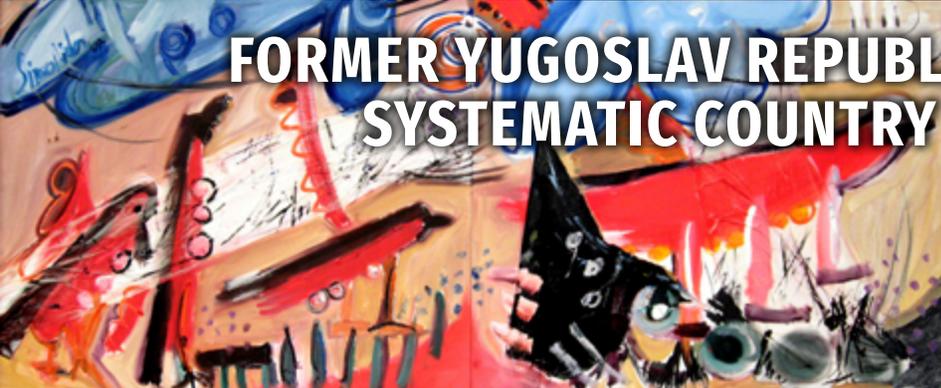




# Seizing a Brighter Future for All



**FORMER YUGOSLAV REPUBLIC OF MACEDONIA  
SYSTEMATIC COUNTRY DIAGNOSTIC**



**OVERVIEW**

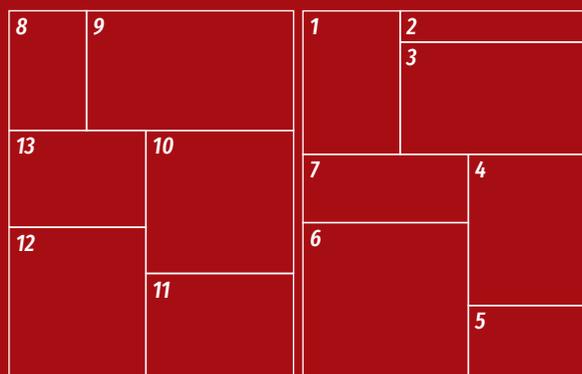
*People forge ideas, people mold dreams, and people create art. To connect local artists to a broader audience, this report features art from Macedonian artists. The World Bank would like to thank the artists and the Museum of Contemporary Art in Skopje for their support and cooperation.*

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Report Number 121840-MK

# Seizing a Brighter Future for All

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FORMER YUGOSLAV REPUBLIC OF MACEDONIA  
SYSTEMATIC COUNTRY DIAGNOSTIC

OVERVIEW

November 2018

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# Executive Summary

## Executive Summary

**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.



# Overview of the Diagnostic



September 8, 1991, was not just another Sunday in Skopje. Results from the national referendum confirmed what most Macedonians were expecting: a landslide victory for independence. Although Marija was thrilled, she was also anxious. Inflation and scarcity had made the last few years very difficult for her and her family. But would independence answer the questions she still had? For instance, could the tobacco factory keep operating? Would the schools still give her children a good education? By 2018—27 years later—Marija knew that her country was much better off—but she also knew there were many things that still needed improvement. For instance, she would like her son to come back from abroad and be able to earn a high salary at home. Every time she picks up her grandson from kindergarten, she hopes the country can seize the opportunities it has to provide a brighter future for all. Especially for little Stefan.

*Dimitar Avramovski Pandilov*  
*Harvesters*

## Overview of the Diagnostic

i. **The Former Yugoslav Republic (FYR) of Macedonia aspires to reach the living standards of the European Union (EU) with a robust middle-class society and access to economic opportunity for all its citizens.** Though ambitious, it is not unrealistic to think that in just over two decades, by its 50th anniversary in 2041, FYR Macedonia will have made substantive progress in closing the gap in living standards with EU countries. Similarly, the country may well celebrate its 50th anniversary having equalized opportunities for all citizens, regardless of their location, gender, ethnicity, age, or other personal characteristics. To achieve these noncontroversial goals, however, it must re-think its current development approach, which so far has delivered only modest results in terms of GDP growth, poverty reduction, and the consolidation of the middle class. Instead, the approach since independence has eroded the fiscal space for government delivery of quality public goods and services; it has diminished the trust of citizens in the state; and environmental threats are becoming increasingly acute.

ii. **This Systematic Country Diagnostic (SCD) identifies three mutually reinforcing pathways for FYR Macedonia to sustainably accelerate growth, reduce poverty, and consolidate the middle class.** An examination of the country's progress in the 27 years of its independence reveals three strategic pathways for FYR Macedonia to overcome its development challenges and leverage new opportunities. The first is to foster a more dynamic and competitive private sector. The second is to build up human capital to be more competitive and adaptive and close opportunity gaps. And the third is to achieve sustainability through effective governance, fiscal prudence, and enhanced environmental management and resilience to natural hazards. Embarking on these strategic pathways would help sustain the robust and inclusive growth necessary to eliminate extreme poverty—a goal FYR Macedonia can achieve within the next decade—and promote shared prosperity. This SCD identifies short- and medium-term policy priorities to help FYR Macedonia achieve its long-term vision.

### 0.1 A Determined Start in a Difficult Context

iii. **FYR Macedonia's development challenges and opportunities are rooted in its history and geography.** As a small, landlocked country, it depends on close relationships with its neighbors to access larger markets. In addition to its small size, high transportation and transaction costs create barriers to international trade. The history of conflict and instability has tarnished the image of the Western Balkans region as a destination for international investors, and these spillover reputational effects have been costly for FYR Macedonia. Moreover, other neighbors like Bulgaria and Greece and important trading partners like Italy were hit hard by the 2008–09 global financial crisis, which depressed external demand for Macedonian products. Yet, geography also represents considerable opportunity: While FYR Macedonia lacks natural resources that can be easily exported, the export potential of its agriculture and services is largely untapped, and its strategic location at the heart of the Western Balkans could enable it to become an overland logistics hub for the sub-region.

iv. **The country's early transition to a market-oriented economy took place in exceptionally difficult circumstances.** While FYR Macedonia largely avoided the violence that afflicted other former Yugoslav

republics, economic sanctions on Serbia closed the border with what was then FYR Macedonia's most important trading partner, while a controversy with Greece over the name of the newly independent nation closed its southern border, cutting off FYR Macedonia's access to the nearest seaport. The new government had no international reserves, and as it struggled to stabilize its new currency the country had to deal with hyperinflation inherited from the Yugoslav economy. The disruption of former chains of production and the loss of markets forced numerous Macedonian firms to close, so that unemployment rose and living standards deteriorated.

v. **Despite its difficult initial circumstances, for over a decade FYR Macedonia undertook market-oriented reforms and kept its macroeconomic policy stable.** The country swiftly moved to promote trade openness, privatization, and price liberalization, enabling it to transition to a market economy faster than its Western Balkan neighbors. The government prioritized the signing of trade agreements such as the Central European Free Trade Agreement (CEFTA), and accession to the World Trade Organization (WTO) and EU membership were clearly articulated as national objectives. By 1996, the government had stabilized the economy, and its commitment to fiscal responsibility and sound macroeconomic management bolstered its resilience to subsequent economic shocks, even the global financial crisis. After an initially difficult shift from state planning to a market-driven economy, the following decades were marked by resurgent growth and rising incomes. By 2006, per capita GDP had recovered to its pre-independence level, and in 2008 FYR Macedonia reached upper-middle-income status.

vi. **With successive administrations all committed to a market-friendly vision of the future, FYR Macedonia has seen international indicators of the business climate rise considerably.** Major regulatory reforms have made it much easier to start and expand a business. In the 2018 *Doing Business* report, FYR Macedonia ranked 11th of 190 countries ease of doing business and 2nd in the Europe and Central Asia (ECA) region. Meanwhile, an ambitious strategy to attract foreign direct investment (FDI) helped increase the volume and sophistication of Macedonian exports, diversify the country's export basket, and create jobs. In recent years, FYR Macedonia has outperformed peer countries in attracting greenfield FDI, and in 2017, of 94 countries it received the 3rd largest amount of greenfield FDI per capita.<sup>1</sup>

## 0.2 Progress, though Modest, on Economic, Social, and Environmental Goals

vii. **For the past two decades, however, economic growth has been too small to narrow the income gap with the EU average.** Since the mid-1990s, the economy has grown more slowly in FYR Macedonia than in many comparable countries, delaying its convergence with EU income levels.<sup>2</sup> For example, using Germany's GDP as a benchmark, in 1995 FYR Macedonia's economy was about the same size as Latvia's (Figure O.1); but in 2017 Latvia's GDP per capita was about twice as high as that of FYR Macedonia (US\$13,600). The implications of growth are staggering: Since 2000, FYR Macedonia's annual GDP

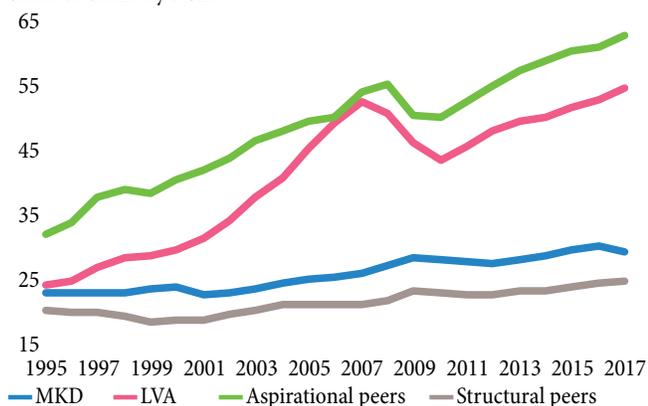
1 Source: fDI Intelligence, 2018. "Greenfield FDI" refers to investments where the parent company builds its operations in the host country from the ground up, constructing production facilities, distribution hubs, offices, or living quarters.

2 This SCD benchmarks FYR Macedonia's performance against that of "structural peers" (Albania, Bosnia and Herzegovina, Georgia, Jamaica, Jordan, Mauritius, Paraguay, and Serbia) and "aspirational peers" (Bulgaria, Croatia, Estonia, Latvia, Lithuania, the Slovak Republic, and Slovenia). See Annex 1 for the criteria for selecting structural and aspirational peers. Annex 2 presents a benchmarking analysis that assesses FYR Macedonia's performance across a wide range of development indicators vis-à-vis countries with similar levels of income, both in ECA and globally.

**Figure O.1: FYR Macedonia's economy has not grown fast enough to close the income gap with the EU**

*GDP per capita in PPP, 2011 prices, as a share of Germany's*

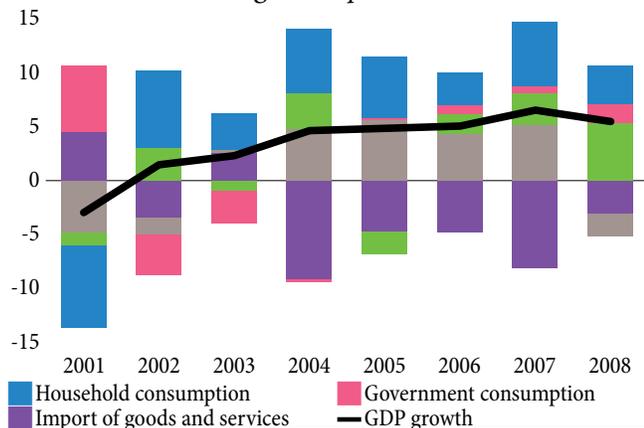
Share of Germany's GDP



Source: Authors' calculations based on data from World Development Indicators (WDI) and Eurostat. See Annex 1 for details on the selection of peer countries.

