus is not conducive to the development of long-term policies to create change. Government budgets must take into account events outside the annual cycle, particularly macroeconomic realities, expected revenues, and longer-term needs of programs and of government’s spending policies. A medium-term, three to five year, expenditure framework (MTEF) consists of a top-down estimate of aggregate resources available for public expenditure consistent with macroeconomic stability; bottom-up estimates of the cost of carrying out policies, both existing and new; and a framework that reconciles these costs with aggregate resources.

Given the history of corruption and inefficiency in public services, the need for effective management and transparent accounting for personnel policies cannot be emphasised enough. Citizens have to trust that public officials are appointed fairly, on merit, and work without prejudice. So developing sound human resources policies and practices is not just an issue of efficiency and effectiveness, it also goes to the heart of people’s trust in government.
The key issues that need to be addressed in the forthcoming period are:

- Comprehensively introducing MTEF starting with selected sectors and then expanding coverage to all of government. A MTEF involves a radical change in the business of budgeting. Consequently, without political commitment, it has little chance of succeeding.
- Public expenditure reviews to be conducted by the government and not by international organisations such as the World Bank, as this tool provides useful evidence on the structure of governance and the functioning of public institutions, as well as linkages between expenditure and policies in various sectors.
- Participatory budgeting and budget monitoring by citizens should be allowed. When the general public is directly involved in making policy decisions and are given an opportunity to allocate resources, prioritise broad social policies, and monitor public spending, evidence shows that public services are delivered more efficiently and add greater value to society.
- In addressing corruption, the Macedonian government should opt for a multi-pronged anticorruption approach that is characterised by the following three features:
  a) operations centred on an Anticorruption Commission or an Agency that will deal with investigations of corrupt behaviour;
  b) prevention by providing policy advice to public and private organisations to combat corrupt practices;
  c) community relations through a department that educates the public, facilitates complaints and alerts the government to reported corrupt behaviour.

This aspect is partly covered in the section on fiscal decentralisation, which sets out most of the principles and practices of good financial management at all levels.

3. Public Value and Processes

Public administration and public service need to demonstrate that their processes are fair and equitable, open to scrutiny and challenge, and efficient. Furthermore, top-level commitment is high and has shown consistency over time. A considerable number of top managers support reform of public administration.

Coordination across Ministries at managerial levels has improved with the introduction of the General Secretariat so that reform policy could become more comprehensive. This body was crucial in the process of preparation of the answers to the Questionnaire of the European Commission. This coordination will facilitate co-operation and create informal peer pressure for setting higher standards for the public administration and public policies in the process of European integration. What is more, the coordination capacity of the government will become a priority when Macedonia becomes eligible for EU structural funds.

Considerable progress has been made in introducing new institutional arrangements to facilitate development of policies. The departments for strategic planning, policy-coordination, analysis and monitoring have been introduced with the promotion of the General Secretariat of the Government as a body responsible for public administration reform in Macedonia. Policy analysis and monitoring and evaluation departments ought to be established in all line ministries to create an environment for change in policy in all sectors. The decentralisation process also sets the policy development capacity of the local self-governments as a high priority. This is because, in a decentralised environment, the local authorities govern key areas such as education, health and culture.

In the context of European integration, Macedonian public administration institutions and courts must know the European law, policies and the basic principles on which the Union is founded and is operating because they will
become guardians of the treaties once the country aligns its legislation with that of the EU.

Better regulation units (BRUs) should be established, responsible to the highest political levels. These better regulation units should ensure that regulatory reform is consistently pursued in all sectors and that the logic of a service orientation is carried through into the operation of the whole range of regulatory and support activities. Careful appraisal of proposed and existing legislation should be undertaken as well as of the costs of new administrative procedures. Special attention should consequently be paid to the development and application of the techniques of regulatory impact assessment. Its objective is to carry out regulatory reviews and to assess the impact of regulations as well as to ensure that the points of view of SMEs, interest groups and civil society as a whole have been taken into account in legislative proposals. In that process, best practices should be identified and efficient tools and mechanisms for introduction of the new regulatory instruments developed.

4. Public Value and Services
Public administration and public services need to demonstrate that the services they deliver are of the correct volume, of high quality, are fair and equitable and responsive to the real needs and concerns of citizens. The reform of public services to improve their economy, efficiency, effectiveness and overall quality of service has hardly begun in Macedonia. Much effort has been invested in creating some of the institutional environment in which this can happen:

- Privatising those functions that do not need to be in the public sector and are better provided for by private or voluntary provision
- Introducing legal safeguards for the rights of businesses and individuals and provisions against administrative abuse and corruption
- Introducing freedom of information and other means to ensure transparency
- Introducing the www.uslugi.gov.mk portal
- Better regulation of public enterprises
- Decentralisation of provision of health, education and social services to the local government level

However, none of these addresses the central problems of the organisation and management of public services to deliver high quality services, even if they do remove some obstacles to addressing them. For those areas that are and will remain in the public sector, and that are not public enterprises, it is difficult to find much reform effort focused specifically on the services they should be producing. Nor should the scale of the problem be underestimated – developed democracies are still engaged in continual attempts to reform and improve services. One of the key tenets of a “public value” approach is that the value of services is never fixed. What is deemed good by citizens today may be seen as irrelevant tomorrow, and, thus, public value in services has to be constantly created and recreated.

We propose a modest reform programme focussed on services and drawing lessons from successful service reform efforts carried out in other countries. The approach proposed is two phased so that: (a) new ideas can be piloted and evaluated without a commitment to wholesale implementation, and (b) the use of phasing allows the maximum leverage for scarce resources by concentrating on a few “early wins”.

