

24. **Improvements are also underway in pensions.** The Government has introduced parametric reforms to the existing defined benefit (PAYGO) system, including an increase in the retirement age and contribution rates and a reduced replacement rate. Further, a voluntary defined contribution component was added in 2009 to complement the mandatory defined contribution system. Improvements were also made to consolidate collection of all social contributions, strengthen the regulatory and supervisory capacity for the payout phase in the fully funded pension scheme, and work with market participants on a range of investable instruments available for the pension funds. These are important measures, but the fiscal strains of the global crisis and the slow recovery are placing these achievements at risk.

25. **Particular attention has been directed to improving education outcomes.** Poor performance on the International Large Scale Assessment Studies (TIMSS, PIRLS and PISA) in 2000 and 2001 has triggered wide reforms in education system. Key challenges included improving teacher performance and strengthening enrollment. Between 2004 and 2008, secondary enrollment increased from 85 to 95 percent, and dropout rates for primary school decreased to below 2 percent. A market for teacher training was established, along with criteria for accreditation and monitoring of teacher training. The State Matura examination, the national assessment of student achievement, was given for the first time in 2008 in all four-year general and vocational schools. From 2004 to 2007, 49 percent of school managers and teachers reported improvements in students' achievements; more than 60 percent saw improvement in planning and assessment processes, and 28.5 percent confirmed improved attendance and participation. The Ministry of Education is administering a second round of School Improvement Grants, with support from the Bank, focusing on elementary and rural schools, as well as introducing electronic "school profiles" for all elementary and secondary schools, to house administrative records.

26. **Progress is also underway toward ensuring the sustainability of the health system.** The Health Insurance law was amended to streamline the operations, decision-making and transparency of the Health Insurance Fund (HIF), the public entity charged with coordinating health financing. These reforms permit a more efficient payment system for hospitals and other health care providers. The managerial capacity of the HIF has also improved, both through training and improved information systems. In addition, efficiencies were realized through the competitive procurement of pharmaceuticals and changes in the payment mechanism to providers. Most recently, the HIF board instituted reference pricing and stronger controls over spending. Financial results improved markedly. Arrears of the HIF to suppliers were cleared in 2007, while financial obligations of the entire public health sector fell from 1.7 percent of GDP in 2004 to 0.4 percent in 2008.

II. DEVELOPMENT CHALLENGES

A. Faster Growth

27. **FYR Macedonia's development achievements have been substantial, but continued effort across a range of areas will be required to generate economic growth that puts people to work and improves living standards for all.** The Government and the World Bank Group agree that such growth will have to be faster, more inclusive and, increasingly, "greener."

28. **Continued growth and employment creation will depend on sustained macroeconomic stability.** A continued prudent policy framework would narrow the fiscal and external imbalances

over the medium-term to ensure debt sustainability and manage the risks of new shocks and crises. At the same time, the structural problems of the FYR Macedonian labor market need to be addressed to ensure that high economic growth rates also translate into employment generation. In the short-run, this will require sustaining employment growth, including in the low-wage sector. Over the medium term, it will require upgrading skills and enhancing productivity to boost employment outcomes. Finally, business environment reforms will support growth but also help “formalize” the economy and contribute to better and more secure jobs. According to official estimates, the informal economy accounts for around 20 percent to GDP, though unofficial estimates put it as high as 30-40 percent of value added in the economy.

Create Jobs

29. **The sluggish pace of employment growth despite a relatively strong pre-crisis economic expansion raises concerns.** The official 2009 unemployment rate as measured through the Labor Force Survey was 32.4 percent, down from 33.8 percent in 2008 and a peak of 37.3 percent in 2005. This compares with 17.4 percent in Serbia; 29 percent in Bosnia and Herzegovina; and 12.5 percent in Albania (2008). Alternative estimates based on the Household Budget Survey and using stronger filters to determine employment search efforts indicate the unemployment rate is somewhat lower, in the—still high—mid-20 percent range. Signs of improvement are evident. Since 2005, employment has grown by an average of 3.8 percent per year as the employment rate increased from below 38 percent to 43.3 percent; but this growth has not resulted in a stronger reduction in the unemployment rate as it was accompanied by a steady increase in labor force participation, including during the crisis. Moreover, most jobs created were low-paid.