**Figure O.2: Household consumption has been the main driver of growth in the past...**

*Contribution to GDP growth, percent*



Source: Authors' calculations based on data from national authorities.

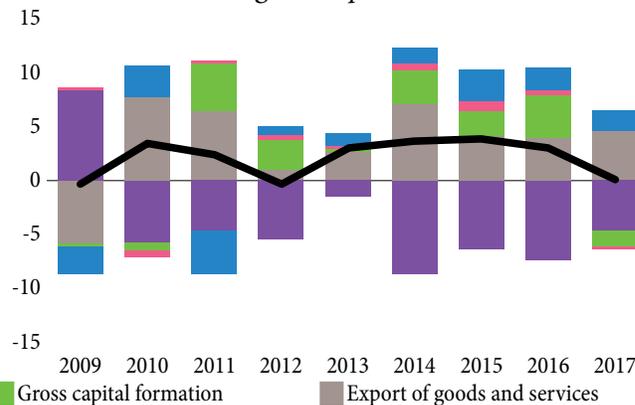
imbalance as imports of consumer goods outstripped growth in exports. By 2008, the current account deficit had reached a historic high of 12.7 percent of GDP, primarily because the trade deficit widened to 29 percent of GDP, as exports declined and spike in oil prices contributed to the imports growth. The drivers of growth changed after the 2008 global financial crisis and the 2011–12 economic crisis in Greece, which depressed private consumption and dampened growth in real wages. Between 2009 and 2017, exports and investment contributed an average of about 5 percentage points (pp) to annual GDP growth rate, and rising exports helped narrow the current account deficit to 1.3 percent. Although most investment in FYR Macedonia is private, and largely foreign, public investment rose from an average of 22 percent of total investment in 2002–08 to 26 percent in 2009–17. The government stimulated the

growth has averaged 2.8 percent. At this rate, a Macedonian child born today will be 75 years old by the time the country converges with EU income levels. However, if annual growth accelerates to 5 percent, FYR Macedonia could converge with the EU by the time the child reached age 30.

viii. In the first part of the 2000s, FYR Macedonia's GDP growth relied heavily on consumption, but after 2009 investment and exports forged ahead. Between 2001 and 2008, consumption represented about 96 percent of GDP, compared to an average of 78 percent in aspirational peers and EU countries, and was also the main contributor to GDP growth, as exports declined and a spike in the price of oil contributed to the growth of imports. However, private consumption, fueled by private transfers from abroad and credit growth, led to a rising external

**Figure O.3: ...but exports and investment gained importance thereafter**

*Contribution to GDP growth, percent*



economy by investing primarily in roads and civil construction projects, which went up from 28 percent of total public investment to 43 percent. Personal consumption recovered after 2013 as employment improved, real wages increased and disposable income went up, due in part also to higher pensions and subsidies. FDI in the motor vehicles and electric machinery industries boosted total exports to 55 percent of GDP in 2017 (22 pp higher than in 2000), and there is ample room for improvement while exports as a percent of GDP in FYR Macedonia are lower than in aspirational countries, where exports exceed 80 percent of GDP.

ix. **A decline in productivity growth poses a serious threat to GDP growth.** Low and slow-growing productivity inhibits economic growth and diminishes a country's capacity to create more and better-paying jobs. FYR Macedonia trails peer countries on indicators of labor productivity (value added per worker), due largely to a lack of growth in total factor productivity (TFP).<sup>3</sup> Negative TFP growth in 1993–2001 and again in 2009–17 dragged down GDP growth. Stagnant TFP, accompanied by very small growth in wages, suggests a continued misallocation of capital, labor, and land resources. Moreover, the decline in TFP has been accompanied by a declining rate of human capital formation as education and skills have deteriorated, as described below.

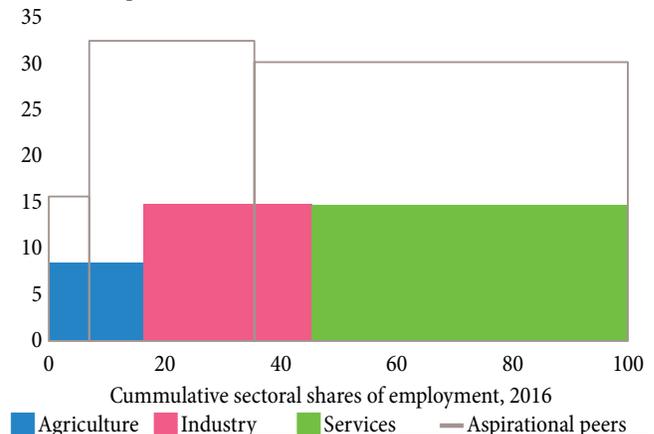
x. **FYR Macedonia's structural transformation to higher-value-added sectors has been relatively slow.** Agriculture employs far more of the workforce in FYR Macedonia than in aspirational peers, and its share of workers employed in services is smaller. Even within sectors, labor productivity in FYR Macedonia is far below the average for aspirational peers (Figure O.4), and most industries have seen little improvement in recent years. Because labor productivity is low and stagnant, most households can increase their income only by working more hours.

xi. **Stagnant productivity has led to stagnant wages and a dearth of quality employment options.** More-productive firms tend to pay higher wages than less-productive firms, and wages there tend to grow faster (Figure O.5 and Figure O.6). The country's incomplete structural transformation traps a large share of workers in relatively low-productivity sectors, especially agriculture and textiles. Poor educational outcomes, high rates of emigration, and long periods of economic inactivity also contribute to the low marginal productivity of labor that inhibits wage growth. Meanwhile, the economy continues to grow but not fast enough to make a dent in critical goals like reducing unemployment, raising productivity and salaries, and enlarging the middle class.

**Figure O.4: In FYR Macedonia a relatively large share of labor is employed in low-productivity sectors**

*Sectoral Employment and Labor Productivity*

Value-added per worker (2010 US\$), 2016, in thousands



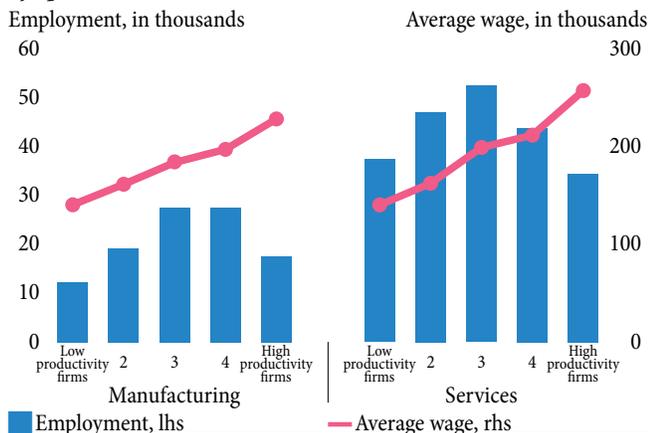
Source: Authors' calculations based on data from WDI.

Note: Colored boxes represent FYR Macedonia; outlined boxes represent aspirational peers. Labor productivity is calculated using the annual growth of value added per worker.

<sup>3</sup> TFP is the portion of output not explained by the inputs used in production.

### Figure O.5: Wages tend to be higher at more-productive firms...

Employment and average level of wages by within-industry total factor productivity of revenue (TFPR), by quintile, 2013–2016



Source: Author's calculations: Background paper for this report by Cusolito, Davies, Hernandez, and Pena (2018), based on data from FYR Macedonia's firm registry. See Chapter 3 for details.

### xii. Improvements in welfare have only recently become apparent, and a sizable share of the population is not yet part of the middle class.

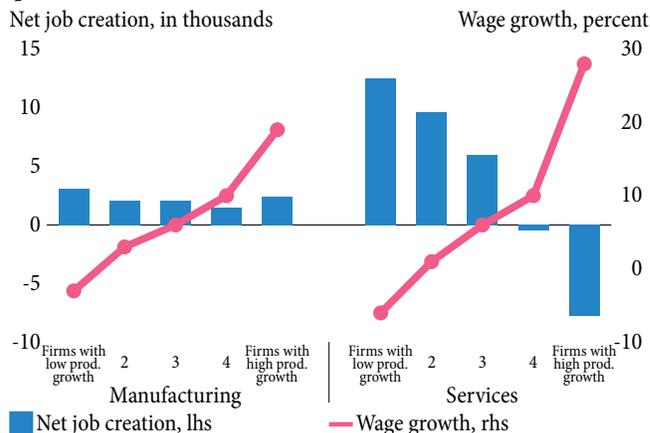
After stagnating since 2000, in 2009 the poverty rate began to decline, and the middle class expanded modestly. But even while poverty was being reduced, the vulnerable, those only one shock away from falling back into poverty, have held steady at about one-third of the population (Figure O.7). Job creation and rising wages have driven poverty reduction, and because wages are the main source of income for all households, a strong labor market is critical. Despite the recent decline, poverty is still entrenched in rural areas, in northern regions, and among ethnic minorities, whose poverty rates are consistently higher than those of ethnic Macedonians. Moreover, in recent years some indicators of nonmonetary poverty in education and health that were previously consistent with the country's upper-middle-income status have deteriorated.

### xiii. The role of public spending as a driver of the recent decline in poverty raises questions about the sustainability of the decline.

The drop in poverty since 2009 is explained mainly by better job opportunities and higher labor earnings for workers at the bottom of the income distribution, but those job opportunities were partly a result of expansionary fiscal policy that pushed up public debt, which suggests that the recent gains in poverty reduction may not be sustainable. FYR Macedonia can only

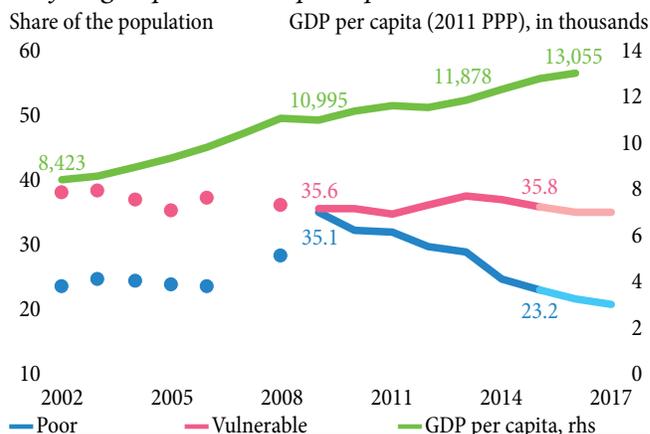
### Figure O.6: ...and wage growth is associated with productivity growth

Net job creation and wage growth by within-industry total factor productivity of revenue (TFPR), by growth quintile, 2013–2016