- Review of 2-3 core services in each Ministry, Public Service organisation and at the local government level to assess their:
  - Quantity, quality and user satisfaction
  - Efficiency
  - The contribution that they make to achieving social outcomes
  - Value for money
  - Any consequent changes to the design, production process and management.
This programme of rolling reviews would be greatly strengthened by involving key stakeholders including parliament, service users, personnel and partner agencies. Wherever possible, reviews should have an independent element and this could include the use of “peer review” teams – small groups drawn from other public services and the private and voluntary sectors.

Another key component is setting service standards, monitoring users’ attitudes to services and providing mechanisms to redress grievances about services, which are often not covered in administrative complaints processes that usually only address the substance of a case and not the services received.

- Developing an approach to setting published “Service Standards” that set out what citizens can expect from all services so as to create pressure for service improvement.
- Developing systematic reviews of user or customer attitudes to civil and public services through a variety of quantitative and qualitative measures, again through pilot projects.
- Developing strong policies for customer/user complaints to be addressed by services, also through well designed pilot schemes.
- Pilotling solutions for promotion of professionalism in public services, such as “teacher of the year”, “doctor of the year”, “event of the year”, etc.

5. Public Value and Social Outcomes
Public Administration and public services need to demonstrate that the services they provide lead to real and lasting benefits to society as a whole greater than could be achieved by any other means. Very little of the existing reform programs seem to be tied to a clear and explicit analysis of how public resources, processes and services lead to desired social outcomes. Too much reform seems to be of the axiomatic sort: if we do “A” then “B” will inevitably follow with little evidence or analysis to support such assumptions. In the absence of such analysis and information, public and political debate easily degenerates into stale exchanges of rhetoric and ideological assumptions. Such analysis cannot resolve the conflicts among values and preferences that exist in any democracy, but they can lead to better debate and more informed judgements.

Coupled with the service reviews suggested above there needs to be a system of regular policy evaluations that look at the overall, end-to-end, effectiveness and value of policies – from resources used to social outcomes:

- Such evaluations should include regular re-assessments of whether the services achieve their designed social outcomes; are still necessary; or could be better provided elsewhere in the public sector or by voluntary or private means.
- As evaluative capacity develops, the possibility of ex ante evaluations of proposed policies should be considered, including, where possible, the use of external evaluators – for example the State Audit Bureau.

6. Public Value and Leadership
Civil and public service leaders need to offer transformational leadership to their organisations. Transformational leadership means leading by example; encouraging, developing and empowering others; aligning the objectives of individuals, groups, organisations and the whole civil and public services; and creating shared vision of the future. The attitudes and competences of the existing cadre of senior leadership in Macedonian public administration and services is a major weakness. Whilst there is a lot of current and proposed training activity aimed at the whole civil and public services, there seems to be little or no activity aimed specifically at transforming the senior leadership. This is a major omission.

Another issue is a generational one. The new employees are constantly being co-opted into the existing culture of inefficiency and ineffectiveness present among many of the more
experienced civil and public servants, while the latter are not given the chance to transfer their knowledge to their young colleagues. There also appear to be structural problems in relation to the coherence of the public administration reform program because leadership is shared by several state organs with some apparent coordination problems emerging.

For the reform program to be successful, the exemplary commitment and involvement of the current senior leadership of Macedonia’s civil and public services as well as of the next generation of potential leaders is crucial. We would therefore propose something like a “Leadership for Public Value” program that develops the transformational leadership skills and attitudes of the most senior, and next generation of senior leaders, in Macedonia. This would focus on:

- Personal development of transformational leadership skills using action learning, 360 degree assessment, leadership assessment instruments and peer-review as well as international experience through visits or courses.
- Organisational and team development for a collective vision of the future of Macedonia’s public and civil services and individual organisations, improved team-working and cross-organisational collaboration.
- Developing action plans and strategies for implementing this vision and better coordination of existing initiatives.

7. Conclusions

The future of the Public Administration Reform in Macedonia is conditioned by three processes: (i) the new democratic governance and market economy, established since independence; (ii) the implementation of the Ohrid Framework Agreement and its effects on the process of public administration reform and the process of decentralisation; (iii) the European integration as an ultimate goal of Macedonia.

The implementation of the Ohrid Framework Agreement requires the modernisation of the public administration, a change of organisational culture, and the reform of government service delivery procedures. This initiative has led to increased empowerment of community groups; has created opportunities for citizens to express their needs; actively incorporates the input of citizens into public decision making; delivers services that promote the social inclusion of vulnerable populations, for instance based on gender, cultural diversity, age or disabilities; and has resulted in a more client-centred service delivery.

European integration sets the priority for Macedonia to develop public administration to reach the level of reliability of the European Administrative Space and an acceptable threshold of shared principles, procedures and administrative structural arrangements. There is a minimum standard of quality and reliability of public administration that candidate countries must attain.

Macedonia has achieved much since 1999, when the Government outlined its Strategy on Public Administration Reform, containing the main principles and priorities. The time has come, however, to re-orient from the current focus on legal, institutional and systemic changes, which nevertheless remain very necessary conditions. A much stronger focus on developing a vision and leadership capacity is now needed, linked to a strong change management programme, one aimed at reshaping the culture and behaviour of the civil and public services in line with the new democratic values of Macedonia.
D. Fiscal decentralisation: a key element of public sector reform


The Republic of Macedonia has retained the simple system of sub-central government organisation, without any intermediary levels between the central and the local government, and, consequently, the municipality is the only form of local government. The municipality’s inhabitants realise their self-governing rights through democratically elected officials, and, directly, through participation in the resolution of local issues. One the biggest challenges facing Macedonia is building an efficient central state while at the same time creating incentives for the development of local capacities.