30. **Reducing stubbornly high unemployment—and creating employment—will require a thorough analysis of structural problems.** The Bank has worked closely with the Government toward understanding the labor market challenges, and analytical engagement has contributed to improvements such as a new Labor code, payroll reform, etc. Addressing the remaining complex and dynamic labor market issues may require more in depth analysis of structural problems. Economic growth is certainly an important prerequisite for further job creation, but other factors can help to create more and better jobs. On the labor supply side, further analysis will investigate whether lack of skills (especially “soft skills”), high reservation wages due to remittances and/or high public sector wages, and discouragement are among important factors contributing to poor labor market outcomes. Enhancing skills would not only increase productivity and the quality of employment outcomes, but might also help reduce unemployment in cases of skills mismatch. The overall social safety net probably does not discourage participation since benefits are not overly generous. Still, it cannot be ruled out that some specific programs, such as the parental allowance and some unemployment benefits, awarded largely in the past, provided disincentives for participation. Moreover, some programs can be redesigned to “award” activation. On the legal and institutional side, the labor code has been reformed and institutional strengthening is ongoing – however, considerable efforts are still needed.

Further Improve the Business Environment

31. **FYR Macedonia has improved its business climate but more can be done to build on recent improvements.** Areas where further efforts can pay off include streamlining administrative procedures, improving contract enforcement, and facilitating foreign trade, particularly by reducing tariffs and simplifying procedures and costs. Advances are needed in safeguarding property rights

and the rule of law, facilitating competition through improved market entry and exit, and improving access to financing. The remaining gaps in the financial sector framework need to be addressed to safeguard its stability and enhance its role in supporting growth. Continuation of reforms of social security contributions will help wage competitiveness, but further reductions in labor taxation should not endanger the sustainability of public finances. Though the burden of excessive regulations has been reduced it still impedes economic activity in certain areas. The establishment of an Investor Aftercare Function can provide a venue for institutional dialogue with businesses and identification of excessive regulation. Similarly, the mandatory Regulatory Impact Assessment needs to be strengthened to avoid build-up of excessive regulations. Licensing and permit issuance, including construction permits, remain critical concerns voiced frequently by business representatives. Box 2 describes the progress made in enhancing corporate financial reporting.

Box 2: Regional REPARIS: Supporting Competitiveness and EU Integration

The authorities have committed to enhance corporate financial reporting and accelerate adoption and enforcement of the *Acquis Communautaire*. FYR Macedonia joined “*The Road to Europe - Program of Accounting Reform and Institutional Strengthening*” (REPARIS) - a regional initiative aimed at creating a transparent policy environment and effective institutional framework for corporate reporting within South Central and South East Europe. REPARIS was developed by the Bank in close cooperation with the Organization for Economic Co-operation and Development (OECD), EC and other partners, and offers training to senior civil servants, financial sector regulators and accounting and auditing bodies in emerging issues and new trends in both EU and global requirements impacting the regulation of accounting and auditing. Other participants include Albania, Bosnia and Herzegovina, Croatia, Kosovo, Moldova, Montenegro, and Serbia.

FYR Macedonia has made strides toward strengthening performance, including establishing a professional accountancy body (Institute of Certified Auditors) and audit oversight function, developing programs for educational and professional development, and proposing existing laws to be aligned with EU requirements. However, as indicated in the EU Progress Report for 2009, much work remains.* “Alignment of the legal framework for accounting and auditing is lagging behind. The administrative capacity of the Institute for Chartered Auditors is still not satisfactory and no public oversight system aligned with the *acquis* has been established yet.” Further, changes in legislation to align accounting and auditing practices with the EU have yet to be adopted by the Parliament; and the Government needs to bolster efforts to strengthen education of accounting professionals and to establish a professional code of ethics.

* http://ec.europa.eu/enlargement/pdf/key_documents/2009/mk_rapport_2009_en.pdf

Build Skills

32. **Ensuring FYR Macedonia’s competitiveness will ultimately depend on educating its population and achieving the national goal of becoming a “country of knowledge.”** The Government’s strategy for education builds on ongoing reforms, such as the introduction of nine-year primary education, compulsory secondary education, and revised curriculums which promote outcome oriented and interactive teaching and learning, early learning of English language and information technology skills. In addition, budget increases for education are sought to reach the Organization for Economic Co-operation and Development (OECD) expenditure target of 5 percent of

GDP. There are significant ambitions for tertiary education, including introducing a credit-transfer system in compliance with the Bologna Declaration, which will open the doors for FYR Macedonian students to continue studies throughout Europe and attract foreign students to domestic universities, creating the basis for greater intellectual exchange. This will help strengthen the capacity of domestic institutions to foster skills applicable to the EU market and increase the competitiveness of the labor force. These investments are to be accompanied by new legislation supporting the legal framework for research in science and technology, with a view to facilitating connections with universities and industries and promoting international coordination in high-tech research.