### Figure O.7: Welfare has improved on average, yet the share of vulnerable has remained constant

Welfare groups and GDP per capita



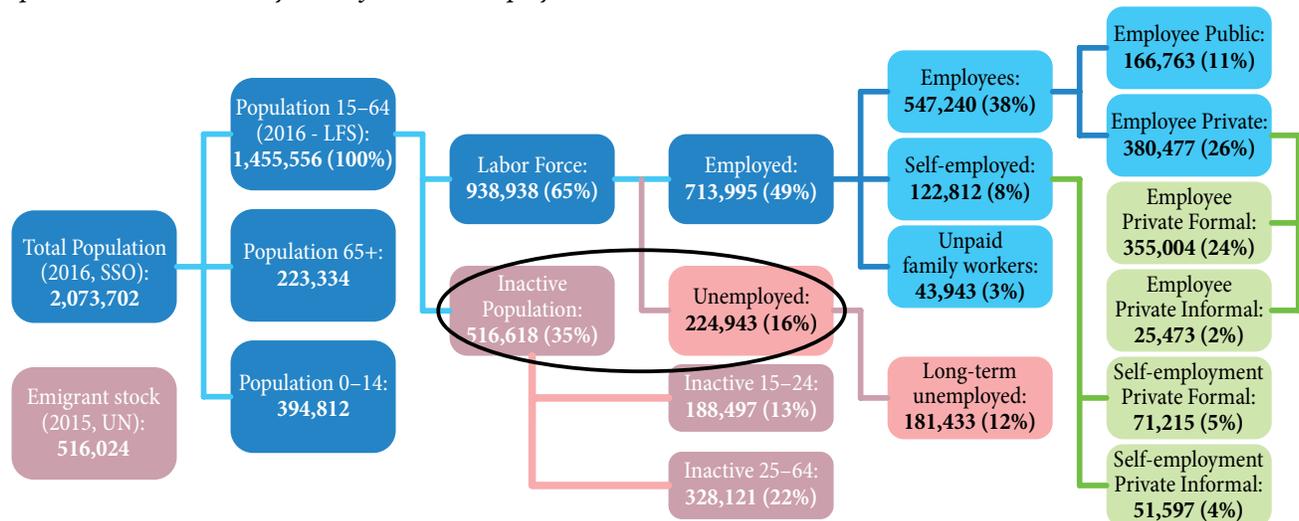
Source: Authors' calculations based on data from WDI, FYR Macedonia's Household Budget Survey (HBS), and FYR Macedonia's Survey of Income and Living Conditions (SILC).

achieve its goals of eradicating extreme poverty, reducing moderate poverty, and building a robust middle class within the next two decades if it has higher, and sustainable, economic growth and job creation: with annual GDP growth of 5 percent, the country could eliminate extreme poverty by 2030.

xiv. **Slow improvements in welfare reflect a significant structural deficit in jobs.** Despite a modest rise in job creation, the Macedonian labor market still does not have enough jobs for people of working age, only 50 percent of whom are employed (Figure O.8). Unemployment is high and labor-force participation is low, especially for those younger than 25 and older than 55, and for women, who are further penalized because on average they have less education. Aging and emigration further complicate efforts to improve welfare. The workforce is shrinking due to low fertility, which raises concerns about the financial sustainability of the country's social safety net. The workforce is projected to fall by 20 percent in the next 35 years, from 1.47 million in 2015 to 1.16 million by 2050. Moreover, although emigration is draining the country of many of its most productive workers, remittances are minimal.

**Figure O.8: Too many Macedonians are not working, creating a significant jobs challenge**

*Population distribution by labor force and employment status, 2016*



Source: Authors' calculations based on data from national authorities, LFS, and UN Population Division.

xv. **Disillusionment with the ability of the country to deliver broad-based gains erodes public confidence in international openness and market-driven growth and could jeopardize integration with the EU.** Many Macedonians do not perceive the country's recent development to be as positive as the data might suggest—public perceptions of inequality and economic mobility are strikingly pessimistic. The 2016 Life in Transition Survey found that only 8 percent of Macedonians believe that their position on the income distribution had improved since 2010, and almost 60 percent saw inequality as rising. These negative perceptions may reflect the economic vulnerability of many Macedonian households, which persists even among those whose incomes have risen above the poverty line. Failure to consolidate a middle-class society may leave households anxious about their economic prospects, even if their income gains have been meaningful. These perceptions may also be influenced by the quality of new employment opportunities; the shortage of desirable jobs encourages potential workers to remain idle or to leave the country in search of better opportunities. As other countries in the region and across the world demonstrate a surprising vulnerability to demagoguery and protectionism, without significant

improvements in living standards FYR Macedonia may face similar pressure to turn away from global markets and international institutions and embrace an inward-looking, even illiberal, political economy. At this point, accelerating growth and reducing poverty and inequality are not merely desirable but critical to sustain the country's transition to democratic governance and private-sector-led development.

xvi. **Maintaining or scaling-up current public support to growth is neither desirable nor feasible.** FYR Macedonia weathered the impact of the global financial crisis and the Greek economic crisis relatively well, sustaining economic growth and reducing poverty for the first time since independence. But simply keeping growth at its current pace will not be sufficient to address the country's challenges and its people's aspirations. Limited opportunities in the domestic labor market discourage investment in education and incentivize emigration by skilled workers. Without large-scale improvements in employment and income opportunities, most Macedonians will reach only a small share of their potential earnings. However, using public spending to accelerate economic growth and job creation may not be feasible with the current level of public revenues or without improving the spending quality; nor would it address the root causes of slow growth and low productivity. Continuing the same FDI-attraction strategy is also not practical, because in addition to its fiscal cost, additional investment incentives may make it harder for domestic firms to compete, particularly if there are few links between foreign and domestic firms. Instead, making factor allocation more efficient will be critical to generate robust growth; but enhancing allocative efficiency will require deep institutional reforms. Thus, a shift in policy will be necessary to pave a realistic path for development. And the policy shift must be based on a keen understanding of the factors that neutralized the FYR Macedonia early-mover advantage. These factors seem to have been strong enough to forestall a positive recognition of the potential for the private sector to drive development, a healthy attitude to public financing, and the early commitment to strong ties with the EU. This SCD looks closely at what has inhibited FYR Macedonia's development and describes measures necessary to sustainably raise productivity and accelerate long-term growth.

### 0.3 The Growth Challenge: Improving the Allocation of Physical and Human Capital to Sustainably Increase Productivity

xvii. **While FYR Macedonia has made considerable progress toward creating the conditions necessary for a dynamic private sector, many firms and workers are still unable to translate these conditions into economic opportunity.** The Macedonian economy has now been stable for two decades, and the country's business environment rates high in international rankings. The economy is open to trade, and the authorities have long had a positive attitude to FDI. However, these policies have not yielded a complete structural transformation. Moreover, reform momentum has slowed since 2009, and productivity growth has declined.

xviii. **FYR Macedonia has yet to fully leverage the advantages offered by its strategic position in the region and its openness to trade and FDI.** External markets have not spurred much growth in the domestic economy, and economic policies designed to attract FDI in export-oriented sectors have had mixed results. FDI in special economic zones (SEZs) has created a significant number of jobs in the auto-parts subsector, although at some fiscal cost, but the textile industry seems to have merely shifted existing jobs into the SEZs, with no net effect on employment (Figure O.9). While FDI in some industries, such as auto parts, has helped to boost the volume and sophistication of exports, links between FDI-supported

businesses and the local economy are limited (Figure O.10). Service exports—especially services used by manufacturing industries linked to global value chains, such as logistics, transportation, information and communication technologies (ICT), and tourism—have significant growth potential, but their share in total exports is only 25 percent. If the external sector is to drive structural transformation, it must be supported by measures to deepen integration in global and regional markets and to remove constraints on the reallocation of productive factors.

**Figure O.9: While motor vehicle firms in the Special Economic Zones (SEZs) created many new jobs, the number of textile and apparel jobs destroyed outside the SEZs equaled the number created inside the SEZs**

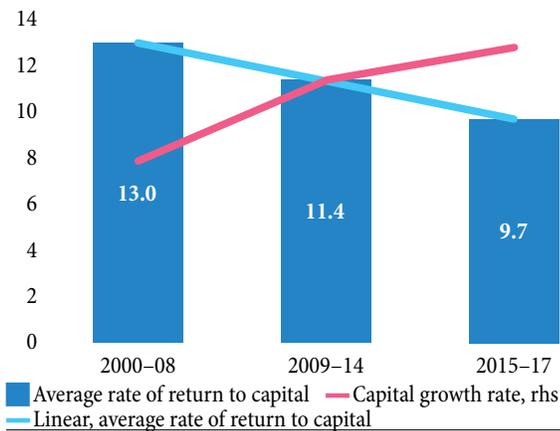
Net job creation by firms inside and outside SEZs, 2011–16, in thousands



Source: Authors' calculations: Background paper prepared for this report by Cusolito, Davies, Hernandez, and Pena (2018). Note: Only sectors with SEZ firms are included.

**Figure O.11: Returns on investment have declined**

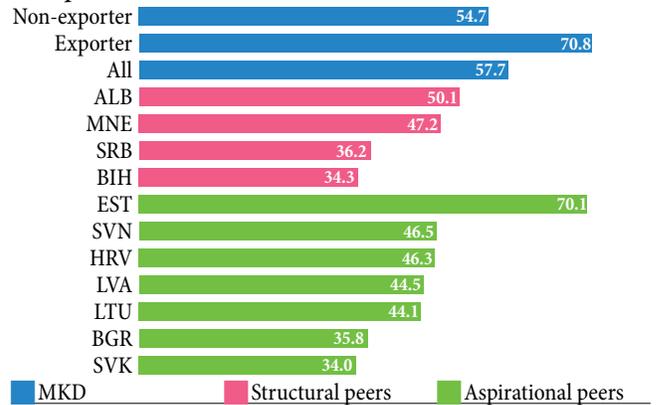
Growth rate and rate of return of investment, percent



Source: Authors' calculations based on data from national authorities and the United Nations (UN) Statistical Database.

**Figure O.10: Export-oriented firms do not rely on local suppliers**

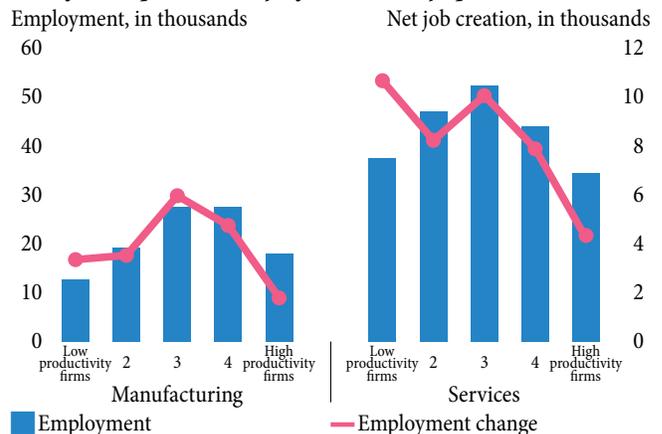
Proportion of total inputs of foreign origin used by firms in exports, 2013



Source: Authors' calculations based on World Bank Enterprise Surveys.

**Figure O.12: Employment and employment growth are relatively low in the most productive firms**

Employment and net job creation by within-industry total factor productivity of revenue, by quintile, 2013–16



Source: Authors' calculations: Background paper prepared for this report by Cusolito, Davies, Hernandez, and Pena (2018).

xix. **There is strong evidence that in FYR Macedonia factor allocation is inefficient:** (1) Relatively high investment and relatively little economic growth suggest that capital is not being directed to areas with the highest returns. Indeed, the rate of return on investment in FYR Macedonia has been sinking since 2001 (Figure O.11). (2) Firm-level analysis shows that resources, both across and within sectors, are not moving from less-productive to more-productive firms. Allocative efficiency within sectors (reflecting technological uptake) is low compared to comparable countries. Moreover, the least-productive firms generate a disproportionate share of employment (Figure O.12). (3) The movement of labor from agriculture to more-productive sectors has been slow, and in general the sectoral allocation of labor has changed little over the last decade. Misallocation of labor compounds the employment and welfare challenges caused by too few labor-force participants, high rates emigration, and an aging population.

xx. **Resource misallocation is exacerbated by the fact that Macedonian firms have limited capabilities and are reluctant to adopt technology.** The domestic economy is composed by a large share of small firms that are slow to innovate. As in other formerly planned economies, the private sector suffers from a high degree of market concentration because the privatization process privileged political insiders. Consequently, resource misallocation has not pressured firms to upgrade their administrative methods or adopt new technologies. The large disparities in productivity between the most- and least-productive firms illustrate the wide gaps in firm capabilities—firms in the 90th percentile of productivity are 7.6 times more productive than firms in the 10th percentile. These problems are compounded by a shortage of workforce, especially managerial, skills. Self-employment and informality are common, and incentives for formalization are weak.