The Law on Local Self Government transferred a wide list of public functions from central to municipal authorities.

- Primary and secondary schools; the network of organizations and structures for primary health care and disease prevention; certain cultural, athletic and recreational centres and activities; the centres for pre-school children, orphans, individuals with social and educational problems, homes for elderly and the disabled.
- The protection of the environment, urban planning and construction, as well as issuance of construction permits. Local authorities are free to explore modes of service delivery such as public-private partnerships, contracting out, concessions, etc. Local governments have the right to establish partnerships with other local governments to benefit from economies of scale.
- The law stipulates that local economic development is a municipal responsibility, as is the identification of developmental and structural priorities, support for small and medium-size enterprises, and otherwise realising the human and natural potential of municipalities.
- The law establishes a system of property, establishes municipalities’ rights, and provides for the creation of a comprehensive local property registry.

The law prescribes the implementation of fiscal decentralisation in two phases, depending on the municipality’s capacity for assuming its new responsibilities. The first phase began on July 1, 2005 within the scope of the Ohrid Framework Agreement. This phase of the transition process calls for the transfer of functional responsibility in a number of areas and of personnel and assets from the central government to local governments and the implementation of local financing mechanisms to provide municipalities with the means to carry out their service delivery responsibilities – property tax, tax sharing, transfer formulas, etc.

With the expansion of the public functions of the local governments, the degree of decentralisation in the Republic of Macedonia, measured by the share of local public expenditures in general government expenditures, should rise to 16-18 percent after the completion of the decentralisation process and consolidation of the new local government system. This would be a decentralisation level equal to that of some European countries in transition such as Estonia, Latvia, Hungary, the Czech Republic, and Poland. Currently, the scope of decentralisation, measured by the local expenditures as a share of GDP is rather low, only 2.7 percent, which means also a low share of municipal expenditures in general government expenditures of 7.5 percent.
According to the provisions in the Law on Local Self Government, the following principles govern municipal finance:

- Municipalities are financed by their own revenue sources, state transfers and other sources regulated by law;
- Municipalities determine their own tax rates, fees and user charges;
- Municipalities, in compliance with their responsibilities and legal obligations, are free to dispose of their own revenue in an independent fashion;
- Municipalities have the right to enter into debt both on the domestic and foreign financial markets, in compliance with the law;
- Municipal revenues should be adequate to carry out the responsibilities assigned to local governments;
- Municipalities adopt their own budgets, which are not subject to prior or posterior approval by the central government.

On the revenue side of the budget, reforms are needed in two areas: (i) increasing local governments’ own sources of revenue; (ii) improving the allocation techniques of intergovernmental transfers and shared revenues. At a minimum, local governments and autonomous institutions must have full access to those revenue sources they are best equipped to exploit, such as user charges for local services and residential property taxes to finance local government expenditures. Second, the central ministries must delegate greater spending authority to local governments in every functional area of their responsibility. Shared PIT and VAT are very much controlled by the fiscal plans set at the national level, but a large part of local taxes and charges have to be spent for programs and targets set outside the local governments.

1. Raising own-source revenues
Accountability requires that local governments should, whenever possible, charge for the services they provide. Only where charging is impracticable should they finance such services from taxes borne by local residents.

The private payments that are common throughout the social service system in Macedonia should be legalised and brought into the open.

Among local own revenues the property tax has the greatest potential. The USAID funded technical assistance project in Macedonia also focused on the property tax by establishing pilot municipalities with higher autonomy under special rules. The results of this experiment should be carefully evaluated and the experience extended to other municipalities if warranted. The real property tax is the tax revenue source that local governments are best positioned to exploit. Property, unlike income, cannot evade taxation through relocation.

There are several basic local tax policy issues that should be addressed by the national government in the immediate future. In thinking about these issues, care should be taken to make the logic and design of local taxes as consistent as possible with the national tax system. Taxing all real property can lead to double taxation where the use of taxable assets is also subject to VAT, as is the case with rents on land or on plant and equipment used for industrial or commercial purposes. Where the property tax is concerned, the issues to be addressed include: specification of the tax base (residential property, all land and improvements, commercial property, etc.); the property tax rate design (higher on land than on improvements, the relative weighting of land and improvements), and which level of government administers the tax. Local governments should be free to set rates, subject to reasonable limits, but property tax administration is complex and in a country as small as Macedonia, perhaps, best centralised.

The Public Revenue Office’s property records must be brought up to date. Currently they are far from complete, and assessments are missing or grossly inaccurate. Support is needed to ensure that these functions are properly carried out. This includes methodological and technical assistance and im-
The improvement of the organizational structure of registration authorities. More reliable registry and assessment data would be a boon for both commercial entities and the authorities, as such data are necessary for an efficient and effective VAT as well as for property taxes and the creation of effective mortgage markets.

2. Intergovernmental transfers
State transfers provide additional revenues for municipalities. The five types of transfers provided by law are: “shared taxes”, earmarked grants, capital grants, block grants and grants to support functions transferred from central to local control. Unfortunately, the allocation of these funds remains subject to the central government except where shared taxes are concerned.

Shared tax revenues are defined on two bases:

a) up to 3% of the total collected value added tax (VAT) in the previous year; and

b) up to 3% of the of the personal income tax from salaries in the municipality in the current year and 100% of the personal income tax on earnings from handicraft activity collected from taxpayers working within the municipality.