33. **Improving education quality and access remain critical challenges.** International standardized tests show that there has been little progress in certain measures of quality. For example, FYR Macedonia participated in the PIRLS international test⁶, which measures performance in reading and comprehension of a variety of texts. Between 2001 and 2006 (the last year with available data) the percentage of students reaching the minimum international benchmark of proficiency remained almost unchanged (decreased from 67 to 66 percent, while the best performing countries reach 95 to 98 percent). Though secondary education is compulsory, expanding access to vulnerable groups remains an important challenge. The gap in enrollment rates between the poorest and wealthiest quintiles is about 18-20 percentage points both at the secondary and tertiary levels. Roma children are underrepresented at all levels of education. This is a common problem in the Western Balkans and one which the Government is taking action to overcome.

34. **Improving higher education is an important item on the development agenda.** Over the last decade, enrollment in higher education institutions in FYR Macedonia has increased rapidly⁷; though much of this increase has been in private universities, which have mushroomed in recent years, raising questions of quality. At the same time, resources for public sector institutions have stagnated.⁸ Some public universities lack basic infrastructure and appropriately trained personnel to address the gaps between educational outcomes and labor market needs. Higher education faces three main challenges. First, the efficiency of the higher education system remains low with high drop-out and time-to-graduation rates; while reforms to address these problems have been started, they have not received sufficient financial support. Second, quality assurance mechanisms need to be put in place. The 2008 higher education law envisions establishing two sectoral bodies to improve outcomes in quality. Third, further investments in the sector will be needed to ensure that FYR Macedonian higher education institutions are competitive in the regional and wider European context.

B. More Inclusive Growth

Reduce Poverty

35. **Poverty in FYR Macedonia is high and static.** To understand poverty in FYR Macedonia it is useful to look at three recent periods over the past decade: the years before growth accelerated (2002-2006); the period when the economy was catching up (2007-2008) and the post-crisis period.

⁶ Progress in International Reading Literacy

⁷ According to data provided by the Ministry of Education and Science in 2008, 85% of graduated secondary school students enrolled in Higher Education Institutions compared with 64% in 2007 and 42% in 2006; higher education enrollment (gross, percent of population aged 19-24) in 2005 was 21,2% and 39,6% in 2007

⁸ This year, 1.36 % of GDP was allocated for higher education and 0.10 % for science.

The Bank completed a comprehensive poverty analysis covering the first period—2002 to 2006. Though this analysis does not reflect the dynamics of the economic crisis of late 2008, it provides a first look into the troubling fact that economic growth has not translated into reduced poverty. Not only did the population living below the poverty line remain at around 20 percent, but, depending on how it is measured, extreme poverty increased by about 2 percentage points to 7 percent. Though discouraging, the analysis noted mitigating trends. First, jobs were created in the economy, including in the formal sector, though these jobs were neither high skilled nor high paying. Second, a similar “stickiness” in poverty was observed in neighboring Albania and Serbia, which experienced lengthy incubation periods for poverty reduction. Third, the Government responded aggressively with innovative, well targeted social protection programs. These three factors, together with continued robust economic growth, provided a basis to expect some improvement in the coming years.

36. **No matter how poverty is measured, progress in FYR Macedonia continued to be slow.** Looking at data for the second period from 2007 and 2008, using different methodologies, reveals little change from the previous four years. The World Bank uses an absolute standard, which looks at some measure of what households should be able to count on to meet their basic needs. Using this measurement, poverty *jumped* from 19 percent in 2006 to 23.5 percent in 2008; this is notable as these two years saw robust economic expansion with annual growth averaging 5.3 percent. The Government, which uses an EU methodology, looks at relative poverty, i.e., defined in relation to the overall distribution of income or consumption in a country (specifically, the poverty line is set at 70 percent of the country’s median expenditures per adult equivalent). Using this methodology, poverty in the two years after 2006 stayed constant at just under 30 percent. There are also regional dimensions to the challenge, with significant disparities between regions. The Bank’s Poverty Analysis revealed that poverty in the nation’s commercial and political capital, Skopje, fell by nearly half during the first half of the decade, while stagnating or increasing elsewhere. Overall, the poverty rate varied from around 10 percent in the Southwest region to more than 30 percent in the Northeast region.