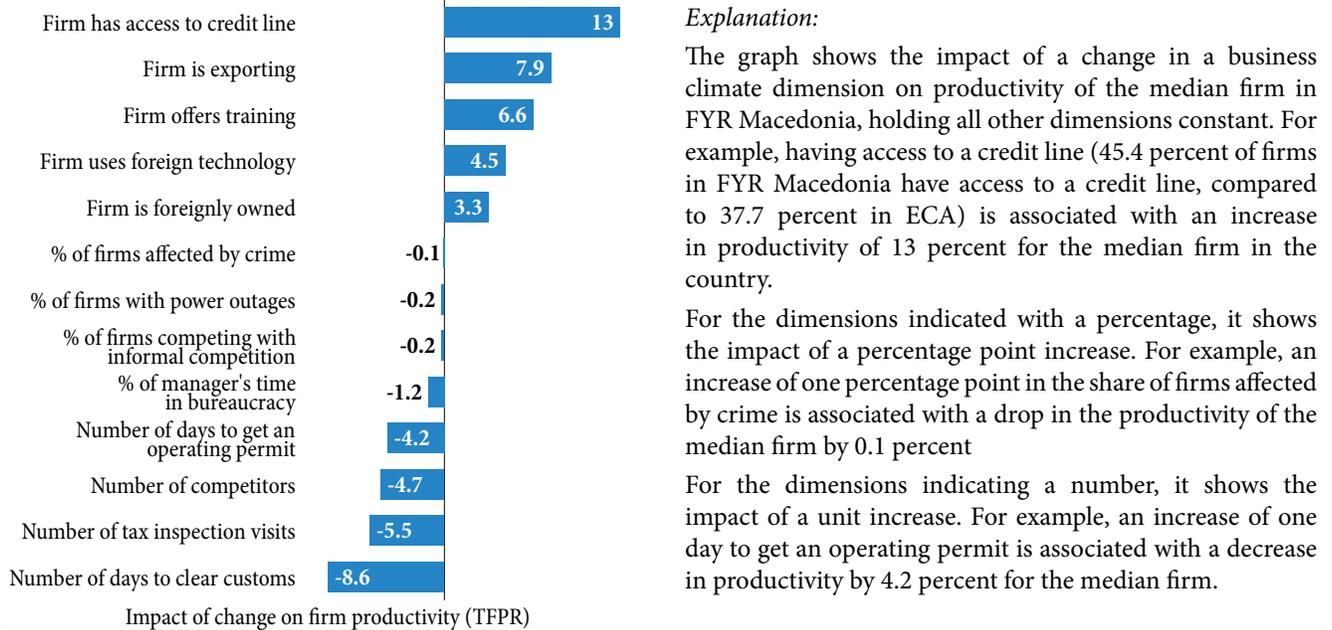
xxi. **Economic policies contribute to the stagnant growth and low productivity of agriculture.** FYR Macedonia's public support to agriculture, as a share of GDP, is well above that of regional neighbors and far above the EU28 average. Agricultural support policies are distortive and contribute to inefficiency, especially among subsidized farms and for heavily-supported products like tobacco and livestock. Subsidies both inhibit agricultural productivity and slow structural transformation by encouraging too many workers to remain in low-productivity agriculture rather than shifting to more productive jobs in agri-business, manufacturing, or services. The legal framework for investment and the institutional framework for agricultural exports create disincentives that reduce productivity, undermining the sector's potential to boost incomes and diversify exports.

xxii. **Reforms are urgently needed to facilitate the movement of resources to the most productive opportunities and to complete FYR Macedonia's structural transformation.** While the country's success in attracting export-oriented FDI has enabled it to integrate into some global value chains, it has not been able to effectively leverage its strategic location. Macedonian firms are unable to take advantage of an otherwise strong business climate, discouraging the development of sophisticated value chains that add more local content, slowing the emergence of new industries, and keeping jobs heavily concentrated in low-productivity sectors with slow productivity growth. Accelerating structural transformation and promoting technological adoption and innovation will become increasingly crucial as FYR Macedonia takes action to escape the middle-income trap and achieve high-income status. This SCD seeks to identify the obstacles inhibiting the dynamism and competitiveness of the Macedonian private sector and define a strategy for overcoming them. Key issues are shortages of workforce skills, weaknesses in trade and transport connectivity and value-chain integration, and deficiencies in competition and

investment policy, business regulation, firm capabilities, access to finance, and digital connectivity. Indeed, quantitative analysis of the impact of aspects of the business climate makes it clear that these can drag firm's productivity, highlighting the importance of supportive policy (Figure O.13). This SCD also identifies challenges specific to selected industries, among them agriculture and agribusiness, auto parts, textiles, tourism, and information and communication technologies.

**Figure O.13: While some aspects of the business climate contribute to a firm's productivity in FYR Macedonia, trade costs, business regulations, and others inhibit it**

*Impact of business climate dimensions on firm productivity, regression coefficients with TFPR as dependent variable*



*Source:* Author's calculations based on data from World Bank Enterprise Surveys, following Cusolito, Correa, and Pena (2018).

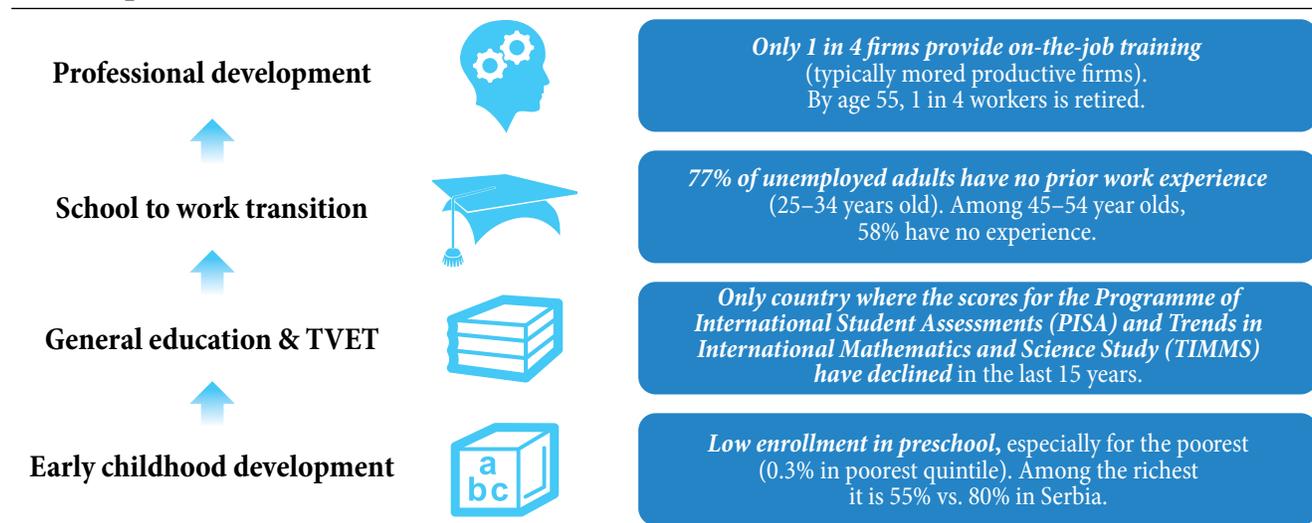
*Note:* Total factor productivity of revenue (TFPR) is measured by deflated sales. The estimated impact on productivity follows the methodology of De Loecker (2013), with TFPR as the dependent variable, and capital and labor as inputs. Since the TFPR measures profitability, it combines both demand- and supply-side factors. Thus, the exercise shows the "marginal and joint effects," which combine the impact of prices and efficiency. It does not assess the performance of the country relative to comparators, but it can identify variables that have the largest impact on productivity in FYR Macedonia. See Chapter 3 for details.

## 0.4 The Inclusion Challenge: Providing More and Better Income-Generating Opportunities for All Macedonians

xxiii. **If FYR Macedonia is to assume its seat at the EU table, it must make reforms that enable all of its citizens to assume their seats at the table of economic opportunity.** The basic challenge is to create a sturdy middle-class society that is resilient to shocks. This will require both high-quality jobs and more opportunities for all citizens to receive a fair return from income-generating assets like skills, land, and capital. Barriers and disincentives to employment and low labor force participation are preventing Macedonian households from accumulating such assets. Moreover, the likelihood of households accumulating assets and benefitting from economic opportunities varies greatly by gender, age, and ethnicity, which deepens economic disparities.

xxiv. **Opportunities for Macedonians to build human capital are limited and may even be deteriorating, which reduces the capacity of workers to meet the evolving demands of a modern economy and contribute to greater productivity.** In FYR Macedonia, gaps in human capital start early and expand over time (Figure O.14). Preschool enrollment is very low, the scores of Macedonian students on international tests are worsening, the majority of the unemployed lack work experience, and firms offer few opportunities for professional development. Neonatal, infant and under-5 mortality rates suggest poor health and nutrition outcomes, which affect individuals' ability to learn, as well as their productivity throughout the lifecycle. Small countries that have sustained robust growth and successfully escaped the middle-income trap, among them some “East Asian tigers,” have all invested aggressively in education. On the 2015 PISA (Programme for International Student Assessment) standardized tests, Singapore, Taiwan, Hong Kong, and Macau all ranked among the top 10 countries in both reading and mathematics. FYR Macedonia ranked among the bottom 5, far behind comparable countries like Albania, Montenegro, Moldova, and Georgia (Figure O.15). With the workforce shrinking and labor productivity low, FYR Macedonia's future growth will increasingly rely on formation of human capital.