We believe that the solution contained in the Law on Personal Income Tax Revenues of Municipalities (Article 5), which comprises the two bases mentioned above, is inadequate both in principle and in practice. In modern tax systems, the personal income tax should be applied to all forms of income. The separation of the tax to be paid on salaries and on handicraft activity by individuals in the municipality negates the essential character of the personal income tax and is a return to the tax system where each separate income is taxed. These two revenue sources, as they are currently regulated by law, will complicate the calculation and application of the personal income tax and will contradict the simplification of the tax system proposed by this Report in its call for a flat tax at the national level. According to the experience of many countries and according to tax theory, the best solution for determining the municipality’s share of the income tax is to treat all income equally.

3. Transparent and objective revenue sharing and grant allocation
The introduction of a shared Personal Income Tax (PIT) was an important innovation of the Law on Local Finances, even though it is only approximately five percent of local budgets. Despite this low scale, shared PIT has a greater potential to link local tax policies to the development of the local economy. Presently up to 3% of PIT is shared with local governments on a derivation basis. Direct linkages between local economic development and the municipal revenue base can be improved by reforming the sharing mechanisms.

In order to improve local governments’ PIT rate-setting autonomy, they should have the authority to set the local personal income tax rate. Similar models are used in Croatia and in the Scandinavian countries. This municipal rate should be kept within specified limits, so there will be a minimum level of PIT shared, but too high local shares can be avoided by the maximum limit on such rates. This will improve accountability through a revenue-neutral technique, as the PIT is shared with local governments now as well. The planned flat tax rate would even make this sharing technique administratively simpler, as only one local and one national PIT rate will be used.

Among the shared revenues the Value Added Tax is a major local budget source. Up to 3% of VAT is reallocated to local governments. VAT sharing creates a relatively stable and predictable revenue stream for local governments. In Macedonia the shared VAT and the various forms of transfers are the major revenue sources of local governments. The traditional “cap system”, which focuses on legislated local government expenditure ap-
proprietions will be completely replaced by a formula based allocation mechanism. This transition to a new transfer allocation model is the most important and urgent task for the fiscal decentralisation reforms.

There is a need to support the further development of the allocation formulas in several areas for the next budget. The planned criteria for the block grants in education, culture and social care should be further modified. The strategic goals of intergovernmental fiscal transfers are to reach three basic objectives: (i) a guaranteed minimum level of services; (ii) horizontal equalisation between local governments of similar type; and (iii) providing local incentives for efficient use of available funds. These aims should be reached on both the expenditure and revenue sides of the budget.

For reaching these goals the planned block grants and VAT sharing mechanisms should be needs based (e.g., school age population) instead of service capacity based (e.g., number of pupils currently taught). Objective grant allocation criteria would increase transparency and they could provide better incentives. These reforms should be implemented gradually; otherwise local governments will not be able to adjust to the new fiscal conditions. Block transfers appear for the first time in Macedonia’s intergovernmental financial relations, and their character and purpose are determined by the need to avoid, in the first phase of decentralisation, any potential difficulties and misunderstandings related to the funding of the decentralised competences in education, health care, culture and social care – spheres that entirely concern block grants. These grants will eventually undergo a certain transformation, and centralized allocation by expenditure class should be relaxed.

4. Municipal debt
The Law on Financing Local Self-Government Units regulates the rights of municipalities to borrow from domestic creditors and abroad and prescribes the terms and conditions under which local governments can borrow, including the issuance of guarantees for long-term loans. Short-term borrowing is allowed only within the country and for the purposes of covering temporary cash shortfalls; such loans should be repaid by the end of the current year. In the long-term, the municipalities can enter into debt within the country and abroad only for the purposes of capital investment, and the total amount of the annual repayment of these loans cannot exceed 15 percent of the amount of the currently operating municipal budget in the previous year. Municipalities are obliged to obtain government approval before entering into debt abroad.

Hence, it is evident that long-term municipal borrowing has not been fully liberalised. In this phase of the implementation of the new local finance system, this can be justified, especially if the amount of the cumulative non-regulated public debt of the municipalities accumulated in the previous period is taken into consideration. Similar limitations exist in almost all European countries in transition and elsewhere. On one side, in many countries the central government may be concerned that the indebtedness of the sub-central governments could make it difficult to sustain macroeconomic fiscal stability. On the other hand, if municipalities wish to have access to credit markets, they must be credit worthy, which means that they, too, have a strong incentive to limit their borrowing.

Indeed, we propose a two-year moratorium on all new long-term municipal borrowing and would permit it then only for those municipalities that have avoided arrears, have liquidated existing debt and are otherwise meeting their financial obligations. Nevertheless, it should be stressed that the development of a long-term municipal bond market is a worthwhile goal. Where local governments issue debt, regularly enough and in small enough denominations to support an active secondary market, the discount or premium reflected in bond prices in those markets can be a highly informative independent
indicator of the fiscal performance of local government. Moreover, the bond market is the principal source of demand for sound local budgeting and financial reporting practices. Bond holders, buyers, and sellers have a real and an immediate interest in local fiscal performance. Lacking a municipal-bond market, it is doubtful that sound local budgets or financial reports will be forthcoming. If Macedonia goes too far in discouraging local debt or permits the central government to underwrite and control all debt issues, this benefit could easily be lost.

The liquidation of existing municipal arrears of EUR 43 Million to EUR 55 Million remains a major impediment to the regularisation of local finances. Practically all municipalities have some debt, either to construction companies, to the electricity supplier, to private parties for the expropriation of land or property, as well as for salaries and supplies. However, ten municipalities owe three-fourths of this debt. This issue has produced endless litigation, some 155 pending cases by one estimate. Consequently, local government accounts are frequently blocked for non-payment, often for months at time, sometimes for more than a year. This situation cannot be allowed to persist. Weighed against Macedonia’s GDP, the inherited arrears issue is a trivial matter. That it has been allowed to delay the transition to decentralisation to the degree that it has is unconscionable. These debts must be expeditiously formalised and discharged.

