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Report No: PGD135

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A

PROPOSED LOAN

IN THE AMOUNT OF EUR125 MILLION (EQUIVALENT TO US$139.25 MILLION) TO

REPUBLIC OF NORTH MACEDONIA
FOR THE

PUBLIC FINANCE AND COMPETITIVENESS DEVELOPMENT POLICY LOAN
August 22, 2019

Macroeconomics, Trade and Investment Global Practice
Europe and Central Asia Region

Public Disclosure Authorized

REPUBLIC OF NORTH MACEDONIA–GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange rate effective as of July 31, 2019)
Currency Unit = Macedonian Denar
US$1 = MKD 55.00
EUR1 = MKD 60.89

ABBREVIATIONS AND ACRONYMS

BOP	Balance of payments	MOH	Ministry of Health
CAD	Current account deficit	MOLSP	Ministry of Labor and Social Protection
CPF	Country Partnership Framework	MTEF	Medium-Term Expenditure Framework
DPL	Development Policy Loan	NPL	Non-performing loans
EC	European Commission	NBRM	National Bank of the Republic of North Macedonia
ECA	Europe and Central Asia	OECD	Organization for Economic Cooperation and Development
ERP	Economic Reform Program	PESR	Public Enterprise for State Roads
EU	European Union	PFM	Public financial management
EUR	Euro	PFR	Public Finance Review
FDI	Foreign direct investment	PIT	Personal income tax
FX	Foreign exchange	PPP	Purchasing power parity
FY	Fiscal year	PSIA	Poverty and Social Impact Analysis
GDP	Gross domestic product	SOE	State-owned enterprises
GFS	Government finance statistics	TSA	Treasury Single Account
GoNM	Government of North Macedonia	TA	Technical Assistance
HIF	Health Insurance Fund	UNDP	United Nations Development Program
IBRD	International Bank for Reconstruction and Development	VAT	Value added tax
IFI	International Financial Institutions	WBG	World Bank Group
IMF	International Monetary Fund	WDI	World Development Indicator
LDP	Letter of Development Policy	WHO	World Health Organization
MOF	Ministry of Finance		

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NORTH MACEDONIA PUBLIC FINANCE AND COMPETITIVENESS DPL

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The World Bank appreciates the close collaboration of the Government of North Macedonia in the preparation of this Development Policy Loan. The operation was prepared by an IBRD team led by Sanja Madzarevic-Sujster, including Gordana Popovik-Friedman, Antonia Viyachka, Bojana Naceva, Bojan Shimbov, Gianfranco Bertozzi, Mediha Agar, Zoran Anusic, Rhedon Begolli, Cesar Cancho, Marjan Petreski, Nina Rinnerberger, Sidy Diop, Marc Schiffbauer, Sasa Eichberger, Tural Jamalov, Luz Meza-Bartrina, and Gulana Enar Hajiyeva. The team benefited from the guidance of Linda Van Gelder (Country Director, ECCWB), Gallina Vincelette (Practice Manager, EECM2), and Marco Mantovanelli (Country Manager, ECCWB). The support from Jasminka Sopova and Anita Bozinovska is gratefully acknowledged.

SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic
P171851	No

Proposed Development Objective(s)

The proposed DPO supports reforms to strengthen public finances, improve market competition, and reduce the regulatory burden in North Macedonia.

Organizations

Borrower:	MINISTRY OF FINANCE
Implementing Agency:	MINISTRY OF LABOR AND SOCIAL POLICY, MINISTRY OF FINANCE

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**139.25**

DETAILS

International Bank for Reconstruction and Development (IBRD)	139.25

INSTITUTIONAL DATA

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Overall Risk Rating

Substantial

Results

Indicator Name	Baseline	Target
Overall PAYG pension deficit reduced.	*4.8 percent of GDP in 2017*	*4.45 percent of GDP in 2019*
Increased social assistance coverage of the bottom quintile overall and for female-led households.	*33 and 22.6 percent, respectively in 2016*	*50 and 40 percent, respectively in 2019*
General government arrears reduced.	*3.5 percent of GDP in 2017*	*Below 2.7 percent of GDP in 2019*
Personal income tax revenues increased.	*2.5 percent of GDP in 2017*	*2.7 percent of GDP in 2019*
Share of fossil fuel consumption subject to excise taxation.	*57.5 percent in 2017*	*92.9 percent in 2019*
Percentage of electricity consumers able to choose an electricity supplier at the open market increased.	*50 percent in 2017*	*100 percent in 2019*
Average number of bidders per competitive procurement procedure increased.	*3.41 in 2017*	*Above 3.41*
Risk-based inspection introduced.	*No inspectorates have risk-based inspection.*	*In at least three inspectorates relevant for businesses by mid-2020*

IBRD PROGRAM DOCUMENT FOR A PROPOSED PUBLIC FINANCE AND COMPETITIVENESS DPL to THE REPUBLIC OF NORTH MACEDONIA

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed Public Finance and Competitiveness Development Policy Loan (DPL) supports North Macedonia's efforts to strengthen the sustainability of public finances, improve market competition, and reduce the regulatory burden on businesses.** After a period of political stalemate, the government in office since May 2017 embarked on an ambitious reform program to safeguard macroeconomic stability, improve citizens well-being, strengthen competitiveness, and pursue the country's aspirations for European and international integration. The government's Economic Reform Program (ERP) 2019-21 aims to strengthen revenues, improve public financial management, increase market competition, make the environment for doing business more attractive, and strengthen labor market and social protection.[1] The DPL supports reforms that aim to safeguard fiscal sustainability, improve market competition, and lower the regulatory burden on businesses in the context of renewed impetus for European and global integration. This operation has been closely coordinated with international partners (including the International Monetary Fund (IMF), the European Commission (EC), United States Agency for International Development (USAID), and other bilateral partners) to ensure that policy support and technical assistance are complementary. The DPL objectives are aligned with the World Bank Group Country Partnership Framework (CPF) FY19-FY23 (Report No. 135030-MK).

2. **North Macedonia has had a good track record of conducting macroeconomic policies and business environment reforms**. Prudent macroeconomic policies prior to the global financial crisis enabled the country to create fiscal space for a countercyclical fiscal policy–centered on stimuli for public employment, pensions, and public works–that largely mitigated the impact of the crises in 2008-09 and 2011-12.[2,3] These measures helped the economy to grow at an average of 2.2 percent in 2012-17 and increase the employment rate by 5 percentage points to above 44 percent by 2017. This helped reduce poverty by about 12 percentage points (to 22 percent).[4]

3. **While the fiscal stimulus measures of 2009-16 helped keep up growth and jobs in North Macedonia, their fiscal cost became a threat to fiscal sustainability:** As a result of overly expansionary fiscal policy, especially related to the Skopje 2014 project, the public and publicly guaranteed debt-to-GDP ratio doubled since 2008 to 47.8 percent in 2017, while fiscal deficit during the same period averaged 3.3

[1] As a European Union (EU) candidate for membership, North Macedonia submitted the ERP to the European Commission (EC) as part of its economic governance surveillance.

[2] Fiscal prudence up to 2008 allowed the country to reduce public debt from 45.7 percent of GDP in 2002 to 23 percent in 2008, which opened up fiscal space for public spending to stimulate the economy thereafter. Monetary policy was also accommodative, and the National Bank reduced interest rates to encourage credit growth. For countries like North Macedonia with fixed exchange-rate regimes, fiscal policy is the primary instrument available for managing the business cycle through a countercyclical policy response.

[3] To spur investment the government spent more on road and civil infrastructure and lowered the tax burden. It abolished the profit tax on reinvested earnings for 2009–14; lengthened the list of goods given preferential tax rates; and exempted from tax FDIs in technological industrial development zones. It also supported consumption by ad hoc pension hikes, reduced social contribution rates, and employment subsidy schemes.

[4] Absolute poverty is measured using the poverty line for upper-middle-income countries, estimated at $5.5/day in 2011 purchasing power parity (PPP). Extreme poverty calculated using the poverty line of US$1.90/day in 2011 PPP, although still higher than expected for North Macedonia's level of development, was almost halved by 2015, to 5.3 percent. Moreover after 2009 growth became more inclusive: in recent years the incomes of those at the bottom of the income distribution has grown by 6.2 percent annually, far above the national average of 1.9 percent.

percent of GDP or 3.7 percent of GDP when the off-budget road agency finances are added. Further fiscal risks stemmed from pressures on pensions due to aging, re-accumulation of public sector arrears and the high level of state-owned enterprise (SOE) indebtedness.[5] The efficiency analysis of public spending in areas like education, health, infrastructure, and agricultural subsidies suggests that the same output levels could be achieved with less public spending.[6] There is also scope for raising revenues by improving tax collection; the tax system is characterized by broad tax exemptions, compliance challenges, and informality. Additionally, the political turmoil of 2015-17 adversely affected investors' expectations, leading to a slowdown in foreign direct investment (FDI) and under-execution of the public investment program, which in 2017 brought economic growth down to almost zero. However, even before that, economic activity was limited by the lack of private sector dynamism due to skills mismatches, barriers to entry, and competition in product markets and critical backbone service sectors such as energy.[7]

4. **Against this backdrop, the authorities have now launched reforms to reinvigorate economic growth and ensure sustainability of public finances.** The proposed DPL supports reforms to improve efficiency of tax policy, public spending, and public finance management that should help reinforce medium-term fiscal sustainability. The cumulative impact of the supported fiscal measures results in a permanent saving of 0.8 percent annually. The operation is also supporting reforms in energy, procurement, and inspections to boost market competition by unlocking energy sector monopoly and offering all consumers a choice of electricity supplier on the open market, by increasing access to private bidders in public tenders, and by introducing risk-based inspections. Reducing the deficit and stabilizing debt over the medium term will reassure financial markets ahead of the country's need in 2020–21 to refinance 8 percent of GDP annually. The proposed DPL is in line with the government debt management strategy to minimize borrowing costs and extend maturity of its public debt portfolio. The DPL helps meet North Macedonia financing needs, while allowing the government to continue developing the domestic market through issuance of domestic bonds in line with available financial sector liquidity.

5. **The assessed risk of the proposed operation is substantial.** Political and governance, stakeholder, and macroeconomic risks are substantial. Political risks stem from political pressures, including from affected by the reforms stakeholders, associated with the implementation of the supported reforms in a current coalition government. Resolution of the country name dispute in February 2019 opened both the North Atlantic Treaty Organization (NATO) accession process and the prospect of the European Union (EU) accession negotiations. These processes are powerful tools to alleviate political risks. Increased transparency and clear public communications on the pursued reforms would mitigate the stakeholder risks. Macroeconomic risks are substantial, despite the country's relatively moderate public and publicly guaranteed (PPG) debt level and are due to: (i) a possible decline in growth related to deterioration in the external (including EU) prospects and political tensions in the region and (ii) possible delays in the implementation of consolidation measures, and accumulation of new contingent liabilities, in particular in case of potential early elections. Support provided by all international partners helps ensure that the

[5] In 2018, the pension deficit stood at 4.8 percent of GDP, arrears at 2.9 percent of GDP, and guarantees to SOEs at 8 percent of GDP.
[6] World Bank (2018) Public Finance Review found that the same output could be achieved with 13 percent fewer resources.
[7] World Bank (2018) FYR Macedonia Systematic Country Diagnostics. Namely, despite surge in the accumulation of capital and labor, North Macedonia's potential output declined from an average of 3.4 percent in 2002–08 to 2.5 percent in 2015–17 due to a fall in total factor productivity and human capital. Return on investment in North Macedonia has been sliding down continuously since the launch of the public investment stimulus program which may explain why rising investment post-crisis did not translate into faster economic growth.

authorities remain committed to their ambitious reform program and actively move it forward.

6. **North Macedonia has recently experienced an increasing number of natural disasters, such as floods and droughts, that exposed the vulnerable poor and the country's overall unpreparedness to respond to anticipated impacts of climate change**.[8] The World Bank 2014 Green Growth Country Assessment for North Macedonia places an urgent emphasis on climate action.[9] By supporting the introduction of excises on coal, gas and electricity and introducing incentives for cleaner fuels and development of renewable energy, the DPL directly supports the gradual shift towards using less emission-intensive sources of energy and contributes to fulfilling the country's Nationally Determined Contribution to the Paris Agreement.[10] In terms of adaptation, the proposed program will address the climate change vulnerabilities exposed in recent disaster events and strengthen the climate resilience within the population and adaptation efforts in the energy sector by (i) reducing local air pollution caused by energy-intensive power generation, (ii) improving energy security, and (iii) providing more reliable and affordable energy access to poor households which are particularly vulnerable to climate change.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

7. **North Macedonia is a small, landlocked, open middle-income country in the Western Balkans with gross domestic product (GDP) of $12.7 billion in 2018.** Trade in goods and services makes up 133 percent of GDP, with services accounting for about 55 percent of economic activity. Industry—energy, mining, and manufacturing—comprise about 18 percent of the economy; 55 percent of exports are generated by textiles and the import-intensive car production value chain. Agriculture makes up 7.2 percent of the economy and is a significant source of income for the southern, relatively less well-off, part of the country.