**Figure O.14: In FYR Macedonia, deficiencies in human capital development begin in childhood and compound over time**

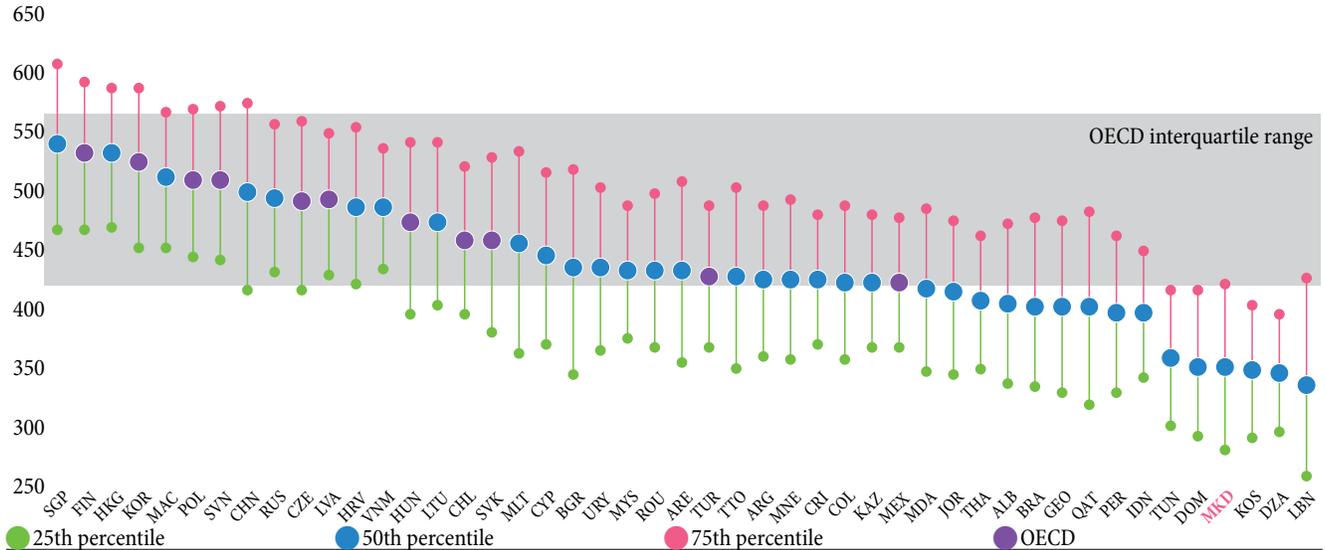


Source: Authors based on various sources.

xxv. **Barriers and disincentives to employment and labor force participation make it harder for labor to contribute to growth.** Beyond the skills shortages, barriers originate in insufficient support services for workers, such as child and elder care. Moreover, labor laws are not flexible enough to facilitate access to work for women, the young, and the elderly. The tax burden on low wages discourages work. For those who benefit from social assistance and pensions, the potential loss of benefits encourages inactivity. Thus, two forces operating in tandem generate lackluster performance despite the efforts of various governments to address the jobs challenge. On the one hand, job creation has been positive, but concentrated in low-productivity, low-wage, and non-tradable activities, and it may not be sustainable because it was partly driven by fiscal stimulus in infrastructure projects, subsidies, and active labor market policies. On the other hand, rigidities in labor market and social protection institutions discourage participation in the labor market, especially for those in the lower half of the income distribution.

**Figure O.15: Macedonian students perform poorly on standardized tests**

*PISA test scores in OECD countries, reading, 2015*



Source: Authors' calculations based on PISA 2015.

Note: Results for mathematics abilities also show FYR Macedonia at the lower end.

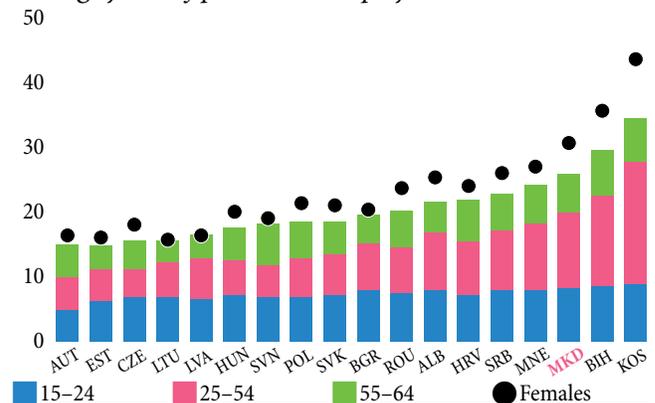
xxvi. **Structural labor market deficiencies result in a considerable waste of working years.** Based on 2016 labor market indicators, it is estimated that FYR Macedonia's low employment rates result in about eight years of employment lost for workers aged 15–24, about 12 years lost for those 25–54, and close to 6 years lost for those 55–64. For the average Macedonian male worker this totals about 25 years lost because of high unemployment and inactivity. For women, the loss is 30 years (Figure O.16).

xxvii. **Inequality in access to economic opportunities equates to less social inclusion** (Figure O.17). Building a stable, robust middle-class society requires enhancing the agency of individuals by expanding access to opportunity. For example, eliminating gender disparities in the labor market could increase FYR Macedonia's annual GDP by an estimated 16 percent. Because

individuals who are economically marginalized and unable to participate fully in growth have difficulty diversifying their assets, they stay vulnerable to shocks. Consequently, efforts to enhance inclusion are critical to both growth and poverty reduction. In FYR Macedonia, many people are still poor and excluded from job opportunities, among whom ethnic minorities are over-represented. Notably, ethnic Albanians account for close to 45 percent of all households in the bottom income quintile, but just 15 percent of those in the top. Roma people in settlements average considerably lower rates

**Figure O.16: Macedonians lose on average about 25 years of employment because of poor labor market outcomes**

*Average years of productive employment lost, 2016*



Source: Authors' calculations based on data from the South East Europe (SEE) Jobs Gateway (wiiw and World Bank) and Eurostat.

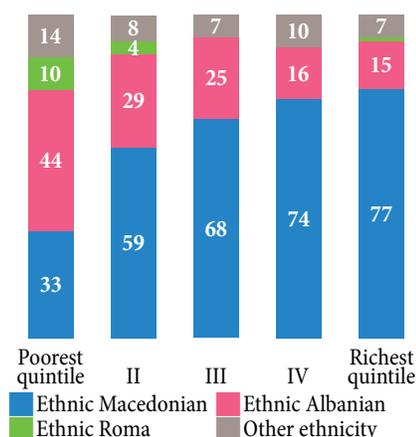
Notes: The average years of employment potentially lost is equal to the share of total working years for the age group, multiplied by one minus the employment rate for the same age group in 2016. Methodology based on Arias et al. (2014).

of completing formal education than their non-Roma neighbors. Vulnerable groups are also at risk of worsening health, measured by such basic indicators as child mortality. The social protection system, especially social assistance, do not contribute enough to social inclusion, in part because the focus has shifted to supporting families with children rather than reaching the poor and vulnerable directly. Promoting inclusion is not only an end in itself, it is also vital to resolve challenges to productivity, because inequitable allocation of employment and entrepreneurship opportunities based on gender, ethnicity, or other personal attribute contributes to the underutilization of labor and capital.

**Figure O.17: Selected examples of inequality in income and opportunities in FYR Macedonia**

**A. Ethnic minorities are more likely to be poor**

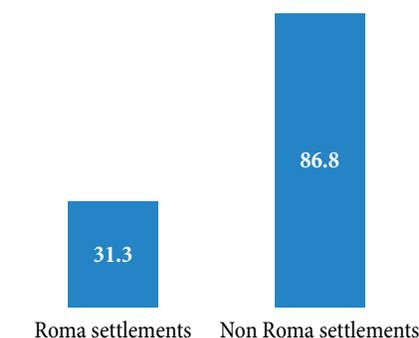
*Population distribution by ethnicity, income quintiles*



Source: Authors' calculations based on 2017 Quality of Life Survey. Self-reported ethnicity.

**B. Roma youth in settlements have less opportunities to build human capital**

*Upper-secondary education completion rate, 16–24 years old, 2017*



Source: UNDP-WB-European Commission regional Roma survey 2017.

**C. Gender gaps in the labor market generate sizeable economic costs**

*GDP loss in FYR Macedonia due to gender gaps in labor force participation, self-employment, and entrepreneurship*



**16%** of GDP lost per year

Source: Cuberes and Teignier (2016).

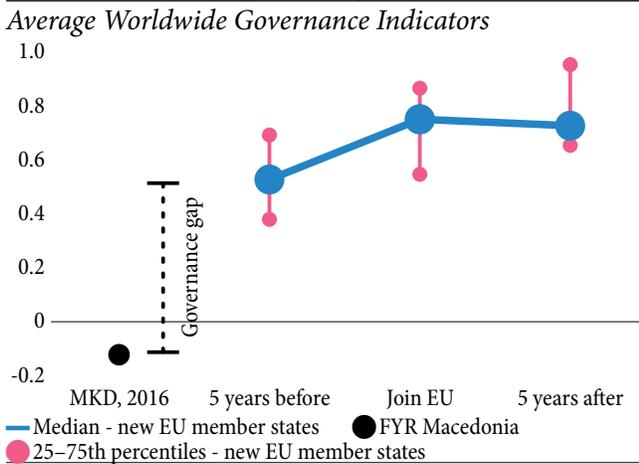
## 0.5 The Sustainability Challenge: Establishing a Solid Institutional Foundation for Long-Term Growth

xxviii. **Incomplete or uneven institutional reforms have created expectations and hope but not delivered the necessary outcomes.** FYR Macedonia has a pattern of launching daring reforms but not always following through to generate sustainable gains. Reforms are often halted midway and reforms have not always been even across all institutional dimensions. There is, for instance, solid evidence that the erosion of state institutions during the 2015–17 political crisis undermined confidence in the economy and led to a slowdown in growth and job creation. The pattern of incomplete reforms is having an impact on three areas of critical importance to FYR Macedonia's future: the creation of EU-compatible institutions, the health of the fiscal account, and the quality of the environment.

xxix. **Although the country moved early to build up solid market-oriented institutions, some still trail those in peer economies in meeting EU standards.** Macro reforms, trade openness, and a rapprochement to the EU took place between the 1990s and the early 2000s. Investment climate reforms

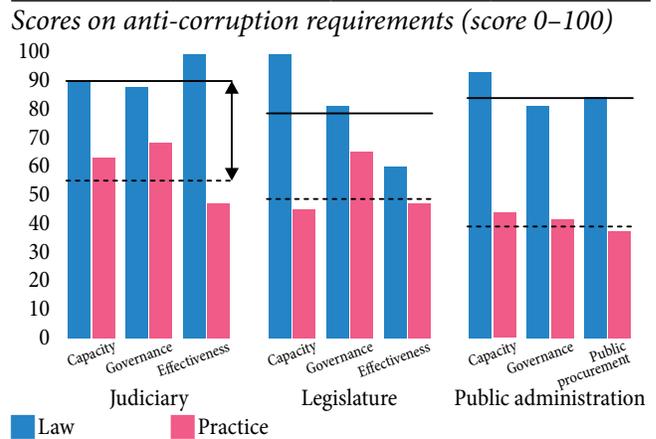
propelled FYR Macedonia up in the *Doing Business* rankings, and the FDI promotion strategy succeeded in increasing exports. However, political stability, accountability, the rule of law, and corruption did not follow. As illustrated in Figure O.18, taking the average of the six areas of the Worldwide Governance Indicators (WGI) with scores ranging from -2.5 (weak governance) to 2.5 (strong), in 2016 FYR Macedonia had an average of -0.7. The median score for aspirational peers five years before each gained EU accession was +0.5, and their median score in 2016 was about +0.7.<sup>4</sup> According to the WEF 2016 Executive Opinion Survey, policy instability and the inefficiency of the bureaucracy are among the top five obstacles to doing business in FYR Macedonia. A gap between law and practice undermines state effectiveness and social trust; for example, in Transparency International’s index of the quality of anti-corruption measures, the Macedonian judiciary scored 93 percent out of 100 for its legal basis but only 60 percent for actual implementation (Figure O.19). Similar large implementation gaps are seen in the legislature and public administration. Moreover, for the last decade, progressive deterioration of the system of checks and balances in the country eroded the trust between people and state. It will therefore be crucial to rebuild and consolidate social trust to ensure that the government has civic people to undertake the reforms necessary to move the country to a path of faster sustained growth and economic integration with the EU and the rest of the world.

**Figure O.18: FYR Macedonia’s governance is far below that of aspirational peers before they joined the EU**



Source: Authors’ calculations based on WGI data and World Bank (2017c) *Revving Up the Engines of Growth and Prosperity in the Western Balkans*.  
 Note: Average WGI is average of the 6 WGI components. Estimates range from -2.5 (weak) to 2.5 (strong) governance performance.