A Working Group for Municipal Debt has been set up to deal with this problem. Unfortunately, there is a lot of uncertainty as to who owes how much and to whom. Some of these debts appear to be the result of the central government reneging on funding commitments, leaving local governments without the wherewithal to meet their obligations. Where liability or the amounts in question are subject to disagreement, the issue should be promptly arbitrated.

Once local governments’ liabilities, by amount and creditor, have been determined, local governments should be permitted to discharge them immediately through the issue of transferable warrants. These warrants should be issued in standard denominations, with standard maturity dates. The face value of the warrants would reflect current obligations compounded at an appropriate rate. Their present value would, of course be their value for the discharge of current debts.

At the same time the long term solutions have to be developed, as well, by stopping those inappropriate procedures which lead to uncontrolled local debt.

5. Municipal Budgets

Each municipality has its own budget, which is independently prepared, adopted and enforced. The budget is developed according to a unique methodology, content and classification of the expenditures and revenues for the central and local budgets prescribed in the new Law on Budgets (03 August 2005). The financial plans for the public services that are provided by the municipality, and completely or partially financed by the municipality budget, are attached as annexes in a special part of the budget.

Uniformity in financial reporting requires the adoption of common templates, standards, and activity classification structures. As the next step in this process, Macedonia should require local governments to conform to international public sector accounting standards (IPSAS). Initially, this should be on a cash basis. Annual published financial statements should include a statement of cash receipts and payments, a statement of receipts by fund classification, including proceeds from borrowing, a statement of payments and expenditures by functions or activities, as appropriate, a balance sheet, and a cash flow statement or sources and uses of funds statement. These reports should be made on a consolidated basis, with an additional set of statements for each of the entities under the control of the municipality. The development of cost-finding systems is also the first step in developing performance management systems.
The Law stresses that the budget revenues can be used only for the purposes and in the amounts determined in the budget. The operating budget should be balanced. The Municipal Council adopts the budget for the following year not later than December 31 of the current year. The Council also passes the annual account and submits it to the Ministry of Finance. The Mayor notifies the public of the annual account’s content. Together with the annual account, the Council adopts an annual report on the municipality’s funds, claims and liabilities emerging from the realisation of its investment program and implementation of the capital and block transfers. The municipality and the public services funded by the municipality shall maintain accounts according to the Law on Budget and Budget User Accounting regulations, which are obligatory at both the national and local levels.

Taking into consideration the bad experiences from the previous period, an important measure for the consolidation of the municipal budget enforcement and of the entire local government funding system is the strict provision specifying that all extra-budgetary municipal funds must be abolished and their property and any pending liabilities and unpaid claims should be assumed by the newly founded municipalities.

Abolishing municipal funds and establishing a unitary budget at the local level will contribute to a more rational use of the municipal financial sources and to more effective control over their use. Ending the dispersion of municipal funds into several independent funding centres will reinforce financial discipline and transparency and will contribute to the consolidation of municipal finances.

There is also a procedure in the Law for taking timely measures to remedy any funding irregularities and disruption of the municipal financial stability. These measures would be applied in cases where irregularities in the local financial operations are detected by the main state auditor or emerge through the irregular servicing of the municipal debt or through the municipality exceeding its indebtedness limit, as well as in cases of continuous blocking of the municipality account for more than 30 days. The Minister of Finance would then constitute a committee that consists of representatives of the Ministry of Finance, the Ministry of Local Self-Government, the State Auditing Institute, the Municipal Council and the Mayor, for the purpose of proposing a program of remedial measures within 15 days. This measure is an attempt to solve a problem: to avoid bankrupting local government units and to avoid the accumulation of arrears in their payments.

6. Representation and Rights of Ethnic Communities

The Law on Local Self-Government contains several articles that regulate certain issues related to the representation and rights of the ethnic communities in the municipalities, in compliance with the constitutional solutions adopted after the signing of the Ohrid Framework Agreement.

First of all, the law prescribes the establishment of a Committee for Inter-Ethnic Relations in those municipalities in which at least 20% of the inhabitants belong to a certain ethnic community. The Committee comprises equal numbers of representatives from each community represented in the specific municipality. The Committee considers issues that concern inter-ethnic relations and offers opinions and proposals for their potential resolution. The municipal council is obliged to consider the opinions and proposals and to make a subsequent decision concerning them. The law also regulates the issue of representation of the different communities in the employment policy of the municipal administration and the public services funded by the municipality. Here, as the law prescribes, the adequate and equitable representation of the citizens of all communities in the municipality should be taken into account. According to the law, criteria referring to the candidates’ professional competence should
be respected in employment decisions. The law also contains provisions that refer to the use of the official languages in the municipalities. The law states that the Macedonian language and its Cyrillic alphabet is an official language in all municipalities. Furthermore, it states that, in addition to the Macedonian language, the second official language will be the language and the alphabet used by at least 20 percent of the municipality’s inhabitants.

7. Financial management

7.1 External and internal audit at local governments

The direct supervision of local service delivery by line agencies of the central government and of local officials by central control agencies is completely inconsistent with the devolution of responsibility. With fiscal decentralisation the purposes and functions of external audit have to be transformed. The State Audit Office and the inherited supervisory functions have to be modified towards building new supportive roles, based on a risk assessment of municipal financial management. The other way of lessening the administrative burden on the national audit system is to develop internal audit capacity at the municipal level. The first units of internal audit will be followed by other first line budget users and eventually by all local governments. An effective internal audit system would require the harmonisation of the legal base, setting up new institutions and significant capacity development.