8. **The country has been able to preserve macroeconomic stability even in the presence of significant shocks**. Its exchange rate is de facto pegged to the Euro, introduced in 2000 as successor to the peg to German mark. It has successfully supported price stability, with inflation averaging 1.3 percent for the last 10 years. The National Bank of the Republic of North Macedonia (NBRM) has kept reserves above 4 months of imports to safeguard against threats to the peg in an environment of relatively high, though declining, euroization of household, corporate, and government balance sheets. The government continues to be committed to attracting green-field FDI in manufacturing to boost exports and keep the current account deficit low (Table 1). The trade deficit has gradually been narrowing, reaching 16.9 percent of GDP by 2018 on the back of exports surge to 60 percent of GDP since 2008. Yet, external debt

[8] Special Report of the Intergovernmental Panel on Climate Change: Global Warming of 1.5^{o} C. Extreme weather events in the last decade caused severe damage to infrastructure, loss of production and human life, and exposed the vulnerability of poor population, lack of DRM capacity and preparedness to respond to climate change impacts in all sectors of economy. Climate change projections for the region show an increase in the frequency and severity of extreme weather events and adverse effects of climate change.

[9] North Macedonia is highly vulnerable to climate change: it is at risk of increased temperatures, changed rainfall patterns and a decrease in annual precipitation, and increased natural disasters, such as floods and more severe droughts. Identified climate change risks for the energy sector include damage to energy infrastructure, decreased hydropower output and reliability and increased energy demand due to heat stresses and extreme cold. The government estimates that extreme weather events and adverse impacts of climate change could potentially reduce GDP by 6.5 percent.

[10] North Macedonia: Nationally Determined Contribution to the Paris Agreement.

is still high at 74 percent of GDP, of which roughly half is private, making the country vulnerable to tightening of external financing conditions.

9. **Post-crisis, despite the stimulus of heavy public spending, economic growth weakened** from an average of 4.3 percent in 2002–08 to 2 percent on average in 2009–17. Between 2009 and 2017, exports and investment each contributed an average of about 5 pp to annual GDP growth, and by 2017 rising exports helped narrow the CAD to 1 percent of GDP. Although most investment was private, and largely foreign, public investment rose from an average of 21 percent of total investment in 2002–08 to 26 percent in 2009–17. To offset the impact of the 2008 crisis, the government has since spent more on infrastructure and lowered the tax burden. It supported consumption with *ad hoc* pension hikes, reduced social contribution rates and costly employment schemes. It also invested heavily in roads and civil construction, which went up from 28 percent of total public investment in 2009 to 43 percent in 2017.

Table 1. North Macedonia: Economic Developments, 2012-18

Percent of GDP	2012	2013	2014	2015	2016	2017	2018
Real GDP growth	-0.5	2.9	3.6	3.9	2.8	0.2	2.7
Consumer prices (period average, %)	3.3	2.8	-0.3	-0.3	-0.2	1.4	1.5
Gross national savings	25.8	27.2	29.8	28.5	30.0	32.0	32.7
Gross investment	28.9	28.8	30.3	30.4	32.5	33.0	33.0
Unemployment rate, percent	31.0	29.0	28.0	26.1	23.7	22.4	20.7
Fiscal sector[1/]							
Revenues and grants	32.1	30.1	29.7	31.0	30.3	31.0	30.4
Expenditures	36.0	34.1	33.9	34.4	33.0	33.9	31.5
Primary balance	-3.0	-3.1	-3.2	-2.3	-1.5	-1.5	0.1
Overall balance	-3.9	-4.0	-4.2	-3.4	-2.7	-2.8	-1.1
Overall balance with the road agency	-3.9	-4.0	-5.3	-4.1	-3.8	-3.4	-1.6
Public debt[2/]	38.3	40.3	45.8	46.6	48.8	47.8	48.5
Of which: Public guarantees	4.7	6.3	7.7	8.5	8.9	8.3	8.0
External sector							
External debt	66.1	64.0	70.0	69.3	74.7	73.6	73.7
Of which: Private debt	39.7	37.4	36.74	37.0	39.1	39.1	38.7
Current account balance	-3.2	-1.6	-0.5	-2.0	-2.9	-1.0	-0.3
Foreign direct investment (net)	1.7	2.8	2.3	2.2	3.3	1.8	5.8

Note: 1/ General Government excludes fiscal accounts of the Public Enterprise for State Roads (PESR) from 2013 onwards. The alignment with the ESA2010 and GFS2014 has not yet taken place.
2/ Public debt does not include arrears amounting to 3.5 percent of GDP in May 2017 and 2.9 percent in December 2018.
Source: State Statistics Office, MOF, NBRM, and World Bank staff calculations.

10. **The fiscal stimulus measures pushed up public indebtedness.** Policy decisions eroded the tax revenue base; increased spending, although to a still moderate level (with roads, spending in 2017 was 33.9 percent of GDP); and thus widened the deficit and public debt.[11] Between 2008 and 2018, as the government borrowed more to cover larger primary deficits, and SOEs borrowed more to fulfill the government's investment agenda, PPG debt more than doubled, from 23 to 48.5 percent of GDP in a decade. The current debt level is already at the median for new EU member states and Western Balkan

[11] The general government has not incorporated the fiscal accounts of the state road agency since 2013. The Public Enterprise for State Roads (PESR) is a nonprofit entity which implements a central government investment agenda through borrowing backed by a sovereign guarantee, as well as tolls and a share in fuel excises.

countries.[12]

11. **By 2018, economic growth and jobs had been restored.** Supported by consumption and net exports, the economy recovered from near stagnation in 2017. While negative through September 2018, investments rebounded in the last quarter with the recovery of FDI (mainly automotive-related parts and electric machinery) and more public investment. The trends continued into early 2019 with real growth picking up to 4.1 percent in Q1 2019, with net exports, private consumption, and investments driving growth. The 2019 growth is thus projected to rise to 2.9 percent. Employment grew as jobs were created in manufacturing, transport and storage and professional services. Despite a rise in job creation, the Macedonian labor market still does not have enough jobs for people of working age, only 45.7 percent of whom are employed. Unemployment is high at 19.8 percent (a four-quarter average to March 2019), and labor-force participation is low, especially for those younger than 25, older than 55, and women.

12. **Bank lending has recovered, while despite improvements, financial sector vulnerabilities are present.** In 2017, total financial sector assets amounted to 89.8 percent of GDP, with 83 percent held by banks (currently 15 banks) and 10.5 percent by pension funds. In March 2019, capital adequacy was 17 percent; liquidity was high, with a ratio of liquid-to-total assets of 31.2 percent; and nonperforming loans (NPLs) had fallen from their 2008 peak of 12.1 percent to just 5.2 percent. Despite the good averages, stability indicators for individual banks vary as some small banks struggle with NPLs and operational efficiency.[13] NPLs are mainly corporate and highly concentrated: over 60 percent are owed by just 10 borrowers. At 48.2 percent, credit to the private sector relative to GDP has in recent years been growing steadily but continues to trail structural and aspirational peers, whose credit-to-GDP ratio is 60 percent. Most new credit has gone to households for mortgages and consumer loans; for corporations and SMEs credit growth has turned positive only in late 2017, despite their consistently high and increasing demand for loans.[14] While more loans are being granted in denars, the share of foreign currency and FX-denominated loans in bank loan portfolios is still above 40 percent.[15]

13. **External imbalance narrowed further in 2018.** The current account deficit (CAD) declined to 0.3 percent of GDP in 2018 compared to 1 percent in 2017 and stayed roughly at the same level in Q1 2019. The continued solid export performance of FDI-related industries like automotive parts and electrical machinery was accompanied by growth in more traditional exports, such as iron and steel, furniture, and apparel. This helped to bring the goods trade deficit down to 15.8 percent of GDP in March 2019. Services (mostly tourism, transport, and ICT) and transfers (workers' remittances) accounts were well in surplus, to a large extent offsetting the trade deficit. Net FDI inflows picked up strongly in 2018, to 5.8 percent of GDP. Over two-thirds of it was in the form of equity and reinvested earnings, and half of it went to manufacturing. Similar trends continued into early 2019, with FDI standing at 3.7 percent of GDP in March 2019, and FDI-related exports increasing by double digits.

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[12] In 2016 in the WB6 (Western Balkans) countries, average public debt as a share of GDP, which had been 26.6 percent in 2008, reached 51.6 percent, above the 50.2 percent average for new EU member states. Comparability issues arise because coverage of the general government budget falls short of the ESA2010 applied in the EU.

[13] North Macedonia adopted Basel III capital adequacy standards in 2017 and completed a self-assessment on the Basel Core Principles in 2018. In December 2018, the government adopted a strategy for better management of NPLs and government institutions are working to reform corporate insolvency regime and harmonize legislation with the EU Bank Recovery and Resolution Directive.

[14] Based on the periodic NBRM Bank Lending Survey *http://www.nbrm.mk/ankieta_za_krieditna_aktivnost-en.nspx*

[15] The Strategy on Denarization adopted in December 2018 pursues a number of policy measures to increase denarization through macroprudential and regulatory measures, consumer protection, development of domestic financial markets through government bonds and T-bills, financial education, and institutional reinforcement.

14. **The fiscal deficit declined in 2018, amid revenue growth and significant under-execution of capital investment.** General government revenues increased by 4.9 percent year-on-year (yoy) as social contributions, excises, and higher corporate and personal income tax revenues rose. Overall spending went down by 0.4 percent yoy, largely driven by the historically largest drop in capital spending. The general government deficit declined from 2.8 percent in 2017 to 1.1 percent of GDP. With Public Enterprise for State Roads (PESR) finances included, the deficit is estimated at 1.6 percent of GDP. Nevertheless, PPG debt increased to 48.5 percent in 2018 (from 47.8 percent in 2017), due to a new Eurobond issuance—at the historically-best terms of a 7-year €500 million bond at 2.75 percent—that fully covered government borrowing requirements for 2018 and secured a deposit for the 2019 financing. Aware of the high fiscal risks arising from pensions, arrears, and other contingent liabilities, as well as high refinancing needs in 2020-23, authorities adopted the Government Fiscal Strategy for 2019-22 (Box 1) proposing additional consolidation efforts to keep the primary deficit low (Table 2).

Table 2. North Macedonia: Government Fiscal Plans, 2018-22

Percent of GDP	**Outturn**	**Projection**			
General Government[1/]	**2018**	**2019f**	**2020f**	**2021f**	**2022f**
Total revenues	**30.9**	**32.5**	**31.6**	**30.6**	**29.9**
Tax revenue	27.1	27.6	27.0	26.5	26.1
Non-tax revenue	2.1	2.9	2.7	2.3	2.1
Capital revenues	0.6	0.6	0.6	0.6	0.5
Grants	1.1	1.4	1.4	1.3	1.2
Total expenditures	**32.0**	**35.5**	**34.0**	**32.6**	**31.9**
Current expenditures	29.4	30.4	29.3	27.9	27.0
Wages and salaries	6.3	6.4	6.2	5.7	5.4
Goods and services	3.4	4.3	3.9	3.7	3.5
Interest	1.2	1.3	1.2	1.2	1.5
Subsidies and transfers	18.6	18.4	18.0	17.3	16.6
Capital expenditure	2.6	5.1	4.7	4.7	4.8
Overall balance	**-1.1**	**-3.0**	**-2.3**	**-2.0**	**-2.0**
Primary balance	0.1	-1.7	-1.1	-0.8	-0.5
Public debt with guarantees[2/]	**48.5**	**51.7**	**52.3**	**50.8**	**49.1**
Of which: Guarantees	8.0	9.5	10.5	11.1	10.1

Note: 1/ General Government includes central and local governments fiscal transactions but excludes road agency since 2013.
2/ Government arrears (2.9 percent in December 2018) are not recorded in the public debt numbers.
Source: Fiscal Strategy 2020-22, MOF and World Bank staff calculations.

Box 1. Government Fiscal Strategy 2019-22

The Government Fiscal Strategy 2019-22 aims to contain fiscal risks. Adopted in May 2019, it proposes gradual fiscal consolidation, largely from sustained economic growth. The average real growth rate for 2019–22 is projected at 4.4 percent but reaching 5 percent by 2021. It assumes continued strong private consumption, a boost in investments (average growth of 5.5 percent in real terms 2019-22), an increasing contribution from net exports, and a small contribution from public consumption. The rise in private consumption is explained by a continued rise in real wages of over 2 percent and a continued rise in private employment. The medium-term fiscal strategy is for the central and local government and does not include the PESR.