**Figure O.19: A gap between law and practice undermines state effectiveness and social trust**



Source: Data from Transparency International (2011).  
 Note: Solid line shows the average for the law aspects of capacity, governance, and efficiency in public procurement. Dotted line is the average of the practice components.

xxx. **Though fiscal stimulus measures can spur growth, it cannot sustain and accelerate it.** The government has little fiscal space to stimulate the economy, and there are risks to fiscal sustainability in doing so that need to be resolved. Thanks to expansive fiscal policy in recent years, the economy grew, generated employment, and reduced poverty. Fiscal policy worked because the previous commitment to a stable macroeconomic environment had created room for countercyclical policy, but that room has

<sup>4</sup> In two of the six indicators reported by WGI—regulatory quality and government effectiveness—FYR Macedonia ranks above the world median and higher than most of its structural peers. However, in the other four areas—political stability, voice and accountability, rule of law, and control of corruption—its rankings are far worse.

already been used up: the public debt-to-GDP ratio rose from 23 percent of GDP in 2008 to 47.6 percent in 2017. Without increasing public revenues or improving the quality of the spending, fiscal space will not be available to sustain, much less accelerate, economic growth. Moreover, when fiscal measures were expansionary, limited attention was placed on related factors that heighten fiscal risks; for example, the current pension deficit is over 4 percent of GDP, and as the population ages spending on pensions is expected to keep rising. Also, the efficiency of public spending on areas like education, health, infrastructure, and agricultural subsidies received only superficial attention. A comparison of actual spending with the minimums necessary to achieve the same output levels suggests that efficiency reforms could save more than 13 percent of total public spending. Meanwhile, education and health outcomes are deteriorating. And there is ample scope for raising revenues by improving tax collection, which is characterized by broad tax exemptions, compliance challenges, and informality. Paradoxically, the relative success of using fiscal stimulus to promote economic growth, generate low-skilled employment, and reduce poverty have diverted attention from needed fiscal consolidation and public administration reform.

**xxxii. Limited public resources and a policy deficit have prevented forceful action to forestall growing environmental threats like air pollution and natural hazards that are amplified by climate change.**

Air pollution in FYR Macedonia is now among the worst in Europe, and the health risks are severe, with an estimated annual cost equal to 3.2 percent of GDP. The main culprits, responsible for more than 90 percent of emissions, are road traffic, industry and energy production, and residential heating; among other sources are agriculture, waste burning, and construction dust. Air pollution is concentrated, with over 45 percent affecting Skopje, the largest city, and several local production zones. Despite introduction of measures like pollution inventories and air quality monitoring systems have, there is need to enforce environmental regulations more vigorously. FYR Macedonia is also highly exposed to natural hazards like floods, earthquakes, forest fires, droughts, landslides, and extreme temperatures. The annual damage to critical infrastructure from climate-related hazards is expected to double by 2020, and by 2080 it could be more than five times higher. A major flood or earthquake disaster could derail economic growth, affect critical infrastructure, cause losses in agricultural incomes, and disrupt rural livelihoods. For example, a 250-year earthquake would affect more than 40 percent of the Macedonian population and cost 50 percent of GDP. That is why reinforcing emergency preparedness and other aspects of resilience is ever more urgent.

## 0.6 Toward Faster, More Inclusive, and Sustainable Growth: Three Mutually Reinforcing Pathways

**xxxiii. To converge with EU incomes and build a strong middle-class society, FYR Macedonia needs to shift gears to promote faster, more inclusive, and sustainable growth** (Figure O.20). Achieving productivity growth will require the country to invest more in human and physical capital and create an environment that enables private-sector growth. Heightened allocative efficiency will be necessary to fully exploit the country's current productive capacity. External markets can provide room for the Macedonian economy to expand and facilitate the reallocation of resources but taking advantage of external opportunities will depend on better domestic and regional connectivity. To become more competitive and dynamic the country will require new technologies and a more highly skilled labor

force. The vision is a better-connected, vibrant domestic economy engaged in the region and beyond as it secures its footing in areas of strong comparative advantage.

xxxiii. **To generate quality income and employment opportunities, productivity growth must be broad based and crowd in the large stock of unutilized human resources.** But the skills deficiencies of the labor force, and especially the recent deterioration in skills could dampen efforts to raise productivity and expand economic activity. That is why it is urgent to facilitate acquisition of skills and refurbish the education system from early education through provision of lifelong opportunities. Unlocking the potential of the local workforce will also require removal of distortions and dismantling of barriers that discourage people—especially women and minorities—from participating in the labor force. Also needing to be addressed to secure are socioeconomic gaps that affect ethnic minorities, women, and inhabitants of certain regions. Only if citizens can fully exploit their productive potential and increase their labor incomes will FYR Macedonia be able to eradicate poverty and expand the middle class.

**Figure O.20: The key elements for faster, more inclusive, sustainable growth in FYR Macedonia**



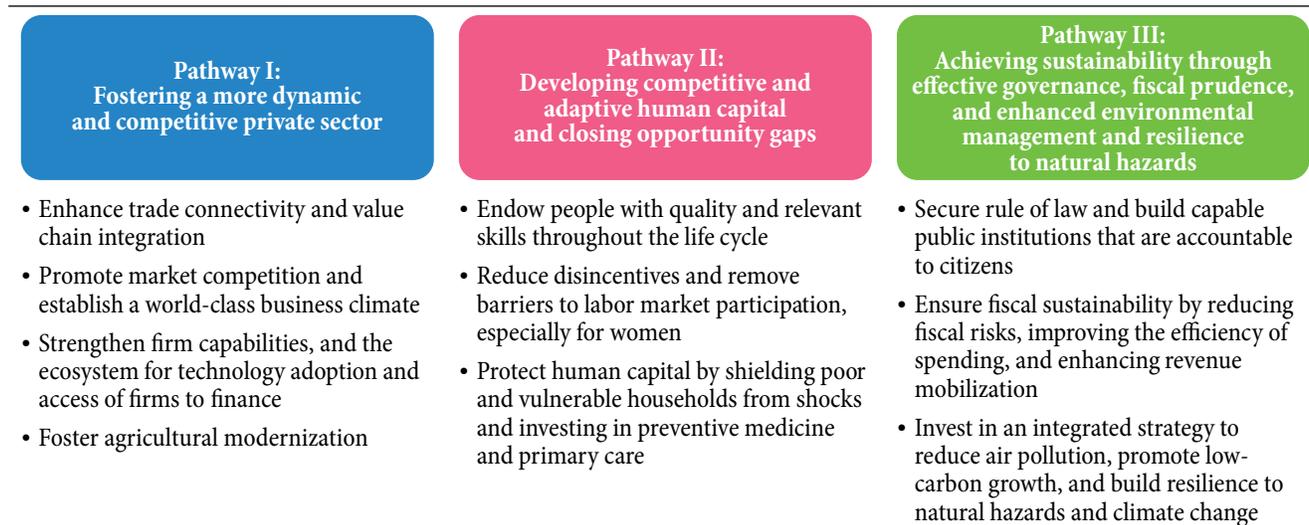
Source: Authors.

xxxiv. **Sustaining initiatives over the long term depends on the country building resilience in a variety of ways.** State institutions must be responsive to the needs of both businesses and citizens so that they coordinate design of policies and—this is critical—ensure the rule of law. Fiscal sustainability is vital to support productivity growth, protect the economy against shocks, and improve delivery of public services. Better environmental management and building resilience against disaster and climate risks would not only help sustain economic growth but also protect the most vulnerable.

xxxv. **FYR Macedonia could achieve more robust, inclusive, and sustainable development by advancing along three complementary pathways.** The first focuses on encouraging emergence of a dynamic and competitive private sector to drive the reallocation of resources and foster technological uptake and innovation. The second focuses on expanding access to economic opportunity by investing in human capital and removing barriers and disincentives that block working-age Macedonians from the labor market. Central to this route is creating a more efficient and more accurately targeted safety net that shields households from economic shocks. The third pathway focuses on reinforcing government

credibility; building the political will to carry through the required economic reforms; enhancing the quality of public institutions and the rule of law; keeping fiscal policy sound so that government can deliver public services efficiently and effectively; and improving environmental management and incentives to promote the emergence of a low-carbon economy. Within these three pathways, the SCD identifies 10 areas for reform (Figure O.21).

**Figure O.21: Pathways to faster, more inclusive, and sustainable growth in FYR Macedonia**



Source: Authors.

## 0.7 Pathway I: Fostering a More Dynamic and Competitive Private Sector

xxxvi. **Attaining the Macedonian vision of an expanding economy driven by private sector dynamism and creating good jobs for its citizens starts with prompt action.** Building on past success, the country must continue attracting FDI and ensuring that new FDI nurtures exports with more local content. Since exporting is an engine of growth for a small economy, it must also facilitate trade and transport. In the domestic market, policy action is needed to foster competition, ensure an effective use of state-aid, and reduce implementation gaps and weaknesses in business regulations so as to improve resource allocation and attract and retain investment. Local firms will need help to build up their capabilities for innovation and adoption of technology. Finally, agriculture, a lagging sector but a major employer, has considerable potential for productivity growth and exports once current subsidy mismatches and an underdeveloped land market are corrected. The result of concerted action in all these areas should be a vibrant private sector that can support the high growth rates and job creation that are necessary steps to high-income status and convergence with EU incomes.

### 0.7.1 Enhance Trade Connectivity and Value Chain Integration

xxxvii. **Policies to attract FDI need to target export-oriented activities with high potential for linking with domestic firms and in parallel raise standards for trade and transport facilitation.** A considerable proportion of exports is currently produced by foreign investors who arrived in the last 10 years—in response to the government strategy of using incentive packages to attract FDI. From now

on, however, FYR Macedonia needs to attract export-oriented FDI that connects better with both the domestic economy and global value chains (GVCs). The growing trend of regionalizing production for GVCs offers an opportunity for FYR Macedonia that complements EU integration: the Western Balkans region abounds in untapped opportunities for production integration, in such sectors as agribusiness, ICT, textiles, and tourism. To profit from these opportunities the country must reduce the costs arising from delays in customs clearance. FYR Macedonia needs to streamline procedures, upgrade customs systems, and coordinate the activities of its own agencies with an interest in exports and with the main destination countries. To take full advantage of the opportunities for services exports opened up by surging technologies, greater labor mobility within the Western Balkans (promoted, for example, by mutual recognition of professional qualifications) would allow the countries to build critical masses as markets. Last, closing the remaining gaps in the main transport corridors will give FYR Macedonia better connections to external markets and establish it as a regional trade and transport hub and rebalancing public spending to invest in maintenance of transport infrastructure and road safety will protect human and physical capital.

### *0.7.2 Promote Market Competition and Establish a World-Class Business Climate*

xxxviii. **Policies to spur healthy competition in domestic markets and actions to enhance the business climate are central to generating much-needed dynamism in the private sector.** In a true competitive environment, the most-productive firms will generate employment by using economic resources efficiently. On paper the Macedonian competition regulations and institutions follow the EU model; in practice, there are gaps. Entry barriers in network industries like electricity and telecommunications and undue restrictions on professionals like attorneys, accountants, and engineers feed concerns about whether private businesses can successfully compete with state-owned enterprises (SOEs). As for business-climate reforms, the country has considerably improved its standings in international indicators, but among areas still needing attention are starting a new enterprise (getting electricity, registering property); the legal framework for firms (resolving insolvency, enforcing contracts); the pattern of continuous and unpredictable changes in regulation; and uneven and discretionary oversight and enforcement.