7.2 Improved staffing and management capacity

Local government administration will be strengthened by transferring human resources connected to devolved functions. At the first stage only the Public Revenue Office staff have been moved to municipalities, as this was a basic stipulation of the legislation on local finances. Modernisation of the national government by gradually developing policy making and regulatory functions might result in further decentralisation of civil servants to the local level. At the moment, local government employees are somehow lower ranked than their counterparts at the national level because they do not enjoy the benefits and obligations of the civil servants. Thus either a unified civil service system that encompasses all civil servants, whether employed by municipalities or the central government should be created, or a separate system for local government employees should be developed.

7.3 Strengthening local government

The central government has a serious interest in preventing local corruption. One of the most effective bulwarks against corruption is a merit-based civil service system. The key point is that local governments must have considerable powers to appoint, and, where necessary, terminate public officials for cause. But securing a high-quality, merit-based civil service system implies an important role for the central government in recruiting, training, and certifying career officials for service at both levels of government. Local governments should be free to set staffing levels and personnel requirements and to hire and dismiss individuals, but constrained to make their selections from a national civil-service list or registry.

The newly created position of secretary of the municipality provides the potential for providing support for developing the professional capabilities of these key civil servants. The major weakness of the existing municipal secretary system is that it is excessively dominated by the Civil Service Agency. The secretary must be selected by the democratically elected council and serve at their will.

8. Fiscal Decentralisation – basis of a new effective local government

The current process in the Republic of Macedonia of constituting a new, modern system of local government, with decentralised public functions and local self-government, rep-
resents a complex reform providing for redistribution of important public functions of the state between two different levels of governments - the central and the local one. At the same time, this is a matter of deep decentralisation generating new local responsibilities in education, health, social care and environmental protection. In addition, a new system of municipal public ownership of real estate is constituted and real possibilities for improving the capacity for the economic development of the municipalities are created. Fiscal decentralisation can make an important contribution to the improvement of the standards and quality of local public services, to the strengthening of democratic processes and to the participation of citizens in the organisation of life in their municipalities, to the mobilization of human and natural resources for the development of the local economy, to increased employment and to a better social position of the citizens.

Local governments must be subject to the following operating principles: fiscal sustainability and a balanced budget; hard budget constraints for financial interventions in the economic sector; abiding by established borrowing limits and rules; financial discipline, transparency and accountability; inclusion of financial transactions of the local budgets in the treasury system of the country.

Willingness of the local authorities to cooperate in a constructive manner with the central authorities is a necessary precondition for the establishment of a balance between the discretionary rights and the autonomy of the local authorities on the one hand, and the need for maintaining a national macroeconomic framework and fiscal discipline on the other.

To better promote fiscal decentralisation and local public service provision, the following specific recommendations are made:

1. Fiscal planning rules and procedures should be modernised with the reform of intergovernmental fiscal relations. The primary task is to separate local government expenditures from national budgets and to classify budget resources by functions. Functional classification should be supplemented with performance indicators. The current and capital budgets should be separated.

2. Fiscal information and reporting should increase municipal capacity to monitor commitments, receipts, and outlays on a regular basis. Uniformity in financial reporting requires the adoption of common templates, standards, and activity classification structures. Cash accounting is adequate to meet local governments’ financial management, internal control and internal audit needs.

3. Local authorities should be free to explore alternative modes of service delivery. Full ownership of municipal assets is a basic condition for developing effective forms of service provision. The regulatory framework for private sector involvement in public service provision would require legal and procedural changes (e.g., public procurement regulations, customer control).

4. Regional equalisation should target differences in expenditures and municipal revenue raising capacity. The most important task is to create a transparent system of equalisation, which could also support solidarity among local governments. National and local governments have to be prepared for planning, co-financing and properly managing external sources of funding that will be available from the European Union.

5. The municipal debt problem should be resolved. Liquidation of indebted municipalities is a joint responsibility of the national and local governments. Solutions for non-payment have to be developed on a case-by-case method. The basis of any solution is an accurate register of local government debt. Possible solutions are: (i) a case-by-case negotiation process on specific components of municipal debt; (ii) setting up a special debt management fund; or (iii) discharging municipal liabil-
E. Reforms in Education

Education has a key role to play in the efforts to increase Macedonia’s human capital. By developing education and training, the government supports the process of creating a developed and functional human capital stock that can be the basis for the country’s prosperity.

The following are considered as priorities in the areas of primary and secondary education:

**Increasing the coverage of students.** In the case of primary education, the policy should be focused on increasing the coverage in rural areas and among populations currently underserved, such as the Roma. Full enrolment of children in grade 1 can be achieved through incentives and rewards, but also through punitive measures against families and schools tolerating negative phenomena. The rate of coverage of students by secondary education in Macedonia is still too low. Other problems include the high dropout rate of students and the poor vertical mobility towards the higher levels of education. It is necessary to overcome the belief that only primary education should be compulsory and to promote the importance of the higher levels of education through an aggressive publicity campaign and through a redesign of curricula. In addition to the government and the non-governmental organisations, local authorities must also play an important role in the efforts to increase the enrolment of students in primary and secondary education at the local level, through direct contacts with families, state agencies, the private sector and educational institutions. Basic education will become a local government responsibility. It is important to see that it is adequately funded, and that local schools perform well, and that they maintain equal opportunities and meet appropriate standards in terms of outcomes.

**Strengthening the quality and efficiency of the educational process.** In this context it is necessary to modernise the curricula in line with the...
standards in the developed countries and link them in a functional manner with the needs of the labour market, as well as to Macedonia’s economic and social needs and to increase the quality of the teaching staff as a whole, and especially of the staff working in the rural areas, by means of additional benefits, to introduce forms of compulsory and continuous assessment of the quality of the staff, as well as the introduction of a model for professional promotion of the teaching staff. Continuous education and re-education of teaching staff should be a given standard practice.

