



Seizing a Brighter Future for All



FORMER YUGOSLAV REPUBLIC OF MACEDONIA
SYSTEMATIC COUNTRY DIAGNOSTIC



WORLD BANK GROUP

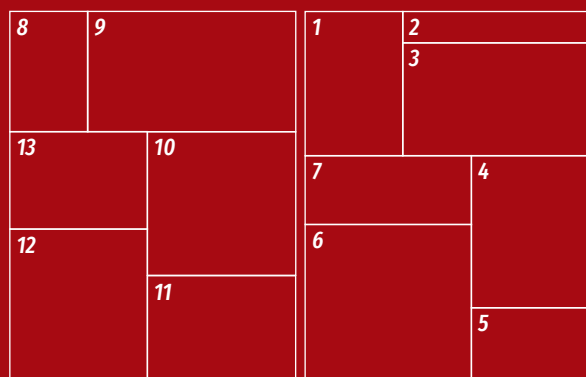
People forge ideas, people mold dreams, and people create art. To connect local artists to a broader audience, this report features art from Macedonian artists. The World Bank would like to thank the Museum of Contemporary Art in Skopje for their support and cooperation.

Front cover paintings:

1. Tanya Tanevska (IV/IV-0403)
2. Nove Frangovski (Folk Dance)
3. Zaneta Gelevska Veljanovska (City of Joy)
4. Nikola Martinovski (Girlfriends)
5. Ordan Petlevski (Macedonian Village)
6. Zani Gelevska (By the Lake)
7. Simonida Filipova Kitanovska (Birds Family)

Back cover paintings:

8. Dijana Tomic Radevska (Rhythm)
9. Lazar Lichenoski (Poppies)
10. Vladimir Simeonov (Peacock from Stobi I)
11. Dragutin Avramovski Gute (Morning in Lombardy)
12. Reshat Ameti (Would Like to Fly)
13. Done Miljanovski (Ohrid Spring)



Back cover

Front cover

Executive Summary

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FYR Macedonia stands at a turning point in its history as an independent nation. In 2018, the country took decisive steps to resolve a long-standing dispute with Greece about its official name, when the two countries reached an agreement that needs to be confirmed. Resolution of the name issue—which has been inflicting political and economic damage since 1991—is essential to consolidate FYR Macedonia’s European Union (EU) and NATO accession process and enable it to become more deeply integrated with regional and global markets.

FYR Macedonia is well-positioned to seize the opportunities that EU accession can bring. Its early market-oriented reforms, openness to trade, and prudent macroeconomic management have created an environment of economic stability that has attracted private investment and boosted exports, particularly in manufacturing. In the last two decades, its economic growth was the most stable in the Western Balkans, income per capita doubled, and the country moved from low-middle- to upper-middle-income status. Its strategic geographical location is also a major asset, given the largely untapped export potential of its agriculture and services sectors.

Seizing opportunities requires full awareness of the country’s challenges. Despite reforms, its economic growth has been lower than in peer countries, and close to 25 percent of Macedonians still live in poverty. Jobs, their main route to prosperity, are scarce: only 50 percent of working-age Macedonians is employed. Moreover, low birth rates and emigration are shrinking the workforce. In terms of governance, the country trails peers in such categories as political stability, voice and accountability, rule of law, and control of corruption—the 2015–17 political crisis is a reminder of the detrimental effects of political instability on economic growth and job creation, and the need to ensure transparent and effective rule of law. Finally, elements central to the current economic model undermine its sustainability. Though countercyclical fiscal policies helped to stimulate growth and employment, now, as fiscal buffers are dwindling, maintaining the current model of public support for growth is neither desirable nor feasible. Meanwhile, passive management of growing environmental threats like air pollution and natural hazards is jeopardizing the well-being of the population. In sum, taking full advantage of the new opportunities that arise with joining the EU will only be possible if FYR Macedonia shifts gears and makes its economy more competitive, inclusive, and sustainable. Otherwise it risks losing even more of its workforce to emigration.

Where can FYR Macedonia change how it does things? This Systematic Country Diagnostic (SCD) identifies not only opportunities for FYR Macedonia to grow faster and more inclusively, but also barriers to be dismantled, while ensuring that benefits are sustained over the long term. The SCD presents a wealth of evidence about the country’s progress in reducing poverty and advancing shared prosperity that suggests in turn policy priorities.