### *0.7.3 Strengthen Firm Capabilities and the Ecosystem for Technology Adoption and Access of Firms to Finance*

xxxix. **Domestic firms, especially small and medium-sized enterprises (SMEs) and start-ups, need support if they are to adopt new technologies, innovate, and have sufficient access to finance to be able to respond to competitive pressures.** Today they find it difficult to access technology, finance, and management skills. Current Macedonian public programs subsidize inputs rather than enhancing firm capabilities. Management and technology extension programs should be emphasized; they have proved successful in building firm capabilities in high-income countries and helping entrepreneurs acquire the soft skills increasingly recognized as critical to firm success and adopt international quality standards. They would help firms attract funding and run their businesses efficiently. With regard to access to finance, current programs can be streamlined based on assessment of the market gap. Helping firms to acquire the capabilities to become more competitive and technologically adept will help them to thrive in a world of shifting production patterns and changing sources of foreign investment. Because there

has been little study of firm capabilities in FYR Macedonia, it would be important to embed impact evaluations to ensure that public resources achieve the desired outcomes.

#### 0.7.4 Foster Agricultural Modernization

xl. **A more dynamic agricultural sector will be critical for broad-based growth and enhanced job opportunities, particularly for those at the bottom of the income distribution.** Along with support to an outward-looking private sector, it will be critical to provide the conditions for agriculture to grow and create better employment, which would directly benefit less-skilled workers in rural areas. An urgent priority is to revise state aid to agriculture, which is a misallocation of resources and also prevents changes in techniques and gains in productivity. More efficient use of land will depend on a more effective land market, which in turn will depend on reforming the system for taxing land and applying current land laws to better effect. With incentives improved, the intensity of physical capital and research and development (R&D) in agriculture and agribusiness should be heightened to spur growth and productivity. Policy must thus change to realize the potential of agriculture to export, generate employment, and contribute to growth, especially in agroindustry and tourism.

### 0.8 Pathway II: Developing Competitive and Adaptive Human Capital and Closing Opportunity Gaps

xli. **If it is to realize its aspirations of a middle-class society, it is urgent that FYR Macedonia move quickly to spur accumulation, and heighten the quality of, human capital, and close gaps in access to economic opportunities.** As the global economy becomes ever more sophisticated, education and workforce skills will become even more essential, and only investing in human capital can enable Macedonian workers to become and stay competitive. A skilled labor force that can readily adapt as circumstances change is crucial to sustain employment and limit inequality. The country needs to take immediate action to improve both the quantity of its human capital (measured by school enrollment, school completion, and child mortality rates—all currently worse than those of peer countries) and its quality of human capital (measured by the results of international standardized tests, on which its students are currently doing badly). Beyond skills, it is also important to reduce disincentives and dismantle barriers that keep any group away from jobs. Finally, human capital needs to be protected by reducing health risks and shielding the poor and vulnerable from shocks. Raising human capital and closing opportunity gaps will support growth, and higher economic growth will in turn make further human development affordable.

#### 0.8.1 Endow People with Quality and Relevant Skills Throughout the Life Cycle

xlii. **Macedonian workers need relevant skills that they can readily adapt to a rapidly changing labor market.** Improving the quality of education will depend on improving the quality of teaching; teachers must therefore be trained in modern teaching methods and quality assurance mechanisms to assure both the quality and relevance of what is taught. First, investments in early childhood development and preschool programs are needed to ensure readiness for school, which is vital to the success of later interventions. That means expanding the supply of school spaces for 3–5-year-olds, especially those in rural areas and from poorer households. Primary, secondary, and tertiary education can then be re-

engineered to shift from delivering content to building critical thinking skills, which can be promoted by using good metrics to monitor learning outcomes and assure quality. Better teacher quality also requires practical experience and a system for teacher career advancement that will reward exceptional performance. At the tertiary level, internal and external quality assurance could ensure the job-readiness of graduates. Revised funding formulas at each level would create more incentives to deliver quality. Finally, adopting a proactive strategy to facilitate a seamless school-to-work transition for students would encourage their acquisition of job-relevant skills. Tertiary programs need to adopt modern pedagogical practices and job-relevant content, shift from narrow occupational to more general technical education, engage more closely with employers, and provide information to help students choose courses with higher market value. Building skills throughout the life cycle would ensure that Macedonians take full advantage of their productive potential.

### ***0.8.2 Reduce Disincentives and Remove Barriers to Labor Market Participation, Especially for Women***

xliii. **Expanding labor market participation to reduce current losses to national income will require a variety of interventions.** Facilitating support to women by, e.g., expanding access to quality child and elder care would give more women in their most productive years the opportunity to work. Revising family leave policies would help to promote the participation of fathers in the care of newborns. To counter traditional social norms and other barriers that still prevent women from pursuing economic activity, awareness campaigns and gender-sensitive public education can have a major impact on gender equality and female activation. Creating more role models and champions can both change young women's expectations about what they can achieve and increase the tolerance of men for women's empowerment outside the home. But it is also vital to support communication campaigns with actual laws to encourage gender parity. For instance, incorporating gender-focused provisions in collective agreements through the Socio-Economic Council, enforcing nondiscrimination laws, and adopting mechanisms to monitor gender equality can foster a more open mindset about the role of women in a productive society. Reducing the tax wedge for below-average salaries and changing social benefit rules so that beneficiaries who work are not penalized would reduce one disincentive to work. Better designed tax brackets for low-income workers can heighten incentives to search for employment and to work more hours. Similarly, reforming the rules of eligibility for social assistance to gradually withdraw benefits when people have paid employment and instead provide complementary benefits to ensure a minimum income, would also make working more attractive. Last, reducing restrictions on part-time, temporary, and seasonal work would allow more employers to test the quality of workers and allow workers to acquire much-needed experience, keeping in mind the need to carefully balance fairness and flexibility.

### ***0.8.3 Protect Human Capital by Shielding Poor and Vulnerable Households From Shocks and Investing in Preventive Medicine and Primary Care***

xliv. **Targeted social assistance, expanded social services, better access to health care, and promotion of healthier lifestyles could together help shield poor and vulnerable households from shocks.** In a tight fiscal environment, social assistance needs to be redirected from categorical to means-tested programs so that more of the poor are protected from shocks that would further reduce their living standards. Current social assistance policies, which give priority to untargeted child-related benefits rather than targeting cash benefits to poor families, need to be reversed and funding expanded for the

Social Financial Assistance program, which primarily supports poor families. To promote access to job opportunities, it is important to provide other services that can increase employability and reduce barriers for poor households; special attention to ethnic minorities would help to reduce their systematic exclusion from economic opportunity. Also, FYR Macedonia's institutional and non-institutional care, which is currently scarce, needs to be expanded beyond children and persons with disabilities to serve other needy adults and the elderly, which would allow family members with care responsibilities to participate more actively in the labor force; in a context of fiscal consolidation these investments would need to be financed from efficiency gains in public financial management and a rebalancing of public spending. There is also an urgent need to build up primary health care to improve health outcomes, especially for infants and children under 5, by, for example, a thorough health care facility analysis to guide the rebalancing of primary care and specialist services, improved pharmaceutical coverage, and aligning medicine pricing with international best practice. Investments in improving or expanding existing physical infrastructure could also be considered. Last, working through an integral strategy for healthier lifestyles (e.g., discouraging smoking and obesity) can reduce the high incidence of noncommunicable disease, especially diabetes and lung cancer, and increase the productive life span of many Macedonians.

## 0.9 Pathway III: Achieving Sustainability through Effective Governance, Fiscal Prudence, Enhanced Environmental Management, and Resilience to Natural Hazards

xliv. **FYR Macedonia needs to move promptly to make sure its efforts to realize its visions for growth and inclusion are sustainable.** These actions should be oriented to three critical areas where structural or emerging problems pose risks to inclusive growth. The first area relates to the need to secure the rule of law and government accountability; the second to emerging risks to fiscal sustainability; and the third relates to environmental issues and the need to address low-carbon growth and raise resilience to natural hazards and climate change.

### 0.9.1 Secure Rule of Law and Build Capable Public Institutions That Are Accountable to Citizens

xlvi. **Government capacity and accountability, which are central to the rule of law, should be built up through a series of policy actions.** While FYR Macedonia has made considerable progress in elaborating the legal framework to support a market economy, there has been much less progress on government capacity and accountability; the country trails peers in such categories as political stability, voice and accountability, rule of law, and control of corruption. A commitment to policy stability and efforts to improve bureaucratic efficiency would enhance both the business environment and government accountability. Legal, policy, and political support for the media as agents for accountability and for more investigative journalism could over time help reduce politicization and corruption in government institutions.

### 0.9.2 Ensure Fiscal Sustainability by Reducing Fiscal Risks, Improving the Efficiency of Spending, and Enhancing Revenue Mobilization

xlvii. **Reducing risks to fiscal sustainability requires reining in pension spending, better controlling SOE debt, more discipline in local government financial management, addressing the efficiency of**

**public spending, and raising tax collection.** Pension spending, the largest source of fiscal risk, needs to be contained by increasing pension contribution rate and limiting indexation to the consumer price index in the short term, and raising retirement ages, over the medium term. SOEs, whose indebtedness has been worsening, require closer monitoring and financial oversight, with special attention to cost recovery. Local governments need more fiscal discipline and greater accountability, especially as related to budget arrears and municipal borrowing, and the capacity to deliver public services efficiently and effectively. Further, they need to have more stable revenue base, through strengthened property taxation. Centrally, more efficient public spending, especially on education, health, infrastructure, and agricultural subsidies, at a time of fiscal consolidation could yield significant savings. Lastly, to address structural weaknesses in FYR Macedonia's public finances, more tax revenue can be collected, for example, by reviewing and eliminating tax exemptions within a defined transition period. A review of tax rates would also clarify which rates could be raised—perhaps those on 'sin taxes' on items that have adverse health or environmental impact, since that might generate some public support, as well as a consideration could be given to increase the progressivity of the personal income taxation. Finally, tax administration desperately needs to be modernized and voluntary taxpayer compliance promoted, which should also help to shrink the informal economy.

### **0.9.3 Invest in an Integrated Strategy to Reduce Air Pollution, Promote Low-Carbon Growth, and Build Resilience to Natural Hazards and Climate Change**

xlvi. **Natural resources need to be managed so as to maintain living standards, avoid detrimental impacts to health, move to a low-carbon path without undermining energy supply, and build more resilience to natural hazards and climate change.** To avoid worsening water scarcity, inefficient water management must be corrected, which will require rehabilitation of aging infrastructure. To counter the dire threat to public health created by air pollution there is need for firmer enforcement of environmental regulations (based on EU air quality directives) and for investment in updated technologies to ensure compliance with regulations. To manage carbon emissions, the energy sector needs to withdraw from dependence on coal, improve the security and efficiency of energy supply, and scale up energy efficiency by turning to renewable sources (small hydropower, biogas, solar, and wind), and integrating them into the regional energy market. Crafting national programs and policies to reduce climate and disaster impacts in priority sectors is the first step to reducing risks to infrastructure; it should be accompanied by improvements in the emergency response system.