Curricula should be reformed to teach students about the European Union as well as about economic and business subjects, even in early grades. A population that understands its global environment and the functioning of the economy will be better able to adapt to new trends in the world economy. Effective globalisation of the Macedonian economy also presupposes foreign language skills broadly disseminated throughout the population; broadened instruction in foreign languages, and particularly in English, should be encouraged.

*Strengthening the IT capacity of educational institutions.* The first precondition for this is the modernisation of schools, setting clear priorities for the improvement and modernisation of their IT capacity, introducing equipment for active teaching and introducing information technologies in the teaching process. In this context, in addition to the budgetary funds that need to be spent in a rational way and in line with the priorities set, non-governmental organisations, donations and sponsorships from international organisations and from the private sector should also play an important role, and a national campaign to involve these non-traditional agents should be organised.

It is necessary to develop the capacity of educational institutions in accordance with the needs for modern education, and to increase the quality of educational management through the introduction of compulsory training for administrative and managerial staff of educational institutions. Moreover, it is necessary that the educational cycles be harmonised with prevailing European practice.

In the area of *higher education*, it is necessary to ensure significantly increased enrolments, and to provide equal access for students to the higher education facilities, to work continuously on qualitative improvement of the curricula and syllabi, to increase the efficiency of studying at a university, to establish and comply with comparable criteria and standards for teaching, assessment and promotion, to improve the availability of equipment, especially IT, and to strengthen the research function and improve the quality of the scientific and research work of faculty and students alike. Macedonia should adopt ambitious quantitative and qualitative targets for expanding the share of students who complete a university education as well as on the congruence of this education with Macedonia’s economic objectives. The Bologna process will have strong implications on the structure of the supply side, as well as on the organisation, financing, quality control and certification of higher education. The Bologna process will also have important implications for teaching methods, the content of the curricula and the mobility of the students between the faculties and to institutions of higher leaning in other countries.

Therefore, Macedonian universities need structural changes in order to define and implement the obligations and the policies promoted by the Bologna process. In particular, they need to be focused on quality assurance, accreditation and diploma recognition. The certification and recognition of foreign degrees and credits needs to be revised. Macedonia urgently needs graduates who have global perspectives and experiences.

To promote the needed globalisation of graduates, higher education institutions must strengthen their mutual links and coopera-
tion with peer institutions from abroad in order to adapt to the global environment and to benefit from the globalisation of higher education. Although it is a relatively easy part of complying with the Bologna process, the introduction of the European credit transfer system has not been completed yet. The difficulties are associated with the implementation of individual reforms, the depth at which they are undertaken and the priorities associated with this system. More elective courses need to be introduced and effective transfer of credits between the faculties and also among Macedonian universities and with foreign universities needs to be made possible. Macedonian universities need to establish ambitious goals for providing meaningful international experience for both faculty and students, and to develop mechanisms that make such experiences possible for a majority of faculty and students.

The mechanisms for quality assurance must aim at achieving international standards in the development of curricula and evaluation of personnel by introducing modularisation in order to make the system more flexible. There is a need to introduce more courses, more interfaculty and interdisciplinary programs linked with the labour demand on the local and the international labour markets, as well as shorter vocational studies.

Research and training for research are critical for the improvement of the quality of higher education. The financing of research, which is now modest, should be increased. The lack of new equipment and the limited time devoted to research are among the main barriers to the integration of Macedonia into the key scientific and intellectual developments at other European universities. The qualifications at the Ph.D. level need to be fully harmonised with the European Higher Education Area framework by using the results-based principle. A key component of the Ph.D. program is the advancement of knowledge through genuine research.

F. Reforms of Health Insurance and the Health Care System

The existing health care system in the Republic of Macedonia, provides citizens with access to adequate medical care, but the organization and financing of the health care system need rethinking and reform because the current system appears to be financially unsustainable and fails to provide appropriate incentives either to the providers of health care services or to those who pay for and utilise these services.

1. Organization of the Health Care System

In 1991, Macedonia, inherited a health care system with good geographical coverage and few financial barriers to citizens’ access to health care, as well as a long positive experience with health insurance covering nearly the whole population. The Law on Health Care of 1991 established the organizational structure of the system with the Ministry of Health in charge of health policy formulation and implementation and the Health Insurance Fund (HIF) responsible for the collection and allocation of funds and the supervision of and contracting with health care and pharmaceutical providers. This law and a separate Health Insurance Law established a system of compulsory health insurance.

Health facilities include health care stations and centres at the primary health care (PHC) level, specialty-consultative and inpatient departments at the secondary level, and university clinics and institutes at the tertiary level, with the latter also carrying out research and educational activities under the responsibility of the Ministry of Education. The last few years have seen considerable growth of the private sector, especially at the primary care level. However, a comprehensive system of coordination and monitoring of the responsibilities for the provision and control of the quality of health care is lacking and needs to be developed.
2. Funding Health Care Providers
Currently, health care institutions receive funds to cover salaries and allowances for employees, for drugs and other medical materials, as well as part of their operating costs, thus providing the financial resources required to cover the minimum needs of the institutions. Over the last decade, over 90% of the HIF’s expenditures covered service delivery costs, while pecuniary compensation of insured individuals, e.g., salary compensation for sick leave accounted for 6.5%. Spending on investments in the health sector was 0.7% of the HIF’s expenditures. So long as health care institutions’ budgets are based on their past operating expenses and staff size, rather than on their actual contribution to the provision of health care, this expenditure pattern is unlikely to change. This is problematic both because it limits resources available for investment and because, in the majority of cases, the money given to any institution does not directly reflect the type and volume of health care services delivered. Financial planning is further aggravated by the provision of health services that had not been anticipated beforehand by some institutions and the underutilisation by patients of other institutions, whose budgets remain essentially unchanged.