The Fiscal Strategy foresees a moderation of public debt starting in 2021 (Table 2). It projects that the primary deficit will decline to 0.8 percent in 2021 leading to a decline in PPG debt to 50.8 percent of GDP after its peak in 2020, when highway construction ends. It also keeps the debt limit at 60 percent of GDP for PPG debt and a maximum 13 percent of GDP for guaranteed debt. The revenues will be boosted by progressive personal income taxation, and higher social contributions for pension and health insurance (by 0.4 in 2019 and 0.1 pp in 2020); it also calls for (i) stricter control of both the wage expense and employment; (ii) the reform of social benefits to improve their efficiency; and (iii) pension reform, to contain growth of spending. To support growth the government plans to increase agricultural investments and employment subsidies and capital spending on regional and local road rehabilitation, railway corridor VIII to Bulgaria, and gasification.

Source: Government Fiscal Strategy 2020-22, which covers 2019 as well.

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

15. **The macroeconomic outlook is moderately positive with annual average growth predicted to be about 3.4 percent through 2022** (Table 3). A gradual fiscal consolidation will have little negative impact on growth. Investment (including in the highway, and private investment in energy and tourism) will be the main driver of growth.[16] It will be supported by exports and personal consumption as employment picks up further and wages continue to grow, propelled partly by a higher minimum wage that will mostly affect private sector employees.[17] Job creation will support more sustainable growth of household consumption. Inflation is projected to average 2.0 percent through 2022 as domestic demand increases. Poverty is projected to decline to 20.5 percent by 2021, subject to private sector employment rebound, especially in construction and tourism.

16. **The Bank-projected medium-term fiscal deficit, after highways are completed, almost reaches a primary balance by 2022, setting the public debt of North Macedonia on a downward path.** With highway spending set to increase substantially in 2019–21, the overall deficit will remain high but will decelerate once the revenue and spending reforms (Box 1) bring savings and highway construction ends in 2021. Once the tax, social, health, and pension reforms are in place, the government is expected to

[16] In October 2013, Parliament approved the construction of two highway sections: Miladinovci-Štip (47 km) and Kičevo-Ohrid (57 km) in the amount of €579 million (7.1 percent of 2013 GDP). In 2014 the Chinese company Synohidro began construction. The work was suspended in 2016 due to poor design and technical difficulties. The construction had a cost overrun of about 1.5 percent of GDP that was negotiated in 2018 and works resumed. The first section was completed in June 2019.

[17] The Government announced two programs to fight informality estimated at 30-40 percent of GDP. A 15-percent paid VAT rebate to citizens upon submission of tax receipts, as well as co-financing of social security contributions to firms for formalizing wages, amounting to 0.8 percent of GDP a year are being introduced for a period of two years aiming to increase awareness and control of tax compliance and the formalization of wages. The cost borne for these programs will be accommodated within the current fiscal plans as envisaged in the 2020-22 Fiscal Strategy.

tighten its control over public finances just as past bonds come up for redemption in 2020–23. Correspondingly, PPG debt is projected to start declining from the 2021 peak of 54.9 percent of GDP to 54.4 percent in 2022. Net public debt will start heading down in 2021, reflecting a change in debt management policy to secure buffers for about two quarters of budget spending.

Table 3. North Macedonia: Macroeconomic Outlook, 2018-22

	2018	2019f	2020f	2021f	2022f
Real GDP (% change)[1/]	2.7	2.9	3.2	3.6	3.8
Contributions (pp)					
Consumption	3.2	1.5	1.4	1.3	1.6
Gross fixed investment	-2.2	1.2	1.7	2.0	1.8
Net exports	1.7	0.3	0.2	0.3	0.4
Unemployment rate	20.7	19.4	18.0	17.0	16.2
CPI period average	1.5	1.8	1.9	2.2	2.2
Fiscal accounts[2/]			*(Percent of GDP)*		
Overall general government balance	-1.1	-2.9	-2.4	-2.0	-1.8
Primary general government balance	0.1	-1.6	-1.0	-0.6	-0.3
Overall balance with roads[3/]	-1.6	-3.5	-2.8	-2.4	-2.1
Total revenues with roads[3/]	31.4	32.6	32.7	32.6	33.0
Total expenditures with roads[3/]	33.1	36.0	35.5	35.0	35.1
Public debt with guarantees	48.5	51.5	52.9	54.9	54.4
Balance of payments			*(Percent of GDP unless otherwise indicated)*		
Current account balance	-0.3	-1.4	-1.8	-1.5	-0.9
Trade balance	-16.9	-17.1	-17.1	-16.6	-15.7
Foreign direct investment (net)	5.8	4.3	4.5	4.7	4.8
Gross reserves in months of G&S	4.2	4.3	4.4	4.5	4.5
External debt	73.7	76.9	78.3	78.0	77.4
Other memo items					
Nominal GDP (in millions of Denars)	660,308	688,522	718,524	755,357	791,441
Nominal GDP (in millions of EUR)	10,735	11,194	11,681	12,280	12,867

Note: [1/] Bank staff projections. [2/] Fiscal projections take into account the government Fiscal Strategy but are Bank staff own projections. [3/] General government here includes PESR fiscal accounts, estimated for 2018–22.
Source: State Statistics Office, MOF, and NBRM; WB Staff estimates and projections.

17. **External imbalances and external financing needs are expected to remain moderate.** Annual external financing needs for 2019–22 will be about 5.4 percent of GDP (Table 4). As imports for highway construction taper off, the CAD will narrow to 0.9 percent of GDP from 2022 on. Growth in exports of car-industry-related products and of transport and tourism services are projected to remain strong if there are no terms of trade shocks. Yet, unless total factor productivity and competitiveness rise, potential growth will remain insufficient to support faster convergence with the EU. FDI is set to remain high for the next three years at 4.6 percent of GDP annually as the FDI subsidy program[18] gets implemented and

[18] The government Plan for Economic Growth provides aid to firms in industrial zones, greenfield investments, SMEs, and exporters.

new manufacturing, tourism, and energy projects take place. This would cover most of the external financing requirements.

Table 4. External Financing Requirements and Sources, Percent of GDP

	Outturn	Projections			
	2018	**2019f**	**2020f**	**2021f**	**2022f**
Requirements	**7.8**	**5.9**	**6.0**	**5.3**	**4.4**
Current Account Deficit	0.3	1.4	1.8	1.5	0.9
(of which scheduled interest payments)	0.7	0.7	0.8	0.8	0.9
Principal Repayments	2.3	2.3	2.2	1.7	1.6
Official creditors	1.4	1.4	1.6	1.3	1.2
Banks	1.0	0.3	1.7	0.2	0.2
Other private	0.0	0.6	-1.1	0.2	0.2
Increase in net official reserves	5.1	2.2	2.1	2.1	2.0
Sources	**7.8**	**5.9**	**6.0**	**5.3**	**4.4**
Foreign Investment (net)	5.8	4.4	4.6	4.8	4.8
Portfolio Investment (net)	3.0	-0.6	-0.4	-0.3	-0.5
MLT Disbursements	1.4	2.1	1.5	1.2	1.2
Official creditors	1.4	3.0	1.7	1.8	1.3
Banks	0.3	1.4	0.3	0.4	1.8
Other private	-0.4	-2.3	-0.5	-0.9	-1.9
Short-term & other capital (net)	-2.4	0.0	0.4	-0.4	-1.0

Note: External financing requirements and sources assume a short-term debt rollover; it is not shown in the data.
Source: State Statistics Office, NBRM, MOF, staff calculations.

18. **In the baseline scenario, public debt would grow by 6.5 percentage points of GDP between 2018 and 2021 before declining in 2022** (Figure 1). Much of the growth depends on disbursements for the highway construction. The gradual fiscal consolidation over the medium term envisaged in the 2019–22 Fiscal Strategy, with support from the DPL program, assumes that sustained political stability unlocked with the resolution of the name dispute, accession to NATO, and opening of the EU accession negotiations, will bolster confidence and accelerate growth. Public gross financing needs would peak in 2020–21 (at 8 percent of GDP a year) due to the general government's amortization of large Eurobonds. Per the government's borrowing strategy, these financing needs are expected to be met primarily by a combination of regular issuances on the capital market and the domestic market.

19. **The baseline scenario incorporating gradual consolidation has downside risks.** These risks include: (i) potential deterioration in the external environment, such as a more clouded EU outlook and regional geopolitical tensions that may lower economic growth more than projected and (ii) potential delays in realizing the planned consolidation measures, accumulation of new arrears, or activation of contingent liabilities. The second risk will be more pronounced in case of materialization of early parliamentary elections in early 2020. Standard stress tests suggest that potential growth decline would have the strongest impact on debt sustainability. With average GDP growth lower by 2 pp than in the government medium-term macro and fiscal scenario, by 2022 PPG debt would rise to 65.6 percent. A 15-percent currency depreciation would push PPG debt to 53.6 percent of GDP by 2020 and decline thereafter; interest rates higher by 200 bps would push public debt to 61.5 percent by 2022. A combination of the risks occurring, although highly unlikely, would push public debt to 70.5 percent. Without fiscal consolidation, in the medium term both public debt and gross financing needs would

continue to surge. This would not only increase financing costs, diverting resources from growth-promoting investments, but would also undermine North Macedonia's ability to respond to emerging economic or demographic shocks: (i) the current pension deficit is close to 5 percent of GDP and is being pressured by an aging population, (ii) public sector arrears, at 2.7 percent of GDP in March 2019, pose a risk of discontinued service delivery, and (iii) a rise in SOE indebtedness, currently 8 percent of GDP, is a substantial contingent liability.

Figure 1. Public and Publicly Guaranteed Debt, 2017–22, Percent of GDP

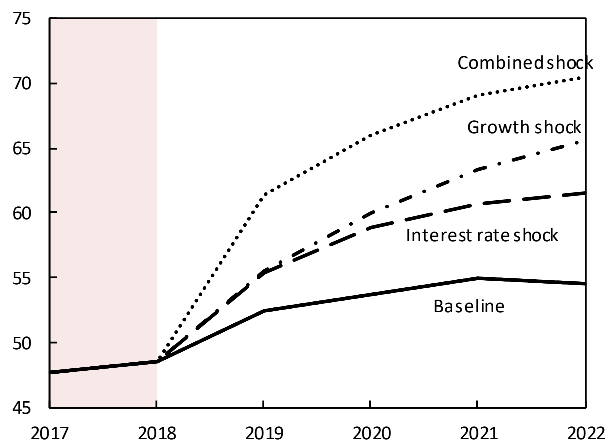
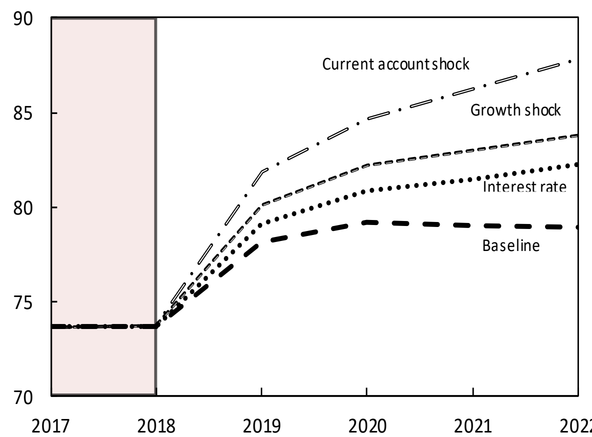


Figure 2. External Debt, 2017–22, Percent of GDP



Source: National authorities and World Bank staff estimates.

Note: The baseline scenario reflects the Bank's assessment of the fiscal and macro scenario. The 15 percent depreciation scenario assumes a one-time real devaluation of 15 percent in 2019. The growth shock scenario assumes average growth of 2.2 percent through 2022, down from 4.4 percent in the baseline. The interest rate scenario assumes a rise in interest rates by 200 basis points. The combined shock scenario assumes there is no fiscal consolidation, lower growth, a one-off depreciation, and a higher interest rate.

20. **Total external debt is projected to slightly increase compared to 2018** (Figure 2). However, the projections are moderately sensitive to changes in macroeconomic assumptions. Lower growth, of only 2 percent, and implicit interest rate shocks (a 30 percent rise) would push external debt to 83.8 percent and 82.2 percent of GDP by 2022, respectively. Yet, external debt is most sensitive to the CAD shock which if restored to historical averages of 3 percent of GDP would push debt close to 88 percent of GDP by 2022.