37. **The crisis may have halted any latent reduction in poverty that could have been expected from the preceding period of economic growth.** Using a standard methodology used in ECA countries, the reduction in GDP experienced in 2008 and 2009 would have been expected to increase poverty in FYR Macedonia from 23.5 to 23.9 percent. However, the picture remains uncertain, particularly as countervailing factors expected to reduce poverty in previous years remain. FYR Macedonia was relatively less affected by the crisis than its neighbors and the labor market was resilient with unemployment remaining stable. Moreover, the Government remains committed to further strengthening its innovative and well targeted social programs.

Strengthen Social Protection

38. **The current social protection system faces two important challenges: (i) ensuring the financial sustainability of the pension system and (ii) improving the effectiveness of the social safety net.** The sustainability of the pension system is threatened by the simultaneous reduction of contribution rates as part of the payroll tax reform and pressures to increase pensions. The coverage challenge relates to the high unemployment and the large informal sector that effectively excludes a substantial population from the pension system. Changes in the indexation formula and ad-hoc increases could affect long term sustainability. The Government is considering additional measures to restore the long term balance in pension expenditures and revenues, including a retirement age

increase, further changes in indexation of pension benefits, changes in the PAYGO pension formula, and adjustments of the mandatory pension system contribution rates.

39. **Continued reform of social safety nets would continue to yield benefits.** The system still contains too many programs, with overlapping objectives and beneficiaries. In addition, coverage of social assistance can be strengthened further, as it reaches only 43 percent of individuals in the poorest quintile. Among other factors, potential beneficiaries are subject to extensive means testing which limit the coverage, such as lack of proper documentation. This is especially true for Roma and internally displaced people (see the Box 3 on Roma population in FYR Macedonia.) The CCT program has been designed to address these and other shortcomings, particularly by consolidating programs and unifying information systems.

Box 3. Reaching the Roma Population in FYR Macedonia

The Roma population is significant in FYR Macedonia, though like elsewhere in the region is difficult to identify with certainty. According to the last census from 2002, there were 53,879 persons counted as Roma in the country, or 2.7 percent of the population. Some UN studies claim that there are around 260,000 Roma in FYR Macedonia or approximately 12 percent of the total population.* FYR Macedonia is a leading participant in the Decade of Roma Inclusion 2005-2015, a multi-country initiative supported by the Bank and other partners. The Government has contributed proactively to the initiative and has formed an inter-sectoral Country Working Group under the auspices of the Minister of Labor and Social Affairs and with active involvement of Roma NGOs. The Country Working Group has developed a Decade Action Plan, which outlines the actions to be taken in the priority areas of education, health, housing and employment.

The Bank is supporting Government efforts to include Roma communities in Government policy. The Conditional Cash Transfer project is designed to support obligatory secondary education and increase enrollment of Roma children into secondary schools, which currently stands at only 16 percent. FYR Macedonia has also been one of the main beneficiaries of the World Bank co-financed Roma Education Fund, utilizing more than US\$3 million for 14 projects related to school-based mentoring support, advocacy activities for more integrated education of Roma students, and overall increase of enrollment rates of Roma children into primary and secondary schools.

* UNDP (2006), *At Risk: Roma and the Displaced in Southeast Europe*

Improve Health Service Delivery

40. **The health sector faces critical challenges in outcomes, sustainability and efficiency.** As noted above, life expectancy, infant mortality and other health indicators, while improving, significantly trail EU averages. Lasting progress will depend on many factors, including more effective and efficient health services. First, most people seeking care use emergency services (55 percent) followed by hospitals (19 percent)—greater emphasis can be placed on promoting primary care and family doctors; second, there appears to be too many hospitals per patient, and productivity is low. FYR Macedonia's in-patient admission rate is half the average for the EU15 and lower than all countries in the region but Bosnia and Herzegovina. Similarly, the hospital occupancy rate was only 54 percent, compared with averages of 78 percent in the EU15 and 74 percent in the newly member states.⁹

⁹ Macedonia Public Expenditure Review, World Bank (2008).