Three findings stand out. First, productivity—which is critical to boost growth and create more and better-paying jobs—is low and has been growing slowly. In the last decade the structure of the economy has changed little. Increased foreign direct investment (FDI) in export-oriented sectors has not created many backward links to domestic firms, and service exports represent only about 25 percent of total

exports. Among private firms, resources are not moving from less-productive to more-productive firms. Indeed, most jobs are in low-productivity sectors, and too many firms are small and uncompetitive. In advanced economies like the United States, the top 10 percent most productive firms are only twice as productive as firms in the bottom 10 percent; in FYR Macedonia, the top 10 percent are over 7 times more productive. Agricultural support policies exacerbate inefficiency and slow structural transformation by discouraging workers from shifting to more productive jobs, not only in agriculture, but also in industry or services. Human capital inadequacies also hinder productivity: the average worker in manufacturing and services in Europe and Central Asia is four times more productive than a Macedonian worker. Low skills are at the core of the issue: about 70 percent of Macedonian 15-year-olds fall short of basic reading and numeracy proficiency, and employers cite lack of skills as a main obstacle for doing business.

Second, social inclusion is hindered by the lack of jobs and opportunity gaps. Among working-age Macedonians (15–64 years old), the low employment rate (49 percent) results from the combination of high unemployment (16 percent of all working-age) and high inactivity (35 percent). For the unemployed, prospects are grim: over 80 percent have searched for a job for more than a year, and over 70 percent have no prior work experience. Further, with 25 percent of workers retiring between 55 and 64 years old, productive human capital is severely underutilized. As a result, over his lifetime the average Macedonian man loses about 25 potential productive years and women lose 30. Employment is critical to overcome poverty. Among the poor, unemployment is almost triple that of the nonpoor; unemployment is the main predictor of poverty, even after controlling for other individual and household characteristics. Women, youth, and ethnic minorities are more likely to be out of the labor force, unemployed, or in precarious employment. Besides the insufficient level of job creation, policy distortions and social norms create additional disincentives and barriers to accessing job opportunities. Opportunity gaps are also evident in health outcomes. Macedonian children, for example, have a higher mortality risk than those in other Western Balkan or European countries, while poor nutrition outcomes affect their ability to learn, as well as their productivity throughout the lifecycle.

Third, social, fiscal, and environmental risks may jeopardize the country's future prosperity. Citizens' perceptions of political accountability and the quality of public services are lower than in European peer countries and have been worsening in recent years. There is also a need to address fiscal risks: between 2008 and 2017 a lack of adequate fiscal discipline led to the doubling of public debt; without reforms, public debt will expand, as so will financing needs. The pension deficit is now over 4 percent of GDP, and the accumulation of public sector arrears is a complex and recurrent issue that threatens fiscal sustainability. Inefficiencies in public spending suggest there is ample potential to improve resource allocation. Finally, growing environmental threats imply high economic costs, both present and future. Every year air pollution, caused mostly by fossil fuels, generates losses equivalent to 3.2 percent of GDP. Meanwhile, the combination of high exposure and low resilience to natural hazards, which are being amplified by climate change, is expected to cause damages to critical infrastructure that can be expected to grow exponentially. Reinforcing emergency preparedness and other aspects of resilience is ever more urgent.

What will it take for FYR Macedonia to take charge of its future? Through an iterative process of evidence-gathering and stakeholder consultations, the SCD aims to inform government, civil society, representatives of the private sector, and development partners by mapping a sequence of policy options to increase productivity, enhance universal access to job opportunities, and achieve sustainability

through effective governance, fiscal prudence, and environmental resilience. These options are grouped in 10 priority areas. For all policy actions the SCD discusses the expected impact and the synergies they create.