21. **Though North Macedonia has lengthened the maturity of its public debt, it is still exposed to refinancing and exchange rate risks.** As of 2018 total average time to maturity (ATM) was 5.2 years, up from 3.8 years in 2012. While the foreign currency portfolio ATM was 6 years, the domestic currency portfolio ATM was only 2.2 years—33.6 percent of its debt is short-term due to the high concentration of T-bills. The proposed DPL with ATM of 12 years will extend maturity of the public debt portfolio. In 2020–21, when Eurobonds mature, gross financing needs will be a sizable 7.5 percent of GDP. Also, with 43.4 percent of domestically issued government securities linked to the euro, foreign currency-denominated debt accounts for about 82 percent of public debt. This makes the country vulnerable to exchange rate risks. Maintaining the exchange-rate peg is thus a necessity for debt sustainability.

22. **Macroeconomic policy, although subject to the substantial risks described, is considered adequate for policy lending.** Staff considers the fiscal trajectory incorporated in the Fiscal Strategy 2019–22, supported by DPL program measures, to be appropriate to ensure medium-term improvement in

North Macedonia's fiscal and public debt positions. The country's exchange rate and monetary policies have been able to preserve macroeconomic, price, and financial stability even in the presence of significant shocks. The real exchange rate adequately supports price competitiveness, leading over the last few years to robust export growth and a reduction of the external imbalance.

2.3. IMF RELATIONS

23. **The government maintains an ongoing dialogue with the IMF, within Article IV surveillance, on macroeconomic policy in North Macedonia**, **with periodic exchanges on macroeconomic, fiscal, and structural reforms.** On January 23, 2019, the IMF's Executive Board concluded the 2018 Article IV Consultation with North Macedonia. The Directors welcomed the revival of reforms following the restoration of political stability, which has renewed confidence and resulted in a pickup in economic activity. They also underscored the importance of pursuing ambitious structural reform to lift productivity growth, accelerate income convergence, open up fiscal space, and rebuild external buffers. In the latest management assessment from August 7, 2019, the IMF emphasizes that growth is expected to firm up supported by a rebound in investments. While fiscal plans are achievable, staff expects the fiscal stance to ease somewhat in 2020 due to several policy initiatives currently considered by the authorities. However, public debt would remain sustainable under the baseline projection, but high gross financing needs and potential shocks to growth constitute downside risks (Annex 3).

3. GOVERNMENT PROGRAM

24. **Strengthening growth and creating jobs are the backbone of the Government Program for the period 2017–20.** The program seeks to improve the welfare of all citizens by strengthening economic growth and competitiveness, the rule of law, and governance, and improving the business climate, infrastructure, and human capital. It envisions increased spending on social transfers, education, health, and active labor market policies. The government has an ambitious program of investments in highways, roads, and railways, to overcome the disadvantages of a small landlocked economy, and in energy efficiency programs and support to small and medium-sized enterprises. The country ranks among the most energy-intensive economies in the Western Balkans because it has numerous energy-intensive local industries (iron and steel, ore extraction, and cement); poorly insulated buildings; inefficient household electrical appliances; and significant losses in electricity distribution. The Economic Reform Program (ERP) 2019–21 and the Fiscal Strategy 2019–22 operationalized the Government Program, setting its priorities in a coherent and sustainable macroeconomic and fiscal framework. Recognizing the *de facto* euro-pegged economy, the Fiscal Strategy is built on commitments to stabilize public finances by 2022 and strengthen growth prospects to ensure that gains in poverty reduction are not achieved at the cost of the prosperity of future generations.

25. **EU accession is the anchor of the government's reform agenda**. In 2005, North Macedonia became an EU Candidate Country and since 2009 the EC has been recommending opening of accession negotiations, but the name dispute with Greece meant the decision was continually postponed. After the dispute was resolved, in June 2018 the EU Council started the screening process for opening accession negotiations in 2019 by acknowledging the progress the country has made so far, though underlining areas where further progress is needed, among them judicial and public administration reforms and fighting corruption and organized crime. Moreover, in February 2019, NATO members agreed to sign an accession protocol with North Macedonia. As a candidate for EU membership, North Macedonia adheres to the EU Climate and Energy Policy and has, on a voluntary basis, submitted its Intended Nationally Determined

Contributions under the Paris Climate Agreement.[19] Intended mitigation policies and measures are directed to energy supply, buildings, and transport.

4. PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

26. **The proposed DPL program supports reforms to strengthen public finances, improve market competition, and reduce the regulatory burden in North Macedonia.** These reforms are consistent with the government's Fiscal Strategy and the ERP. Over the medium term, the government priorities are to reinforce macroeconomic stability, social equity, and competitiveness. The first set of government priorities is to be addressed through improving management and transparency of public finances; making public spending more efficient, especially spending on health, social assistance, state aid, procurement, and wages); and consolidating public finances through tax reform and pensions. Beyond fiscal consolidation, the ERP outlines the need to strengthen skills, the financial sector, and the business environment in particular by unlocking the energy sector monopoly, making public procurements more competitive, and reducing the cost of doing business by reforming inspection and insolvency processes. This operation directly supports a subset of these reforms. The program was prepared with coordinated support, including relevant technical assistance (TA), from the EC, the IMF, and USAID.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

27. The prior actions supported by this operation support a key subset of the reform agenda. While the team explored broader set of reforms with the authorities (for e.g., in health, education, state aid, and insolvency), the final list of prior actions was agreed upon the following criteria: (i) *government ownership* to pursue reforms in the short term, (ii) readiness for and access to capacity building and TA on for *reform implementation*, and (iii) the potential short-term *impact* of strengthening the country's public finances and competitiveness.

Pillar I: Strengthening public finances

28. **Stabilizing public debt and narrowing the long-standing fiscal deficits require efforts to mobilize additional revenues, make spending programs more efficient, and bolster public financial management (PFM).** The total fiscal adjustment supported by this operation amounts to 0.75 percent of GDP and is split between permanently reducing excessive spending and raising more tax revenues (Table 5). Regarding public spending, policy reforms in the areas of pension and social benefits aim to improve efficiency and fiscal sustainability of spending by consolidating a variety of social benefit programs and more accurately targeting the poor. Regarding revenue, tax reform aims to increase the low and eroding level of revenues, particularly from direct taxation, broaden the tax base by rationalizing tax exemptions and introducing progressivity into personal income taxation, while improving equity. In parallel, this DPL supports the strengthening of the institutional side of fiscal policy by improving control and monitoring of liabilities to prevent arrears re-accumulation. Currently World Bank-UK TA is helping to tighten commitment control through a new Organic Budget Law (OBL) and the integrated financial management system (IFMS).

[19] The country intends to reduce CO_2 emissions from fossil fuels combustion by 30 percent (36 percent at a higher level of ambition) by 2030 compared to the business-as-usual scenario.

Table 5. Fiscal Impact of the Supported Policy Measures by DPL, Percent of GDP

Policy Measure	Percent of GDP
Personal income tax reform	0.25
Social benefit reform (savings over the medium term)*	0.15
Of which: Means-testing of the parental allowance (over the medium term)*	0.23
Increase of the child allowance	-0.01
Guaranteed Minimum Benefit and Energy-Poor Program introduction	-0.07
Pension system reform	0.35
Of which: Increase of pension contribution rate	0.15
Total Savings	**0.75**

Note: *While means-testing of the parental allowance will be launched 10 months after the enactment of the law, the previously granted benefits will be respected until they expiry, i.e. child reaches the age of 10.

29. **Prior Action 1:** *Enactment of the amendments to the Law on Pension and Disability Insurance, the amendments to the Law on Compulsory Capitally Funded Pension Insurance, and the amendments to the Law on Compulsory Social Insurance Contributions to introduce price indexation of benefits, harmonize the accrual rates, and introduce a higher pension contribution rate to improve fiscal and social sustainability of the multi-pillar pension system.*

30. North Macedonia allocates about 9 percent of GDP on pensions resulting from high accrual rates and generous indexation pattern, despite the highest system dependency ratio (at 1.85, measured as the share of contributors to pensioners) in the region.[20] General taxes fund half of this spending because the contribution base is low. Without reform, pension system spending, and deficits, would continue to grow. At the same time, the multi-pillar system parameters have generated low multi-pillar pensions and created inter-generational imbalances.[21] Problems with administering the funded pension system have resulted in missing or excessive transfers of pension contributions to individual members, which has also undermined system reliability. Unless accrual rates are adjusted, and the contribution transfer problem is corrected, replacement rates for both voluntary and mandatory second-pillar participants will continue to be lower than for PAYG-only retirees.

31. The amendments to the Law on Pension and Disability Insurance,[22] the Law on Compulsory Capitally Funded Pension Insurance,[23] and the Law on Compulsory Social Insurance Contributions[24] in December 2018 address key weaknesses of the pension system including its fiscal sustainability, inadequate multi-pillar pensions, and missing or excessive contribution transfers to individual accounts in the funded pillar. With these changes the government has demonstrated its determination to maintain the three-pillar system. Measures oriented towards pension system fiscal consolidation and greater equity include: (i) the consumer price indexation of pensions (from 50-percent wage and 50-percent CPI indexation) with supplementary real GDP wage indexation in case of real GDP growing above 4 percent

[20] In 2017, pension expenditures stood at 10.6 percent of GDP, of which 8.6 percent of GDP accounted for pension benefits payment.
[21] The North Macedonia's pension system rests on three pillars: (i) a pay-as-you-go (PAYG) pillar; (ii) a second fully-funded mandatory pillar based on individual accounts; and (iii) a voluntary private open and occupational pension fund. Accrual rates for funded system participants are disproportionally lower than for the PAYG-only participants.
[22] Official Gazette 245/18 as of December 28, 2018.
[23] Official Gazette 245/18 as of December 28, 2018.
[24] Official Gazette 247/18 as of December 31, 2018.

per year,[25] (ii) harmonization of accrual rates by lowering accruals of participants in the old system for post-2018 service and raising service year accruals for multi-pillar participants,[26] (iii) repayment of all missing contributions and return of second pillar participants born before 1967 to the PAYG pillar,[27] and (iv) the pension insurance contribution rate increase by 0.4 percentage points in 2019 and again in 2020. While this package of laws will help address sustainability issues in the short run, given the aging population, what will be necessary in the long term are measures to tighten conditions for early retirement and raise the retirement age. The Government commitment to strengthen the pension system is reinforced by the preparation of a Bank-financed Social Insurance and Pension Administration project.

32. *Expected results.* Overall PAYG pension deficit reduced from 4.8 percent of GDP in 2017 to 4.45 percent of GDP in 2019.

33. **Prior Action 2:** *Enactment of the Law on Social Protection and the amendments to the Law on Child Protection to consolidate social assistance benefits, expand the coverage of the bottom quintile and protect the energy poor, while maintaining good targeting accuracy through the introduction of a Guaranteed Minimum Assistance program.*

34. Social assistance spending in North Macedonia, comparatively low at 1.2 percent of GDP, covers only one-third of the poorest quintile of the income distribution. Poverty is relatively high for North Macedonia's level of GDP per capita, and the poor have few opportunities to generate income. While coverage of the social assistance program is low, it is well targeted as more than 70 percent of all social transfers (Social Financial Assistance and other non-contributory social benefits) go to the poorest quintile of the income distribution. Spending is fragmented across several programs, and introduction of categorical programs such as the Parental Allowance (PA) has recently shifted spending to non-means-tested programs.[28] Cost-effectiveness is also a challenge, especially for programs like the PA, for which spending surges have not had the intended impacts on population growth. Moreover, Social Financial Assistance benefits are low, and financial incentives for social assistance beneficiaries to look for work are nonexistent. These gaps in program coverage leave many households stuck in poverty or vulnerable to returning to it.

35. In late 2018, the government launched social benefit reforms intended to improve the social assistance coverage of the poor while keeping targeting accurate. The new Law on Social Protection[29] and the amendments to the Law on Child Protection[30] enacted in May 2019 introduced a new Guaranteed

[25] In case real GDP grows above 4 percent, pensions are supplementary indexed with the difference.

[26] Net accrual rates in the multi-pillar system (0.75 and 0.86 percent for men and women, respectively) were lower than in the PAYG only (1.6-2.6 percent depending on service period and gender) and below the share of PAYG contributions (two-thirds of overall contributions). The reform reduced the PAYG accrual rate to 1.47 percent and increased multi-pillar rates to 1 and 1.14 for men and women.