## **0.10 Seizing Emerging Opportunities Now to Shift Gears and Advance Key Objectives**

xlvi. **The current context offers FYR Macedonia a real opportunity to resume convergence with the EU.** Two opportunities stand out. The first arises from the political understandings that have coalesced in the last year and that have transcended the political crisis (2015–17) that generated uncertainty and stalled reforms. Its resolution should allow for renewed progress on reforms agenda. The recent political stabilization has also facilitated a tentative agreement with Greece on the country's name (which needs to be confirmed), thereby energizing the EU and NATO accession agenda.

i. **EU accession can be a powerful device to advance and sustain reform efforts.** International experience illustrates clearly how the accession process can catalyze welfare convergence. The most

successful countries have fully accepted the EU's *Acquis Communautaire* and frontloaded it to hedge against the risk of policy slippage. The *Acquis*, which covers a broad range of areas, must be tailored to the country context—care must be taken to find the best fit. Needing special attention are local constraints that the *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 other international financial institutions are well positioned to assist in these areas.

li. **Resolution of the political crisis offers a chance to establish a new consensus on the future to guides the process of EU accession, facilitate the difficult political choices involved, and dilute resistance from vested interests.** Renewed political stability offers the opportunity to strengthen institutions and lock in long-term policy commitments. Successful transition economies, like those in the Baltics and Central Europe, have built strong, vigilant, and credible public institutions that serve all members of society. Enhancing the quality of state institutions is necessary to address foundational challenges to growth, inclusion, and sustainability.

**Table O.1: The Prioritization Criteria for Policy Areas**

	<i>Priority Policy Areas</i>	<i>Increasing Productivity</i>	<i>Enhance job opportunities for all</i>	<i>Achieving Sustainability</i>
Highest Expected Impact	1. Secure rule of law and build capable public institutions that are accountable toward citizens	Red	Red	Red
	2. Endow people with quality and relevant skills throughout the life cycle	Red	Red	Red
	3. Strengthen firm capabilities and the ecosystem for technology adoption and access of firms to finance	Red	Orange	Red
	4. Enhance trade connectivity and value chain integration	Red	Yellow	Red
	5. Promote market competition and establish a world-class business climate	Red	Yellow	Red
High Expected Impact	6. Reduce disincentives and remove barriers to labor market participation, especially for women	Yellow	Red	Red
	7. Ensure fiscal sustainability by reducing fiscal risks, improving the efficiency of spending, and enhancing revenue mobilization	Yellow	Orange	Red
	8. Invest in an integrated strategy to reduce air pollution, promote low-carbon growth, and build resilience to natural hazards and climate change	Orange	Yellow	Red
	9. Protect human capital by shielding poor and vulnerable households from shocks and investing in preventive medicine and primary care	Orange	Orange	Orange
	10. Foster agricultural modernization	Red	Orange	Yellow

Color by expected impact: Red Highest Orange High Yellow Medium

Source: Authors.

xi. **The 10 top policy areas identified by the SCD are well-suited to FYR Macedonia's present circumstances.** While urgent action is required across all policy areas, the impact of different actions will vary even within a single policy area. Setting priorities followed a two-stage process. First, based on the SCD evidence and analysis, 10 broad priority areas were identified: 4 on Pathway I, 3 on Pathway II, and 3 on Pathway III. Second, the SCD team drew on the diagnostic findings, experts' opinions,

and stakeholder consultations<sup>5</sup> to cluster the 10 priority areas in terms of their expected impact on productivity, enhancing job opportunities for all, and achieving sustainability (Table 0.1). Furthermore, for each area, the SCD team proposes policy actions (“What would it take?”) to give more specificity to the policy agenda (Table 0.2). These represent a core agenda for shifting to more robust, inclusive, and sustainable growth, including a schedule for completing each policy action based on its expected complexity. There are notable complementarities between priorities. Capturing synergies, drafting sequences, and building institutional capacity to design reforms and get them done will be critical to maximize the impact on productivity, jobs, and sustainability.

**Table O.2: Summary of Priority Areas for FYR Macedonia and Selected Policy Actions**

Priority Areas	Selected Priority Actions		
	Medium	Expected impact	High
Secure rule of law and build capable public institutions that are accountable to citizens.	Strengthen mechanisms ensuring freedom of the press and of civil society organizations.	Increase the transparency and accountability of government decision-making and build public sector capacity.	Ensure the independence, accountability, and professionalism of judicial system.
<i>Time horizon for implementation</i>	⊕	⊕ ⊕ ⊕	⊕ ⊕ ⊕
Endow people with quality and relevant skills throughout the life cycle	Invest in workforce development, job readiness, and labor market information systems to support job intermediation.	Put in place a broad-based strategy to strengthen the quality and relevance of primary, secondary, tertiary, and technical education.	Invest in early years (early childhood and pre-school education), especially for the poor.
	⊕	⊕ ⊕ ⊕	⊕ ⊕ ⊕
Strengthen firm capabilities and the ecosystem for technology adoption and access of firms to finance.	Streamline support programs for access of firms to finance.	Consolidate current firm-level programs to achieve economies of scale, and rebalance public support from subsidizing firm inputs to facilitating firm-upgrading.	Combine an investment support strategy for high-potential sectors with export intelligence interventions to reduce firm discovery costs to introduce new products and reach new markets.
	⊕	⊕	⊕ ⊕
Enhance trade connectivity and value chain integration.	Facilitate labor mobility to promote trade in services, reduce nontariff barriers to trade in goods, and strengthen export promotion systems.	Close infrastructure gaps in key transport corridors and rebalance spending to invest in road and railway maintenance and in road safety.	Improve soft connectivity (focusing on border-crossings and trade and transport logistics).
	⊕	⊕ ⊕ ⊕	⊕ ⊕

<sup>5</sup> The SCD team conducted interviews and workshops in FYR Macedonia with government officials, academics, civil society groups, private sector representatives, and development partners to guide identification of binding constraints and successful experiences of growth and inclusion (see Chapter 7).

**Table O.2: Summary of Priority Areas for FYR Macedonia and Selected Policy Actions**

Priority Areas	Selected Priority Actions		
	Medium	Expected impact	High
Promote market competition and establish a world-class business climate	Address gaps and weaknesses in the regulatory framework that impair the business environment.	Reinforce the effectiveness of the competition policy framework and enhance the effectiveness of state aid.	Promote pro-competition conditions in key product markets by strengthening public sector neutrality, promoting entry into network industries, and removing barriers to competition in professional services.
	⊕	⊕ ⊕	⊕ ⊕ ⊕
Reduce disincentives and remove barriers to labor market participation, especially for women.	Reform the tax-benefit system to encourage labor participation.	Expand the availability and affordability of child and elder care and promote behavior changes to achieve gender parity in employment.	Reduce restrictions on part-time, temporary, and seasonal work.
	⊕ ⊕	⊕ ⊕ ⊕	⊕
Ensure fiscal sustainability by reducing fiscal risks, improving the efficiency of spending, and enhancing revenue mobilization.	Increase tax compliance and progressivity.	Reinforce the efficiency of public spending.	Address fiscal risks (pensions, municipal finances, SOEs), and strengthen the transparency and credibility of public finances.
	⊕ ⊕ ⊕	⊕ ⊕	⊕ ⊕
Invest in an integrated strategy to reduce air pollution, promote low-carbon growth, and build resilience to natural hazards and climate change.	Shift the energy sector to a low-carbon development path, away from the current dependence on coal, while improving security and efficiency of energy supply.	Enhance the implementation of the National Program for inter-agency coordination for disaster risk management and build resilience to climate change.	Adopt a comprehensive approach to reducing air pollution.
	⊕ ⊕ ⊕	⊕ ⊕	⊕ ⊕ ⊕
Protect human capital by shielding poor and vulnerable households from shocks and investing in preventive medicine and primary care.	Implement an integral policy for healthier lifestyles to reduce the incidence of noncommunicable diseases.	Shift the focus of social assistance from categorical to means-tested programs, and expand the provision of social services.	Expand access to health care to reduce child mortality and better manage noncommunicable diseases.
	⊕ ⊕	⊕ ⊕	⊕ ⊕

**Table O.2: Summary of Priority Areas for FYR Macedonia and Selected Policy Actions**

Priority Areas	Selected Priority Actions		
	Medium	Expected impact	High
Foster agricultural modernization.	Promote inclusion of agribusiness SMEs in value chains, strengthen sanitary and phytosanitary services, and facilitate agglomeration and market access.	Put in place a system for taxing rural land and facilitate the sale of untenanted state-owned agricultural land.	Rationalize agricultural subsidies from direct coupled payments to investment-driven measures.
	⊕	⊕ ⊕	⊕ ⊕ ⊕
<b>Time horizon coding:</b>	⊕ <b>Short-term</b>	⊕ ⊕ <b>Short/Medium-term</b>	⊕ ⊕ ⊕ <b>Medium term</b>

Source: Authors.

## 0.11 Process, Knowledge Gaps, and Data

xii. **This SCD draws on previous analyses and publications, new analysis, and, perhaps most important, consultations and continuing dialogue with stakeholders in FYR Macedonia.** In the discussions, there was broad consensus on the challenges FYR Macedonia faces and what should be the priorities.

xiii. **In identifying knowledge gaps, the SCD emphasized areas where new information would support design of evidence-based policies.** The following knowledge gaps were identified:

- What is driving the recent decline in nonmonetary welfare indicators?
- How many people are in FYR Macedonia?
- How are ethnic minorities faring?
- Where are the remittances?
- What is the relationship between exports, imports, and productivity?
- What is the country's potential to integrate into global value chains?
- How local firms better connect with export-oriented FDI?
- What is the impact of state aid?
- How do reservation wages affect labor market outcomes?
- What are the main challenges to improving the quality of public institutions in FYR Macedonia?

xiv. **Addressing data gaps is essential for evidence-based policymaking.** FYR Macedonia needs to collect, process, and make publicly available important primary data to support informed policy decision making. Population and housing censuses in most countries are carried out every 10 years and are a prerequisite for producing high-quality macroeconomic and microeconomic data. However, FYR Macedonia's last census is more than 15 years old, dating from 2002, which makes a new census the most important data priority. Coordinated efforts by different stakeholders are also needed to improve the frequency of, and public access to, data. Limited funding and technical capacity to ensure quality often discourage public institutions from publicly sharing collected data. Access to microdata also needs to improve to enhance debate about the design of public policies. Usually access to this information

requires lengthy processes and is sometimes only possible through safe-rooms on premises or restrictive agreements. The SCD team is especially grateful to the authorities of FYR Macedonia for granting significant access to data for this analysis, including household- and firm-level microdata.

xv. **The policy priorities presented here are grounded in today's reality; the world of tomorrow will bring additional challenges and opportunities.** Rapidly changing technology will call for economies with flexible regulation, resource allocation, firm capacity to absorb new technologies, and capacity to adapt skills to demand. The future may see self-driving trucks in FYR Macedonia, some manufacturing jobs taken by robots, and smart farms that can edit plant DNA. What might all this mean for FYR Macedonia, and what can the country do to prepare for new challenges and seize new opportunities? If the government acts on the areas identified in this SCD, Macedonian workers and firms would be better prepared to learn and to use new technologies, and take advantage of opportunities where markets are growing.

## 0.12 Structure of the SCD

xvi. **Chapter 1** presents the country context. **Chapter 2** analyzes poverty, shared prosperity, and the labor market. **Chapter 3** assesses trends and drivers of growth and job creation. These chapters thus build the evidence that supports the SCD conclusion that FYR Macedonia needs to *increase productivity, enhance job opportunities for all, and ensure the sustainability of development gains*. **Chapters 4 to 6** present three pathways to achieving these objectives: *Fostering a More Dynamic and Competitive Private Sector; Developing More Competitive and Adaptive Human Capital and Closing Opportunity Gaps*; and *Achieving Sustainability Through Effective Governance, Fiscal Prudence, and Enhanced Environmental Management and Resilience to Natural Hazards*. Finally, **Chapter 7** offers policy priorities as a foundation for dialogue in FYR Macedonia.

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