C. Greener Growth

41. In 2009, in the midst of the global financial crisis, OECD members issued a declaration committing not only to sustain environmentally sustainable growth policies but stated that “green and growth go hand in hand.”¹⁰ It further added: *Economic recovery and environmentally and socially sustainable economic growth are key challenges that all countries are facing today. A number of well targeted policy instruments can be used to encourage green investment in order to simultaneously contribute to economic recovery in the short-term, and help to build the environmentally friendly infrastructure required for a green economy in the long-term, noting that public investment should be consistent with a long-term framework for generating sustainable growth. Green growth will be relevant going beyond the current crisis, addressing urgent challenges including the fight against climate change and environmental degradation, enhancement of energy security, and the creation of new engines for economic growth.* The FYR Macedonian authorities have committed to fundamental elements of this green growth agenda and are moving forward with environmental, energy and natural resource policies that will be necessary for EU accession.

Prepare for Climate Change Challenges and Vulnerabilities

42. **Climate change is already affecting FYR Macedonia.** Of all 28 ECA countries studied as part of the World Bank Study, “Adapting to Climate Change in Eastern and Central Europe”, only three have experienced more climate related natural disasters since 1990. Only four countries are likely to experience more dramatic increases in climate extremes, and FYR Macedonia is near the bottom in capacity to adapt to these changes. It is projected that by 2050, FYR Macedonia will be exposed to an average 1.9 C degree increase in mean annual temperature; a 5 percent mean annual drop in precipitation; a riskier agricultural environment; and exposure to new pests and crop diseases.

43. **The development implications of these trends are profound.** The expected drop in precipitation will have serious impacts on agriculture and planned investments in hydro power. Other infrastructure assets, such as roads and railways may require engineering improvements to better withstand heavier rainfall. Trends may exacerbate health risks as warmer temperatures and other factors increase the occurrence of certain diseases.

44. **Climate change will affect agriculture and forestry.** Rain-fed crop yields could decline substantially over the next 40 years (between 10% and 80% on average) with corresponding economic losses.¹¹ Opportunities could occur from climate change, such as possibilities to extend the growing season with the doubling of crop cycles and enabling warm weather crops; however, preparation and investments would be required to realize such benefits. Given this increasing uncertainty, as well as the environmental and economic importance of agriculture—which accounts for 18 percent of employment and 12 percent of GDP—developing a long-term adaptation strategy is critical to address two basic questions: first, which agricultural systems, including crop and livestock varieties, production technologies, irrigation systems, and farmer skills, will be most resilient in a changing climate? And second, which products will be most competitive in the EU market?

¹⁰ OECD Declaration on Green Growth <http://www.oecd.org/dataoecd/58/34/44077822.pdf>

¹¹ Climate Change and Agriculture Country Note, FYR Macedonia

Box 4. Green Growth in Cities

In FYR Macedonia, as around the world, cities are at the frontline of sustainable development. Increasingly, they recognize that they are not only part of the problem of climate change, but central to the solution. Home to two-thirds of the country's population and accounting for most of its GDP, employment, productive services and knowledge-based sectors, cities are the driving forces of the economy and social development. Worldwide, cities consume between 60-80 percent of total energy production and contribute to 70% of the world's GHG emission. An emphasis on sustainability can mean thinking beyond cities in the conventional sense of "engines of economic growth," to cities as incubators for technological innovation, cultural enrichment, social integration and global connectivity—serving a range of national goals leading to faster, more inclusive, and greener growth.

Cities are highly vulnerable to the adverse impact of climate change because they have the highest concentration of human and physical assets, and are often located near water bodies and along river banks. At the same time, owing to economies of scale, cities offer major opportunities to reduce energy demand, minimize pressures on natural resources, and reap the co-benefits of climate change.

FYR Macedonian cities continue to face major environmental challenges including aging and inefficient infrastructure and housing stocks; and residual pollution and defunct factory buildings within urban populated areas which require redevelopment or recovery for more growth-oriented land uses. As FYR Macedonia has implemented its decentralization program, municipalities in partnership with local stakeholders are taking greater responsibility in delivering sustainable solutions. Therefore, strengthening municipal capacity in this context is a key element of both mitigation and adaptation to climate change.