[27] The return of second-pillar participants to the PAYG pillar, i.e., giving up individual savings in exchange for the full PAYG pension, is triggered by inability to reduce the old system accrual rates and alleviate them with the annuities generated by the mandatory savings. For a large majority of older mandatory members, the second pillar annuity could not compensate for the disproportionately reduced PAYG accrual rate. The discrepancy would be largely reduced for those under 50 who were mandated to remain in the second pillar and will start retiring in the early 2030s. Expected to leave the second pillar are about 18,000 individuals (6 percent of membership) with about €30 million in assets. For all the individuals who must remain in the second pillar the discrepancy between accrual rates form two pillars is expected to be eliminated.

[28] The PA was introduced in 2009 for mothers who gave birth to a third child. Compared to other social assistance programs, the benefit level is very high, MKD 8,362 per month, and is granted until the third child reaches the age of 10. The program costs close to 0.5 percent of GDP annually but goes to only 23 percent of the poorest quintile.

[29] Official Gazette 104/2019 as of May 23, 2019.

[30] Official Gazette 104/2019 as of May 23, 2019. The law was amended on July 17, 2019 (Official Gazette 146/2019), but

Minimum Assistance (GMA) program and consolidated existing social assistance benefits, as well as transformed the untargeted PA program into a means-tested one. The GMA is a means-tested program that provides a comprehensive social safety net for the poor and replaces all current means-tested social assistance programs.[31] The GMA level of support equals the difference between the household income and the established threshold which is set at MKD7,200 a month (EUR120 or around 28 percent of the median income) for a five-member family using an equivalence scale. It is estimated to benefit some 50 percent more households than was the case before the reform. In the short term, until the PA is gradually reduced, the additional costs are projected at 0.16 percent of GDP. The GMA households are now also entitled to a financial assistance in the amount of MKD1,000 per month to cover the energy cost during the cold period (October to March). This program will improve the energy security of primarily rural households and increase their climate resilience by providing more reliable and affordable access to energy. Better social protection will strengthen their resilience to weather-related natural disasters and the increasing adverse effects of climate change.[32]

36. With the amendments to the Child Protection Law, the government redesigned the Child Allowance (CA) program and introduced a new means-tested Education Allowance. CA eligibility is now delinked from the employment requirement and the benefit will be awarded to all households with children where income falls below the threshold. The monthly benefit will depend on the number and ages of the children and will range from monthly 1,000 to MKD1,900 per child, while the established threshold is set at MKD15,000 a month for a five-member family using an equivalence scale. At the same time, the monthly Education Allowances will cover both primary (MKD700 per student) and secondary (MKD1,000 per student) education levels.[33] The estimated additional outlays for these two programs in 2019 amount to 0.11 percent of GDP. The one-off assistance for a new-born will be provided to the first and the second child, while the reformed Parental Allowance that is to be launched 10 months after the enactment of the amendments to the Law on Child Protection introduces a means test for the applicant families, with the eligibility threshold set at the level of minimum wage for a previous year.

37. The government is replacing the current Permanent Financial Assistance for the elderly (over 65) without pensions with a long-term means-tested social protection program (Social Safety for the Elderly, established in a separate law), the amount of which will be set at 40 percent of the average pension (or EUR100). The estimated additional cost in 2019 is 0.04 percent of GDP. The reform supports the shift of government resources to more effective social assistance programs and thus increases the efficiency of public spending. It will raise the incomes of the bottom 40 percent of the population and over the medium term will help reduce poverty.

38. *Expected results.* Increased social assistance coverage of the bottom quintile overall and for female-led households from 33 and 22.6 percent, respectively, in 2016 to 50 and 40 percent, respectively,

changes made have not changed the substance of the DPL-supported reform program, nor the substance of the agreed prior action.

[31] These include Social Financial Assistance, Permanent Financial Assistance, and Financial Assistance for person who had a status of child without parents and parental care.

[32] In recent decades many communities have been severely affected by floods, long dry periods, and heat waves that damaged infrastructure, and loss of production, income, and human life. Floods and heat waves have led to the short-term increase in the number of deaths and the aggravation of certain chronic conditions, and stress on agriculture influenced the nutritional status of the poor, particularly children and the elderly. Natural disasters of recent decades exposed the extreme vulnerability of these groups to higher adverse effects of climate change, worsened by the low level of their social protection.

[33] The Education Allowance will replace the Conditional Cash Transfer program that currently benefits secondary school students.

in 2019.

39. **Prior Action 3:** *Enactment of the Law on Reporting and Monitoring the Liabilities to effectively identify and monitor arrears of the general government and the launch of the quarterly publication of reported arrears from September 2018.*

40. The fast accumulation of large arrears across the government has revealed some critical weaknesses in North Macedonia's current PFM system.[34] These weaknesses undermine both the confidence of private investors and public spending controls and accountability. The government PFM Reform Program 2018–20,[35] anchored in a new Organic Budget Law, is ambitious and comprehensive. The new budget law seeks to improve fiscal accountability and transparency by modernizing fiscal and arrears management. Specifically, it is designed to improve the institutional coverage of central and general government budgets and broaden the definition of the budget to cover all types of funding sources. It also foresees introduction of a Fiscal Council, a fiscal rule, and the inclusion of fiscal risks in the Fiscal Strategy. Moreover, the new law will broaden the functionalities of the Single Treasury Account system and introduce a commitment module. Fiscal transparency and accountability will be directly improved by enhancing the quality of fiscal accounting and reporting by alignment with international standards and extending the coverage of external audits of the final budget account. Consultations on the draft law have begun in June 2019.

41. The intent of the new law is to address critical, systematic deficiencies that in the past have permitted public arrears to accumulate. In the short-term, through the enactment of the Law on Reporting and Monitoring the Liabilities,[36] the government introduced a new arrears reporting system through a new software aiming to identify and take stock of arrears. As part of this new system, all public entities started reporting their liabilities and arrears on a monthly basis. This has allowed the MOF to start regularly publishing the reported arrears on a quarterly basis on their website since September 2018.[37] This also helped advance the public finance transparency agenda. The latest data on arrears available as of June 2019 suggests the general government arrears declined to 2.74 percent of GDP. The government can thus effectively identify and monitor central and local government arrears in the short term even before the new Organic Budget Law is enacted and becomes effective and new Treasury system functionality is fully in place. The new Treasury system will allow the MOF to effectively monitor all government commitments, payments, and invoices and thus prevent emergence of arrears. It will also help enforce the new multiannual budget ceilings.

42. *Expected results.* General government arrears reduced from 3.5 percent of GDP in 2017 to below 2.7 percent in 2019.

43. **Prior Action 4:** *Enactment of the Personal Income Tax Law to introduce progressive rate of 18 percent, remove exemption on capital income taxation and increase the rate to 15 percent, and reduce the allowed tax deductions, while increasing the personal tax allowance to protect the low-income households.*

44. Government tax revenues as a share of GDP has declined from over 29 percent of GDP in 2008 to 27 percent in 2018, putting pressure on the sustainability of public finances. The personal income tax (PIT) reform is intended to enhance public revenues; it broadens the tax base by reducing exemptions and

[34] At 3.5 percent of GDP in May 2017. Major sources of arrears are health sector, local governments, and SOEs.
[35] The Action Plan for Implementation of the PFM Reform Programme for 2018 was issued on February 28, 2018 https://www.finance.gov.mk/files/ACTION%20PLAN%202018_PFM%20Reform%20Programme_fev%202018_EN.pdf.
[36] Official Gazette 64/2018 as of April 2018.
[37] Website link: *https://finance.gov.mk/mk/node/7317.*

makes the tax system more progressive. North Macedonia collects only 2.4 percent of GDP from PIT, compared to averages of 3.7 percent in the Western Balkans and 9 percent in the EU28. Until 2018, its PIT schedule had no progressive rates; instead, it applied a flat tax rate of 10 percent and offered generous exemptions for capital and property income.[38] Deductions and exemptions for specific types of income were prevalent, regressive, and costly.

45. In December 2018, the Parliament enacted the Law on Personal Income Tax[39] that introduced a new marginal PIT rate of 18 percent for the labor incomes above a threshold of DEN90,000 a month (about EUR 1,500) corresponding to 26 percent of North Macedonia's GDP per capita. With nearly 99 percent of taxpayers earning less than this, a higher-income threshold would deliver both revenue and equity gains. To broaden the tax base, the government introduced a flat PIT rate of 15 percent for capital income and eliminated exemptions for interest earnings, insurance income, and capital gains from securities; it also cut tax allowances by at least 30 percent for rental income, capital gains, royalties, and authorship rights. This will improve progressivity because capital income is heavily concentrated at the top of the income distribution: it represents 34 percent of the richest earners' incomes and only 2.5 percent of the incomes of the poor. The PIT allowance also went up from 7,500 to 8,000 DEN a month to protect the low-income households. The PIT reform enables the government to mobilize revenues to support gradual fiscal consolidation; makes the North Macedonia tax system more progressive and broadens the tax base. More equity and higher revenue mobilization are expected to help fund higher-quality public services. Eliminating tax exemptions will also reduce the administrative cost of verifying exemption eligibility.

46. *Expected results.* Personal income tax revenues increased from 2.5 percent of GDP in 2017 to 2.7 percent of GDP in 2019.

47. **Prior Action 5:** *Enactment of the Law on Excises that introduces excise on coal, gas, and electricity.*

48. The government collects about 3.7 percent of GDP in excise duties, of which excise duties on diesel account for one-third.[40] Revenues from excise taxes in North Macedonia are lower than in peer countries and excise rates have yet to be harmonized with the EU. [41] In November 2017, the Parliament amended the Law on Excises to increase excise tax for diesel by DEN3 per liter as of January 2018. The reform brought the country's taxes on fuel closer to EU standards. A higher excise tax also discourages the consumption of fuel, and thus helps to reduce emissions, benefitting the environment. The introduction of an excise tax on coal, gas, and electricity, even though initially at a zero-rate until closer to EU accession, through the new Law on Excises[42] enacted in May 2019, enables the government to prepare the administrative processes to readily collect green-taxes once a positive rate is set.[43] The new law retains the current excise on coke and fuel but has expanded the list of affected products also to electric cigarettes and heat-not-burn tobacco, etc., which also will both bring in more revenue and discourage consumption of goods with negative externalities.

49. *Expected results.* Share of fossil fuel consumption subject to excise taxation increased from 57.5

[38] A PIT allowance of DEN 96,000 a year made the tax system slightly progressive: the effective tax rate would rise from 6 percent for low-income earners to 9 percent for the top earners.
[39] Official Gazette 241/18 as of December 26, 2018.
[40] An additional 0.4 percent of GDP in fuel excises is directly collected by the PESR.
[41] Revenues from excise duty in 2017 were 5.3 percent of GDP in Montenegro and 4.2 percent in Croatia.
[42] Official Gazette 108/19 as of May 28, 2019.
[43] In 2017, less than 58 percent of fossil fuel consumption was taxed by excises. After the reform, this share will increase to close to 93 percent (*http://www.stat.gov.mk/pdf/2018/6.1.18.60.pdf)*.

percent in 2017 to 92.9 percent in 2019.

Pillar II: Improving market competition and reducing the regulatory burden

50. Political turmoil, under-execution of the public investment program, and lack of dynamism in the private sector brought the economy to a halt in 2017. However, even before the political turmoil, firm productivity and the rate of return on capital had both been trending down for a while—despite the country's rank among the top 10 for ease of doing business and generous incentive packages had attracted considerable FDI. An overreliance on fiscal stimulus for growth has made the economy more vulnerable. North Macedonia's growth potential needs to be unlocked by removing obstacles to market competition and market entry, increasing job creation and firm capabilities, and reducing the administrative burden on businesses. Over the medium term, encouraging competition in product markets through the public procurement reform, in critical backbone service sectors such as energy sector, as well as removing barriers to business conduct would also help unlock the economy's potential.

51. **Prior Action 6:** *Enactment of the Energy Law to deregulate electricity generation, open the electricity supply market for all customers, and introduce competitive-based support mechanism for renewable energy generation.*

52. Until 2018, only about half of the electricity market, mostly industrial and large commercial consumers, was liberalized. Before markets were opened, small businesses were not able to choose an electricity supplier based on market competition, and their prices were set by the Energy Regulatory Commission. Within the regulated market, commercial consumers were subsidizing households: in 2018, single-tariff household consumers paid half of the business consumer price of 8.63MKD/kWh. All residences and small businesses are still supplied through a regulated market, with its power generated by the state-owned company ESM (formerly ELEM). But Energy Community Treaty obligations now require North Macedonia to transpose EU directives to the internal electricity and gas market. This legislation, known as EU's Third Energy Package, aims to further open energy markets for competition.