In 2002 a capitation model of payment was introduced in primary health care for private clinics and in 2005 for private dental clinics. In 2004 a budget allocation model was started in public hospitals, based on budget calculations on the needs of the three preceding years as well as the projected types and volume of services in the future. This is only a modest step forward, and it should be evaluated and revised as necessary, perhaps moving to a greater emphasis on more closely relating the actual services provided by such institutions to the amount of money they receive from the HIF. The HIF must be made capable of allocating its funds in a rational and transparent way to reflect the emerging, rather than past, health needs of the population. It is necessary to enable the Health Insurance Fund to be a strong negotiator for the purchase of health services from providers, regardless of whether those institutions are public or private. It is also necessary to direct the reform of the financing of health institutions towards a methodology according to which “money follows the patient”, instead of providing a fixed amount that covers the expenditures for the salaries of the personnel, with minimal funds allocated for equipment and supplies. In the system of public health financing, a form of “internal market” needs to be established with a view to forcing the health institutions to work more efficiently and to attract patients. Barriers to the private provision of health care should be reduced, and the HIF should not discriminate between state-owned and private providers of health services. Private health care is potentially an extremely important segment of the system. Conditions should be created for opening new private hospitals.

3. The Health Insurance System
The health care system is financed largely by payroll deductions, which, in 2004, accounted for more than 95% of the public resources available for health care delivery and other related benefits and activities. This way of financing the health care system is neither an efficient nor an equitable way of funding the Health Insurance Fund, bringing about a feeling of inequality among insured persons. Contribution payments for private sector employees, including self-employed people and farmers, an area in which there is both under-reporting of obligations and evasion of payments, as well as for public sector employees, foster a sense that those who do have deductions taken from their pay are supporting many free riders. Moreover, many citizens working abroad or in the grey economy fraudulently register themselves as unemployed in order to receive free health care because, upon registration as unemployed the individual receives a set of coupons which form the basis for health service delivery.9

The compulsory health insurance system provides access to a very comprehensive range of health care services and thus is very costly.
As a result both the HIF and individual health service providers are under financial strain while the system of financing health care contributes to the existence of shadow employment and the growth of the informal sector.

We suggest that these problems be resolved by making basic health care a right of every Macedonian citizen, and making additional health care provision a service for which people have to pay. The government should decide what medical services are parts of a package of “basic” health coverage and provide these as a right to everyone who is a Macedonian citizen. Such coverage might include basic immunization, periodic physical checkups, emergency care, pre-natal care, etc. General tax revenues would finance this program, with fees to providers negotiated by the HIF. Health care institutions would thus receive some fraction of their budget based on their capacity to provide these basic health services, and the remainder of their income would have to be generated by providing services beyond those in the basic package, for which they would be compensated on a patient-by-patient basis.

Any coverage beyond the basic services could be provided by employers, if so negotiated under collective bargaining agreements, or purchased by individuals from the HIF or from consortia of health providers or insurance companies. Individuals receiving pensions or disability payments could have their coverage subsidised (but not covered entirely), as could poor people. This would reduce the total tax burden on wages and it would also reduce incentives for people to report themselves as unemployed in order to be eligible for health care since the basic health care would be provided to all regardless of their employment status. Coverage beyond the basic package would require outlays by individuals or their employers, which would encourage workers to press grey sector firms to become legal ones.

Finally, any reform of the finances of the health sector presupposes that the arrears that exist in payments between the HIF and health service and pharmaceutical suppliers are promptly paid and that the payroll deductions due to the HIF from employers are also promptly and effectively collected by the Ministry of Finance and the tax authorities, even if such measures put some firms that lag behind in their payments into bankruptcy.
Endnotes

1 We do not provide a detailed analysis of Macedonian trade policy because Macedonia has recently attracted considerable attention in the international community due to its intentions to join the European Union. Such studies of the trade regime have been carried out by the World Bank, NGOs, *The Economist* and various EU- and USAID-sponsored activities. Additional information was obtained from the WTO.


4 Falcetti, Elisabetta; Sanfey, Peter; and Taci, Anita (2003), “Bridging the gaps? Private sector development, capital flows and the investment climate in south eastern Europe”, EBRD Working Paper No. 80, London: EBRD

5 Barth, James R., Tong Li, Sangeetha Malaiyndi, Donald McCarthy, Triphon Phumiswana, and Gkenn Yago, 2005 Capital Access Index. Miliken Institute, October, 2005.

6 Although politically sensitive, the agricultural land tax is a necessity in a market economy, and its collection and (partial) use can be delegated to the local governments. The use of these revenues can be tied to agriculture land improvement investments such as access roads, flood protection, etc.

7 An example of good practice in the region that details the challenges as well as good policy responses for creating an enabling environment for the accelerated agricultural sector adjustments required to meet the competitive pressures that stem from international market integration is the recent Agriculture Sector Strategy of the Government of Serbia (http://www.minpolj.sr.gov.yu).


9 Co-payments have been introduced to counteract excessive use of health services or consumption of drugs, as well as to provide additional resources for financing the health care system. As might be expected, co-payments have not led to significant resource increases to finance health care as they amount to only 3–4% of the total fund revenue. Furthermore, the exemptions from co-payments that have been introduced have served to reduce the importance of co-payments as a revenue source.