Improve Management of Water Sector

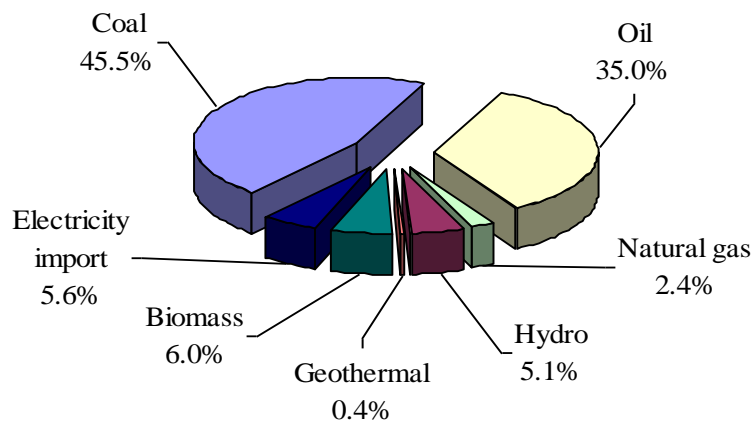
45. **Pressures on water supply and water sector administration are growing.** The country's water resources are now, on average, adequate, but precipitation is uneven throughout the country and during the year. About 75 percent of the country is classified as semi-arid. Due to the seasonal fluctuation, FYR Macedonia depends heavily on its 22 large dams and more than 100 small dams for urban and industrial water supply and irrigation. The water security of the southeast is a particular concern, with parts already classified as arid. Desertification is likely to expand; by 2030, the average river run-off is projected to fall by 25 percent. In the southeast, farmers are already experiencing water shortages for irrigation leading to substantial economic losses. Industry and mining face similar challenges. More integrated water sector planning is needed to inform decision making to ensure a sustainable growth path. For example, the water and irrigation sectors have been consolidated and restructured, and a number of so called "water economies" have been established. However, governance and resources for maintenance and dam safety continue to be a concern.

46. **The municipal water utilities need reform to promote demand management.** A Public Private Investment Advisory Facility (PPIAF) funded strategy for reform of the water, sanitation and the solid waste sectors was prepared at the request of the Ministry of Finance. The study recommended a phased program of reforms to address over-consumption, high water losses, operational inefficiencies, inadequate pricing policies, and poorly targeted user subsidies. Financial stability is precarious, reflecting the mismatch between weak revenues and a high backlog of maintenance and rehabilitation. The administration of the municipal water sector is fragmented. Local utilities are responsible for providing services but receive inadequate guidance and financial support from both municipalities and the central government.

Address Energy Sector Challenges

47. **The Government is concerned about the growing reliance on imported fossil fuels and energy inefficiency.** Fossil fuels account for more than 80 percent of energy consumption in FYR Macedonia, and an increasing amount of this is imported, including all liquid fuel and natural gas. Absent investment in new energy sources this trend will continue as demand grows while domestic production erodes. The Government is committed to reversing this trend and strengthening energy security. Greater energy efficiency is the first step in this direction—FYR Macedonia consumes very little energy per capita but a high amount per unit of GDP. An immediate area of opportunity is to improve the efficiency of residential, commercial and public buildings, which account for up to 50 percent of energy consumption. The authorities also want to exploit renewable energy sources, starting with hydro-power, but also wind, solar and biomass. Other aims include increasing the use of natural gas and reducing the use of electricity in heating buildings.

Figure 2. Sources of Primary Energy Consumption (2006)



48. **Reforming the regulatory framework and appropriately pricing energy supplies are critical to achieving energy efficiency.** The Government has been striving to improve electricity regulation but it is still unable to balance consumer and investor interests. Regulation needs to incorporate a more objective methodology to estimate operating costs of power utilities, provide allowances for losses and bad debts, and adjust tariffs to enable recovery of the costs of doing business. As at the last quarter of 2009, non-residential electricity tariffs in FYR Macedonia were up by about 25 percent compared to 2007, and by about 36 percent compared to 2006. At US cents 11.86/kWh, non-residential tariffs in FYR Macedonia are higher than most other countries in South-East Europe except Montenegro and Bosnia and Herzegovina. However, the residential tariff for electricity is very low due to a substantial cross-subsidy from non-residential to residential consumers, which constitutes a major barrier to shifting to gas for heating. Though residential electricity tariffs have increased slightly, they lag well behind those in EU and other transitional countries. Some important steps have been taken in recent years. In 2008, prices for large commercial consumers were liberalized; residential consumers are set to follow in 2015 in terms of the Energy Community Treaty to which FYR Macedonia is a signatory. The EC Treaty requires rebalancing tariffs through the gradual elimination of cross-subsidies; it requires each class of consumer to pay a cost-covering tariff, while allowing the government to provide a direct subsidy to the socially vulnerable consumers. However, the financing of energy infrastructure will remain an issue, and more will need to be done to attract private capital.