53. The new Energy Law[44] aims to open the electricity supply market to competition. It foresees several reforms, including deregulation of both generation and supply markets to allow all electricity and gas customers to freely select their suppliers. The Third Energy Package also requires the unbundling of ownership of power companies. While the electricity supply market will be fully open to all consumers, including households, it is envisioned that deregulating the supply of the Universal Service Supplier will take seven years. In 2019, the largest electricity generator (ESM) must provide no more than 80 percent of total annual electricity needs to the universal supplier, with the amount gradually reduced to 30 percent by 2025. The consumer market was opened in January 2019. The new law also takes into account the need for the government to put in place annual programs to protect the energy-poor (vulnerable consumers) who are now covered by social assistance. The Energy Law also seeks to promote investment in renewable energy through feed-in premiums. in line with the EU Directive on promoting use of energy from renewable sources. The premium support mechanism for renewable energy envisages that the government will pay the difference between the market price and the fixed premium guaranteed for new investments in renewable energy. Because of the possible financial burden for the government, it will need to be assessed carefully. The reform will, over the medium term, level the playing field for electricity suppliers in a backbone service that is critical for the country. This is expected to ensure that electricity

[44] Official Gazette 96/2018 as of May 28, 2018. The law was amended on May 17, 2019 (Official Gazette 96/2019), but changes made have not changed the substance of the DPL-supported reform program, nor the substance of the agreed prior action.

pricing for North Macedonian firms, especially small businesses, is competitive. It will also support climate change mitigation by reducing greenhouse gas (GHG) emissions through cleaner sources of energy and contribute to achieving the country's priority adaptation goals by building up climate resilience in the energy sector.

54. *Expected results.* Percentage of electricity consumers able to choose an electricity supplier at the open market increases from 50 percent in 2018 to 100 percent in 2019.

55. **Prior Action 7:** *Enactment of the Public Procurement Law to strengthen transparency and increase private sector competition in public procurement.*

56. Increasing competition and transparency in public procurement would make public spending more accountable and increase private sector competition. By 2018 the law relating to public procurement had several elements that undermined competition because they were burdensome for bidders, especially smaller companies. Improvements in PFM, including public procurement, is also a priority for accession to the EU. The goal of the reform is to establish an effective procurement system aligned with the EU *acquis*, with a comprehensive and well-structured Public Procurement Law based on sound principles. More competitive public procurement is expected to help level the playing field for firms, which is critical to boost North Macedonia's competitiveness and unleash the country's growth potential.

57. The Public Procurement Law enacted by Parliament in January 2019[45] aims to increase competition among private sector bidders in public procurement. Among other provisions, it (i) strengthens the principle of proportionality to ensure direct correlation with the subject of a public procurement contract when defining minimum requirements and eligibility criteria, (ii) makes e-auction optional rather than mandatory (in particular for specific professional service procurement that rewarded price rather than quality aspects), and (iii) adds quality (Most Economically Advantageous Terms) to lowest price as a criterion for contract awards. In the past lowest prices were often misused to get very low bids accepted that were later re-negotiated up in annexes to the contracts. The new law also encourages more bidders to participate by introducing an e-marketplace and e-catalogue for small-value procurements; mandates publication of annual public procurement plans; and creates an e-appeal system and an *ex ante* control role for the Public Procurement Bureau—all of which have already been put in place.

58. *Expected results:* Average number of bidders per competitive procurement procedure increased above 3.41 achieved in 2017.

59. **Prior Action 8:** *Enactment of the Inspection Supervision Law to introduce (a) risk-based inspections, (b) a provision for inspectors to issue warnings, and (c) a grace period for businesses to correct first-time infractions.*

60. The current system of inspections creates uncertainty for investors and discourages the entry of new firms and the growth of incumbent firms. Lack of a risk-based approach has led to excessive visits and sampling by inspection authorities. As a result, firms with low risk profiles are often subject to more inspections than is economically beneficial, at a high cost in management and staff time to deal with inspectors' requests and high numbers of sanctions for minimal infractions. Moreover, the law has been inconclusive about issuing warnings, so that usually sanctions are immediately imposed. There is also a

[45] Official Gazette 24/2019 as of February 1, 2019.

broad range of fines (e.g., from EUR200 to EUR5,000) and inspectors have considerable discretion in defining the amount. Overlapping mandates and fragmentation further raise uncertainty. A USAID-funded project on modernizing inspections found, for instance, that different inspectors from the same inspectorate interpreted the same issue at a business premise differently. The Council of Inspection Authorities overseeing all inspectorates has a weak mandate as it may order inspectorates to conduct a specific inspection, but it cannot take actions on the reports and decisions of the inspectorates.

61. The Law on Inspection Supervision[46] enacted in May 2019 for the first time introduces risk-based planning of the inspections conducted by different inspectorates. It also introduces checklists and other mechanisms that substantially increase inspection predictability and transparency so that businesses are aware of inspection requirements. Importantly, it also requires inspectors to issue warnings except where infractions are causing or can cause an immediate threat to human life and well-being, to the environment, or to the public interest; and to provide a grace period for corrective actions. The magnitude of fines is slashed by half across the board. The new law harmonizes the Laws on Inspection Supervision and on General Administrative Procedure and gives the Council of Inspection Authorities the ability to resolve issues with inspectorates in ways consistent with international good practice. Within six months the Council is required to issue bylaws to define methodologies and operating procedures and to create capacity for data collection and risk assessment, such as IT systems or profiles of firm and product risk.[47] Over the medium term, a more transparent and business-friendly inspection system is expected to facilitate the entry of new firms and reduce the uncertainty and operating costs of current firms.

62. *Expected results.* Risk-based inspection introduced in at least three inspectorates relevant for businesses by mid-2020.

Table 6. DPL Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Pillar I: Strengthening public finances	
PA1. Enactment of the amendments to the Law on Pension and Disability Insurance, the amendments to the Law on Compulsory Capitally Funded Pension Insurance, and the amendments to the Law on Compulsory Social Insurance Contributions to introduce price indexation of benefits, harmonize the accrual rates, and introduce a higher pension contribution rate to improve fiscal and social sustainability of the multi-pillar pension system.	Government PFM Reform Program 2018-20 Economic Reform Program 2018-20 WB (2018). North Macedonia Public Finance Review analyzed the sustainability of the pension system. WB (2018). TA on Pension System Reform elaborated on the implementation aspects.
PA2. Enactment of the Law on Social Protection and the amendments to the Law on Child Protection to consolidate social assistance benefits, expand the coverage of the bottom quintile and protect the energy poor, while maintaining good targeting accuracy through the introduction of a guaranteed minimum assistance program.	Government PFM Reform Program 2018-2020 Economic Reform Program 2018-2020 WB (2018). North Macedonia Public Finance Review analyzed the equity and effectiveness of social assistance. WB (2018). TA on Social Assistance helped with the reform design.

[46] Official Gazette 102/2019 as of May 22, 2019.
[47] Through its Programmatic Competitiveness Development Policy Loan series (2012–14) the World Bank supported piloting of risk-based inspection in the Food and Veterinary Agency and the State Health and Sanitary Inspectorate. The methodologies and operating procedures developed there serve as models for other inspectorates. The Inspection Council and individual inspectorates will also receive substantial training on risk-based inspection.

PA3. Enactment of the Law on Reporting and Monitoring the Liabilities to effectively identify and monitor arrears of the general government and the launch of the quarterly publication of reported arrears from September 2018.	Government PFM Reform Program 2018-2020 WB (2018). North Macedonia Public Finance Review analyzed the public finance management aspects.
PA4. Enactment of the Personal Income Tax Law to introduce progressive rate of 18 percent, remove exemption on capital income taxation and increase the rate to 15 percent, and reduce the allowed tax deductions, while increasing the personal tax allowance to protect the low-income households.	Government PFM Reform Program 2018-2020 Economic Reform Program 2018-2020 WB (2018). North Macedonia Public Finance Review analyzed the progressivity of the personal income taxation and tax exemptions.
PA5. Enactment of the Law on Excises that introduces excise on coal, gas, electricity, electric cigarettes and heat-not-burn tobacco.	Government PFM Reform Program 2018-2020 Economic Reform Program 2018-2020
Pillar 2: Improving market competition and reducing regulatory burden	
PA6. Enactment of the Energy Law to deregulate electricity generation, open the electricity supply market for all customers, and introduce competitive-based support mechanism for renewable energy generation.	WB (2018). FYR Macedonia Systematic Country Diagnostic analyzed the energy sector challenges and the competition aspects. EC (2018). North Macedonia Country Report
PA7. Enactment of the Public Procurement Law to strengthen transparency and increase private sector competition in public procurement.	WB (2018). FYR Macedonia Systematic Country Diagnostic analyzed the market competition aspects. WB (2017-18). TA on Public Procurement helped with the e-procurement introduction. EC (2018). FYR Macedonia Country Report outlined the EU acquis harmonization gaps.
PA8. Enactment of the Inspection Supervision Law to introduce (a) risk-based inspections, (b) a provision for inspectors to issue warnings, and (c) a grace period for businesses to correct first-time infractions.	WB (2018). FYR Macedonia Systematic Country Diagnostic analyzed the business barriers aspects. WB (2012-14), the Programmatic Competitiveness Development Policy Loan

4.3. LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

63. **The proposed operation is fully consistent with the Country Partnership Framework for the period January 2019-June 2023**. The proposed policy program helps the authorities to reinforce PFM, strengthen the stability of the economy, and unlock private sector growth. By supporting fiscal sustainability and promoting market competition—among priorities identified in the 2018 Systematic Country Diagnostic—the operation enforces elements that are critical for sustaining shared prosperity. Such reforms are necessary to avoid abrupt adjustments that could reverse the welfare gains of Macedonians.

64. **The DPL builds on current and earlier operations in North Macedonia**. The Programmatic Competitiveness PBG focused on business reforms, the Public Finance Reviews of 2015 and 2018 on building PFM institutions, tax policy, and public spending efficiency, and the ongoing Social Services Improvement Project on, among other elements, strengthening social benefit programs. TA on public procurement, pension reform, and the organic budget act has informed policy actions in these areas.

4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

65. **North Macedonia has in place a solid framework, recently renewed, for consultation with the public on proposed laws**. Since 2008, the Rules of Procedure of the Government of the Republic of North Macedonia have mandated public consultation on all new laws and strategies; there is a website (ENER)[48] for disclosing draft laws for consultations, as well as the regulatory impact assessment (RIA) of the draft laws that are under preparation and proposed to be adopted by the Parliament. There are a few exceptions to the consultation requirement, such as urgent procedures, international agreements, and draft budget and budget execution laws. The Methodology for RIA (from July 30, 2013 and amendments thereof) defines necessary steps for conducting an RIA; it specifies a minimum of 15 day-notice for consultations, involvement of all stakeholders, organizations, and management in the RIA process, and the role and tasks of each participant. All the laws supported by the DPL went through such consultation process, although for the PIT law, at the late stage of the process.

66. **The World Bank has collaborated closely with other development and social partners.** For instance, IMF and Bank staff have sought each other's input in their internal review processes. Further, the Bank also coordinated closely on the reforms with the EU Delegation and the Directorate General ECFIN of the EC; USAID on inspection reforms; and the Energy Community in Vienna on energy reforms. Employer associations were also consulted on market competition and regulatory reforms.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

67. **The overall program is expected to yield positive poverty and social impact in the medium term.** It addresses issues such as fiscal sustainability critical for sustainable poverty reduction and shared prosperity. The social benefit reform will have the highest positive impact on the poor. The introduction of the better-targeted Guaranteed Minimum Income with an increased threshold and benefit will have positive direct social impact on the poor. The reformed Parental Allowance will also be better targeted to low-income households, and with the strengthened Child Allowance system, will relieve child poverty. Reforming social benefit elements that discourage employment should have positive impacts on labor market engagement and labor income, employment being the most important channel for sustainably reducing poverty. The energy law requires the government to develop annual energy poverty programs to protect vulnerable customers, while pension reform aims to keep replacement rates from declining in the future. The PIT reform will have a positive, though very small, impact on reducing income inequality: the proposed introduction of a progressive rate will affect only the top 1 percent of tax payers; and raising the nontaxable part of income will boost the incomes of the bottom 40.

68. **The country's previous fiscal system reduced poverty but not inequality**.[49] While both dropped, the former due to employment growth rather than improved distributional impact of the fiscal policy. By international standards North Macedonia has relatively high inequality, with the Gini coefficient of market income after taxes and benefits at 35.9 percent. Pensions and social payments have a considerable positive impact on poverty alleviation: the share of Macedonians living in poverty declines from 42.3 to 22.7 percent when pension and social payments are taken into account. Within this decline, pensions

[48] https://ener.gov.mk/.

[49] MK-MOD is the tax and benefit microsimulation model, built and maintained within an initiative of Finance Think by Skopje Economic Research & Policy Institute' it has been used to simulate the impact of policy reforms based on the 2016 Survey on Income and Living Conditions.

contribute with 16 pp and social transfers only 3 pp.