1. **Secure rule of law and build capable public institutions that are accountable to citizens.** A commitment to greater public sector transparency and accountability, a well-defined rule of law respected by all and that serves all equally, and a qualified bureaucracy encouraged to take calculated risks without being punished for failure, would build social trust while improving the business environment and the delivery of public services
2. **Endow people with quality and relevant skills throughout the life cycle.** Human capital is the country's main asset, but there is an urgent need to improve its quantity and quality. Investments in early childhood development will ensure school readiness. Better primary, secondary, and tertiary teaching methods will help build critical thinking skills. Quality assurance mechanisms can monitor learning outcomes to assure job-readiness for graduates, especially by facilitating early exposure to the work environment.
3. **Strengthen firm capabilities and the ecosystem for technology adoption and access of firms to finance.** FYR Macedonia has untapped opportunities to expand trade in both goods and such services as tourism, logistics, information technology, and healthcare. But firms need to be ready to compete in a global market. Programs that support domestic firms—especially smaller ones—to adopt international quality standards and update their management skills would help them access funding, improve their operations, and integrate into value chains.
4. **Enhance trade connectivity and value chain integration.** On “hard” connectivity, major progress has been achieved in building transport infrastructure; now the need is to complete the main corridors and rebalance spending to invest in maintenance and road safety to protect physical and human capital. “Soft” connectivity also demands attention: streamlining procedures, upgrading customs systems, and coordinating the activities of export-related agencies will forge closer links between export-oriented FDI-firms and domestic firms.
5. **Promote market competition and establish a world-class business climate.** On paper the Macedonian competition regulations and institutions follow the EU model. In practice, however, there are gaps that create an uneven playing field. Making competition policy more effective by strengthening public sector neutrality, promoting private entry into network industries, and removing barriers to competition in professional services will enhance productivity. Meanwhile, FYR Macedonia can build on its solid track record of reform to enhance the quality and predictability of business regulation.
6. **Reduce disincentives and remove barriers to labor market participation, especially for women.** Expanding access to quality child and elder care, revising family leave policies, and working to counter traditional social norms and other barriers would give more women in their most productive years the opportunity to work. Better designed tax rates, social benefits, and labor regulations can heighten incentives to work, always keeping in mind the need to carefully balance fairness and flexibility.

7. **Ensure fiscal sustainability by reducing fiscal risks, improving the efficiency of spending, and enhancing revenue mobilization.** Reining in pension spending, better controlling the debt of state-owned enterprises, enforcing discipline in local government financial management, improving the efficiency of public spending, and raising tax collection would ensure better public services and provide buffers as needed to stimulate economic activity in times of need.
8. **Invest in an integrated strategy to reduce air pollution, promote low-carbon growth, and build resilience to natural hazards and climate change.** To counter the dire threat to public health created by air pollution, state-of-the-art technologies and firmer enforcement are needed to ensure compliance with regulations. Reducing dependence on coal; making the energy supply more efficient, and more secure; and investing more in renewable energy would help curb carbon emissions. Crafting national programs and policies to reduce climate and disaster impacts in priority sectors is the first step to reducing risks to infrastructure; these efforts should be supported by advances in emergency response systems. Managing water resources more efficiently by rehabilitating aging infrastructure would help to avoid worsening water scarcity.
9. **Protect human capital by shielding poor and vulnerable households from shocks and investing in preventive medicine and primary care.** Better-targeted social assistance, expanded social services, better-quality health care, and promotion of healthier lifestyles together would help shield poor and vulnerable households from shocks and improve health standards. There is an urgent need to build up primary health care, especially for children, and increase the productive life span of all Macedonians.
10. **Foster agricultural modernization.** A well-functioning agricultural sector can foster sustainable use of resources and become an economic engine for rural areas. For this, a more effective land market is needed to improve the intensity of physical capital use and technology adoption in agriculture and agribusiness. That will in turn spur farmer productivity and export-readiness. An urgent priority is to revise state aid to agriculture, which currently distorts the allocation of resources and reduces technological improvements.

FYR Macedonia can use the EU accession process to advance and sustain many of these priorities. The country needs to be ready to compete with its EU peers on an equal footing. The most successful new EU members have frontloaded the EU's *Acquis* to modernize institutions and hedge against the risk of policy slippage. Importantly, special attention will be needed to advance priorities that the EU *Acquis* may not fully cover. For instance, education, workforce skills, and firm capabilities in FYR Macedonia are likely to require attention beyond the *Acquis*, although the EU and international financial institutions are well-positioned to help.

The success of FYR Macedonia's economic policy will depend on its ability to hold to a steady reform course. Individuals and businesses planning for the long term will benefit from an environment of stability and trust. Difficult times will come. A clear strategy based on a shared political vision and public awareness will ensure that daily political firefighting does not dilute reform momentum.



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