69. *Personal income tax reform.* The personal income tax reform has positive, though very small impact on reducing income inequality. In 2019, North Macedonia abandoned the flat tax system that had been in force since 2007. To improve social justice and strengthen income equality, it introduced a mild progression and a higher capital gains tax (by raising the rate to 15 percent and reducing exemptions). Both changes mainly affect the top two quintiles; the 10 percent rate is retained for monthly incomes below MKD90,000. Further, the PIT allowance—the nontaxable part of income—was raised from MKD 7,531 to MKD 8,000 MKD per month. Simulation of the impact shows that tax reform improves the Gini coefficient of final disposable income (after transfers and pensions) by an incremental 0.02 pp. The relatively small change in the Gini coefficient is because the reform is mainly directed to the top 1 percent of earners by reducing their disposable income and simultaneously expands the tax allowance for all wage earners, increasing their disposable income. Poverty remains largely unchanged.

70. *Social benefits reform.* The reform will have significant positive distributional and poverty impact. The average income of the poorest decile doubles and that of the second decile goes up by 4 percent. For wealthier deciles, the effect is expected to be neutral. Social benefit reform is reducing Gini by 0.5 pp (Table 7). The changes in social assistance, such as child allowances, also reduce poverty; the poverty rate at US$5.5/a day drops by 3.6 pp and at US$1.9/day drops by 2.9 pp. The government has (i) replaced the current fragmented system of social benefits with a more unified GMA system with more people eligible and a higher benefit, (ii) increased the amounts and coverage of the child and educational allowances and introduced means-testing of the parental allowance, and (iii) introduced a social safety net for those older than 65. The GMA gives higher weights to single parents and disabled persons (at 1.5 of an equivalent adult). Recipients of guaranteed assistance and elderly social support are also entitled to a monthly energy allowance of 1,000 MKD for October through March (the impact is discussed at paragraph 72). The number of recipient households increases by almost 50 percent, and the number receiving child and educational allowances quadruples. Compensation for the PA reform is generous. Current PA beneficiaries continue to receive the same monthly benefits until the third child is 10. The same condition holds for all women who become pregnant within 10 months after reform of the PA was enacted. The new scheme, to be means-tested, is expected to improve targeting efficiency—currently only 23 percent goes to the lowest decile.

71. *Pension reform.* The pension reform will have a small but positive impact on poverty, although the slight increase in the pension contribution will slightly offset that. The reform raises the pension contribution, harmonizes accrual rates, and indexes benefits to prices. Only 4 percent of old-age pensioners, 10 percent of survivor pensioners, and 18 percent of those on disability live in households in the two poorest deciles. Thus, the proposed reform will have small impact on poverty reduction. The rise in pension contributions will reduce the poverty reduction effect of pension reform by 0.1 pp. However**,** the new option of employees born before 1967 returning to the first PAYG pillar lifts the replacement rate for minimum wage-recipients, which may help reduce poverty.

Table 7. Inequality and Poverty Effects of Social Reform

Change due to Social Reform (percentage points)	**Guaranteed Minimum Assistance**	**Child and Educational Allowances**	**Social Pension**
Gini coefficient	–2.2	–0.5	–0.5
Poverty rate (under $5.5/day in 2011 PPP)	–5.1	–2.9	–3.6

Source: Authors' calculations based on SILC 2016.

72. *Energy sector reform*. The energy tariff structure is expected to be reformed as part of the sector reform. Apart from deregulation of prices and elimination of subsidization of households by higher commercial prices, what happens with prices will depend on the growth of demand for electricity and gas and on planned investments in hydropower and power generation from renewable sources. While the deregulation of residential tariffs is gradual, and the impact is not expected to be as high as in neighboring countries—ELEM/ESM wholesale prices are closer to prices on the open market—introduction of a program for energy-poor vulnerable customers, the GMA beneficiaries, would protect the poor against higher energy costs. Simulations suggest that fully compensating the bottom 20 percent (equivalent to the share of the poor) for an assumed energy price increase of 10 percent could reduce poverty below the pre-increase level but could raise the cost to the national budget by 0.10 percent of GDP. Without the energy-poor program, higher energy prices could worsen poverty by about 1.4 pp.

73. **Gender dimensions**: There is a direct positive impact of the social benefit reform on female-headed households. Social benefit coverage of bottom-quintile female-led households is expected to rise from 22.6 to 40 percent or more. Means-testing for the parental allowance will not worsen female poverty because the threshold is set high, at the minimum income level, and the reformed child allowance system will expand coverage to the poorest 40 percent of the population. Over the medium term, PA reform is expected to improve female labor force participation, which, at 44.7 percent in 2018, trails that of men by over 24 pp. The World Bank intends to continue engaging with the government to monitor implementation of the legislated social benefits and child allowances.

5.2. ENVIRONMENTAL ASPECTS

74. **This operation is expected to have positive environmental impact.** Direct positive impact on the environment is expected through three prior actions related to the introduction of excises on coal, gas and electricity (PA#5), social benefit reform (PA#2), and the energy law (PA#6). The DPL-supported reforms will also contribute to mitigation and adaptation measures to combat adverse climate impacts. The new Law on Energy will deliver climate change co-benefits by (i) introducing a more competitive support scheme for renewable energy investments; and (ii) promoting adaptation by requiring that energy poverty be addressed. The excises on coal, gas, and electricity should reduce the consumption of goods with negative environmental externalities (even at the time they are set to zero, as it might lead to increased awareness of the higher cost) and thus help reduce emissions and make the energy sector more resilient to climate change. Finally, the social benefit reform would contribute to climate change adaptation by addressing households vulnerabilities to the anticipated effects of climate change exposed in recent weather disasters. Recent climate related disasters affected the poor and vulnerable parts of the population at the hardest and increasing resilience of such parts of the population to the anticipated increasing numbers of adverse events is among the country-specific adaptation priorities. These parts of Macedonian population will benefit from the improved energy security and more reliable and affordable energy supply.

75. **The quality of the institutional and legal framework for protection of North Macedonia's environmental resources (e.g. forests, water resources, etc.) and natural habitats is sound.** The Ministry of Environment and Physical Planning (MoEPP) is the principal government agency responsible for environmental protection policies related to air, soil, water, waste management, biological diversity, natural resource management, and climate change. Other environmental protection mandates have been assigned to the Ministries of Agriculture, Forestry and Water Economy, Health, Science, and Transport and Communication. The MoEPP's State Environment Inspectorate monitors environmental performance and enforces environment-related laws. The environmental monitoring function is shared with other

government agencies and local governments; however, the capacity to carry out this responsibility remains insufficient especially at the local level. The Law on the Environment (2005) and subsequent regulations created the legal and institutional framework for environmental assessment in compliance with the EU EIA Directives. Considerable progress has been made in advancing horizontal legislation (e.g., EIA, SEA), moving the climate change agenda forward (GHG inventory, CDM/JL national strategy), and controlling industrial pollution. However, major efforts are still needed to ensure full compliance in such areas as air and water quality and waste management. A number of short-term priorities have been identified, among them enforcement of the laws, environmental monitoring, and building administrative capacity, both national and local.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

76. **The PFM system is reliable, and the government is committed to continued strengthening of the system.** While North Macedonia's public financial management (PFM) and public procurement systems are relatively sound, they have several shortcomings that call for improvement. In 2018, the government adopted a Public Finance Management Reform Program 2018–21, which seeks to reinforce PFM and promote transparency, accountability, fiscal discipline, and efficiency in the use of public resources to enhance service delivery and economic development. The inadequacy of commitment control and monitoring and of fiscal risk oversight constrain the system's performance with important impacts on its fiscal performance. Remedies for those shortcomings include strengthening the treasury information system so it can record and monitor commitments, building up MoF capacity for macro-fiscal forecasting, adopting a comprehensive medium-term budget framework linked to the fiscal strategy, and making the activities of SOEs more transparent by publishing all SOE financial reports. The detailed central government budget is made available to the public in printed form and on an external website, while the general government budget is made available on the external website in more aggregate form.

77. **The internal audit system continues its progress on implementing the public internal financial controls required for EU accession**. The laws and regulations are in place and coverage of internal audit and financial controls is expanding. All first-level budget institutions now have internal audit units. Although the PIFC law and the related manuals comply with international standards, both the quality of audits and management responses to internal audit recommendations still fall short. According to the Central Harmonization Unit 2016 report, only 36.3 percent of all internal audit recommendations were adopted. This is in part because of management inaction in addressing the irregularities identified, but also in part because some recommendations were not articulated clearly and were too general.

78. **The Single Treasury Account is held in the NBRM and is operated in a reliable environment.** No additional fiduciary arrangements including audit are required for the operation, given the progress in PFM reforms, the clean audit opinion provided in NBRM-audited financial statements, and the positive assessment of the capacity of the Treasury. The Treasury Euro account forms part of the country's foreign exchange reserves. In terms of external audits, there has been progress in strengthening the State Audit Office, which is independent of the executive branch and is mandated to cover all public-sector activities. The proposed DPL will follow standard World Bank disbursement procedures. The Bank will not disburse funds unless it is satisfied with the Program being carried out by the North Macedonia, and with the adequacy of its macroeconomic policy framework. The DPL will be deposited to the Treasury account in EUR currency. The MOF will report to the Bank within 15 days that an equivalent amount has been accounted for in the Borrower's budget management system.

79. **Public procurement in North Macedonia rests on sound foundations***.* The central procurement institutions are the MOF Public Procurement Bureau (PPB), the State Appeals Commission, the MOF, the State Audit Office, and the Administrative and Higher Administrative Courts. The PPB is responsible for the development, implementation, and coordination of the entire public procurement system: normative issues, development of e-procurement, publishing notices, international cooperation, and EU integration issues. The PPB owns and manages the national e-procurement system, Electronic System for Public Procurement; all public entities must use it to publish procurement and contract award notices, together with the necessary tender documents, which registered economic operators can download. The 2019 Public Procurement Law is fully aligned with EU legislation.

5.4. MONITORING, EVALUATION AND ACCOUNTABILITY

80. **The MOF is responsible for coordinating the proposed operation.** The line ministries have major roles in implementing the actions set forth in the policy matrix (Annex 1) and have been coordinating the technical support requirements with development partners. The results indicators set out in Annex 1 will be used to monitor progress. The Bank, in collaboration with the North Macedonian authorities, will monitor and evaluate the program's achievement of these results.

81. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

82. **The proposed operation faces substantial overall risk, with political and governance, stakeholder, and macroeconomic risks assessed as substantial, and fiduciary, technical, environmental/social, and sectoral risks as moderate.**

83. ***Political and governance risk***: These risks stem from political pressures associated with achieving the proposed reforms in the coalition government that came into power in May 2017. With resolution of the country's name dispute, the NATO accession process has been opened and accession negotiations with the EU are expected to open in 2019. However, delays on that front and weaker than expected economic growth could undermine public support for reforms. Public discontent against reforms might reduce public support for the government's agenda, which would reduce the government's ability to launch and sustain the needed fiscal and structural reforms. This could also lead to calls for snap elections. Loss of support for the government's agenda of better managing public finances could induce the loss of consumer and investor confidence and exacerbate financial market volatility. The EU accession negotiations and overall improved economic governance help ensure that reforms stay on course.

84. ***Stakeholders risk.*** Some stakeholders affected by the tax policy, pension, and social benefits

reform, such as those affected by the redesign of the parental allowance (PA) for families with three children, may express discontent despite generous compensatory actions, such as granting the right to current beneficiaries until scheduled expiration, and increased coverage and higher guaranteed minimum income and child allowances. The PA will also be available on the same terms to all women who become pregnant within one year after the reform is passed—a decision in fact made to address possible discontent. A clear communication strategy, engaging with all affected stakeholders, adopting compensatory measures, as in the PA case would mitigate these risks. Achieving sustainable results in combating climate change through the reforms of the energy sector and excises will depend on enhanced sector management and effective enforcement of the new regulation. The country's resilience to shocks, particularly preparedness to counteract the risks of natural hazards and climate change, to which the country is highly vulnerable, is an area that requires more intensive effort.

85. ***Macroeconomic risk:*** Lower economic growth than expected would make it more difficult to achieve the operation's expected results. With the EU the country's main trading partner, slower EU growth than expected could dampen recovery of North Macedonia's economy, straining public finances and negatively affecting the fiscal and debt consolidation agenda. Given the increasing share of US$-denominated public debt, any appreciation of the US dollar would worsen debt metrics and strain public finances. Delays in undertaking consolidation measures and renewed accumulation of arrears and contingent liabilities could worsen refinancing options as a large part of public debt comes due in 2020–21. However, fiscal measures and structural reforms supported by this operation directly support sustainable recovery in growth and help mitigate the risks over the medium term. Furthermore, given the government's financing needs, the proposed DPL will help mitigate financing pressures over the medium term.

Table 8: Summary Risk Ratings

Risk Categories	Rating
1. Political and Governance	Substantial
2. Macroeconomic	Substantial
3. Sector Strategies and Policies	Moderate
4. Technical Design of Project or Program	Moderate
5. Institutional Capacity for Implementation and Sustainability	Moderate
6. Fiduciary	Moderate
7. Environment and Social	Moderate
8. Stakeholders	Substantial
9. Other	Moderate
Overall	Substantial

ANNEX 1: POLICY AND RESULTS MATRIX

Component/ Rationale	Prior Actions	Results indicators
Pillar I: Strengthening public finances		
Strengthening sustainability of the pension system	Enactment of the amendments to the Law on Pension and Disability Insurance, the amendments to the Law on Compulsory Capitally Funded Pension Insurance, and the amendments to the Law on Compulsory Social Insurance Contributions to introduce price indexation of benefits, harmonize the accrual rates, and introduce a higher pension contribution rate to improve fiscal and social sustainability of the multi-pillar pension system.	Overall PAYG pension deficit reduced Baseline: 4.8% of GDP (2017) Target: 4.45% of GDP (2019)
Improving the coverage and sustainability of social benefits	Enactment of the Law on Social Protection and the amendments to the Law on Child Protection to consolidate social assistance benefits, expand the coverage of the bottom quintile and protect the energy poor, while maintaining good targeting accuracy through the introduction of a guaranteed minimum assistance program.	Increased social assistance coverage of the bottom quintile, total and female-led households Baseline: 33% and 22.6% (2016) Target: 50% and 40% (2019)
Strengthening public finance management	Enactment of the Law on Reporting and Monitoring the Liabilities to effectively identify and monitor arrears of the general government and the launch of the quarterly publication of reported arrears from September 2018.	General government arrears reduced. Baseline: 3.5% of GDP (2017) Target: below 2.7% of GDP (2019)
Strengthening the exhaustiveness and progressivity of personal income taxation	Enactment of the Personal Income Tax Law to introduce progressive rate of 18 percent, remove exemption on capital income taxation and increase the rate to 15 percent, and reduce the allowed tax deductions, while increasing the personal tax allowance to protect the low-income households.	Personal income tax revenues increased. Baseline: 2.5% of GDP (2017) Target: 2.7% of GDP (2019)
Increasing carbon taxation	Enactment of the Law on Excises that introduces excise on coal, gas, and electricity.	Share of fossil fuel consumption subject to excise taxation increased. Baseline: 57.5% (2017) Target: above 92.9% (2019)
Pillar II: Improving Market Competition and Reducing Regulatory Burden		
Opening the energy market	Enactment of the Energy Law to deregulate electricity generation, open the electricity supply market for all customers, and introduce competitive-based support mechanism for renewable energy generation.	Percentage of electricity consumers able to choose an electricity supplier at the open market

		Baseline: 50% (2017) Target: 100% (2019)
Strengthening competition and transparency in public procurement	Enactment of the Public Procurement Law to strengthen transparency and increase private sector competition in public procurement.	Average number of bidders per competitive procurement procedure increased. Baseline: 3.41 (2017) Target: Above 3.41 (2019)
Reducing discretion in firm inspections	Enactment of the Inspection Supervision Law to introduce (a) risk-based inspections, (b) a provision for inspectors to issue warnings, and (c) a grace period for businesses to correct first-time infractions.	Risk-based inspection introduced in inspectorates relevant for businesses. Baseline: 0 inspectorates Target: 3 inspectorates (June 2020)

ANNEX 2: FUND RELATIONS ANNEX

Republic of North Macedonia—Assessment Letter for the World Bank
August 7, 2019

Recent Developments and Outlook

1. **Macroeconomic conditions are stable.** Real GDP growth rebounded to 2.7 percent in 2018 after stalling in 2017, driven by strong net exports and private consumption. In the first quarter of 2019, GDP grew at its fastest pace in three years, reflecting a pick-up in corporate credit growth, a recovery in both public and private investment, and a continued reduction in unemployment. Against a background of low inflation, solid deposit growth, and favorable FX market developments, the National Bank of the Republic of North Macedonia further cut its policy rate by 25 bps to 2.25 percent in March 2019.

2. **Growth is expected to firm up to 3.2 percent in 2019, supported by a rebound in investment.** Rising wages—including from minimum wage and planned public sector wage increases—are expected to provide a further, albeit temporary, boost to consumption. Rising trade tensions and a protracted increase in global risk aversion are key downside risks to the outlook. On the upside, a decisive push for structural reforms and opening of EU accession negotiations could boost capital inflows and confidence.

3. **The 2019 budget target of 2.5 percent of GDP is achievable.** Based on budget execution through June, some shortfalls in revenue and projected overruns in transfers and subsidies are expected to be offset predominantly by under-execution of capital spending. However, there are potential downside risks to the fiscal outlook from new measures that could be adopted as part of the 2019 supplementary budget in September.

Economic Policies

4. **Staff expects the fiscal stance to ease somewhat in 2020.** Beside the recently implemented VAT reimbursement scheme, several other initiatives are now being discussed. In particular, ad-hoc increases in the minimum wage and pension benefits are under discussion, which would represent a deviation from the rules-based frameworks adopted in 2018. To mitigate any potential negative effects on employment of the minimum wage increases, the government is considering subsidizing social security contributions. Moreover, agricultural subsidies may be further increased. Assuming these policy initiatives move ahead, public debt is projected to increase and stabilize just above 50 percent of GDP over the medium term. The government also plans to use Public-Private Partnerships for various investment projects, but limited information is available at this time. An assessment of the framework for public investment management (PIMA) is planned for 2020.

5. **A gradual but steady consolidation would be needed to preserve the fiscal policy space.** Public debt is sustainable under the baseline projection, but high gross financing needs and potential shocks to growth constitute downside risks. Rebuilding room for fiscal policy maneuver and placing public debt firmly on a downward path would require a cumulative consolidation of 1½ percent of GDP over 2020–24, compared to staff's baseline projections, to reach a primary

budget balance. The consolidation should be achieved through steadfast implementation of recent reforms to pensions and social assistance, as well as enhanced revenue administration and rationalization of agricultural subsidies. Staff recommends protecting capital and social spending in light of North Macedonia's large infrastructure and human capital investment needs, underpinned by measures to strengthen the public investment management framework.

6. **The banking system is healthy, but risks need to be closely monitored.** The 2018 Financial Sector Assessment Program (FSAP) found that banks are well capitalized, liquid, and profitable. Further efforts to gradually increase deposit denarization, coupled with carefully calibrated macroprudential measures to reduce foreign currency lending to households, would help strengthen financial system resilience.

7. **Achieving faster income convergence with the EU will require structural reforms to address key labor market and institutional weaknesses.** Enhancing the quality of secondary and vocational education remains central to tackling skills shortages that constrain growth and investment, together with strategic planning to realign tertiary education toward delivering the skills demanded by the economy. Active labor market policies should focus more on skill building and facilitating education-to-work transition. Efforts to strengthen governance and the judiciary system, reduce corruption, and ensure more effective rule of law should continue. Better public administration, including through tackling tax evasion, strengthening labor inspection, and ensuring predictable implementation of business regulations, is critical to combatting informality.

8. **IMF Relations.** The 2018 Article IV consultation took place during November 8–16, 2018 and was concluded by the IMF's Executive Board meeting on January 23, 2019. IMF capacity development in the next year will focus on strengthening revenue administration, public investment management, and government finance statistics.

3

North Macedonia: Selected Economic Indicators

	2015	2016	2017	2018	2019 (p)	2020 (p)
	Year-on-year change, unless otherwise specified					
Real GDP	3.9	2.8	0.2	2.7	3.2	3.5
Real domestic demand	5.4	5.0	0.3	0.3	3.6	3.2
Consumption	4.3	2.1	0.1	3.5	2.4	3.0
Gross investment	8.3	12.5	0.8	-7.2	6.5	3.5
Net exports	-14.1	-16.7	-2.1	7.8	-2.9	-1.5
CPI inflation (annual average)	-0.3	-0.2	1.4	1.5	1.6	2.2
Unemployment rate (annual average)	26.1	23.8	22.4	20.7	20.4	19.7
Private Sector Credit 1/	9.5	0.0	5.3	7.3	8.8	7.2
	In percent of GDP					
Current account balance	-2.1	-3.1	-1.3	-0.3	-0.9	-1.3
Goods and services balance	-16.4	-15.1	-14.0	-12.9	-12.6	-12.2
Exports of goods and services	48.6	50.1	55.2	60.1	62.6	64.8
Imports of goods and services	65.0	65.2	69.2	73.0	75.2	77.0
Private transfers	16.9	15.4	15.9	15.8	15.2	14.7
External debt	69.3	74.7	73.6	75.2	76.7	76.5
Gross investment	30.4	32.5	33.0	33.0	33.5	33.4
Domestic saving	28.3	29.4	31.6	32.7	32.6	32.1
Public	-0.1	0.2	0.5	0.1	0.4	0.3
Private	28.5	29.2	31.2	32.6	32.3	31.8
Foreign saving	2.1	3.1	1.3	0.3	0.9	1.3
General government gross debt 1/	38.1	39.8	39.5	40.4	41.9	42.2
Public sector gross debt 1/ 2/	44.0	46.7	46.1	47.3	49.9	50.8
Central government balance	-3.5	-2.7	-2.7	-1.8	-2.5	-2.7
Memorandum items:						
Nominal GDP (billions of denars)	559.0	594.8	616.6	660.3	694.7	733.7
Nominal GDP (billions of euros)	9.1	9.7	10.0	10.7	11.3	11.9
GDP per capita (euros)	4,380	4,657	4,825	5,163	...	...

Sources: NBRM; SSO; MOF; IMF staff estimates.
1/ The historical debt ratios differ slightly from the numbers reported by MoF due to using end-year debt in local currency divided by local currency GDP.
2/ Includes general government and public sector enterprises.

ANNEX 3: LETTER OF DEVELOPMENT POLICY

Republic of North Macedonia
Ministry of Finance

- International Financial Relations and Public Debt Management Department -

No. 15 - 7436/1
Date: 14-6-2019 **Skopje**

To: **The World Bank**
1818 H Street N.W.
Washington D.C. 20433, USA

Attn. **David Malpass, President**

Subject: **Letter of Development Policy**
Republic of North Macedonia: Public Finance and Competitiveness Development Policy Loan

Dear President,

On behalf of the Government of the Republic of North Macedonia, we kindly request endorsement of the EUR 125 million Public Finance and Competitiveness Development Policy Loan (DPL) to support our economic reform program. We are committed to strengthen the efficiency of our public finances and boost competitiveness of our economy through market competition and regulatory reforms. The reform agenda is incorporated into our 2020-22 Fiscal Strategy and builds on the Government Economic Reform Program 2018-21 submitted to the European Commission (EC) as part of the economic governance surveillance for the European Union (EU) candidate countries.

The Republic of North Macedonia has had a good track record of conducting macroeconomic policies and business environment reforms in the past. Prudent macroeconomic policies prior to the global financial crisis enabled the country to create fiscal space for a countercyclical fiscal policy that largely mitigated the crisis impact in 2008–09. Growth and fiscal measures helped increase employment and reduce poverty after 2009. However, prolonged political turmoil during 2015-17 resulted in stalled growth in 2017. In addition, the expansionary discretionary policy between 2009 and 2016, including both counter-cyclical policy and measures related to political business cycles, doubled the public and publicly guaranteed debt-to-GDP between 2008 and 2016. As of end-2018, it stands at 48.5 percent of GDP. While the growth recovery is underway, ongoing road infrastructure investment, pressures on pensions from aging population, the rise in categorical social benefits, and the re-accumulation of public arrears required

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a gradual fiscal consolidation program that would not wipe out the poverty reduction gains but would stabilize finances and stem further public debt growth. My government is deeply committed to these policy objectives. Reducing the deficit and stabilizing debt over the medium-term will reassure financial markets ahead of the 2020-23 refinancing surge up to 14 percent of GDP a year. The DPL program proposed here is supporting our fiscal consolidation plan and reforms to underpin private sector growth.

This letter summarizes crucial aspects of our program focused on strengthening public finance sustainability and competitiveness. We believe that this DPL provides the appropriate tool for the Bank's support in addressing our medium-term policy agenda, whereby we count on the World Bank as a partner.

Strengthening public finances

With the implementation of the envisaged tax, social, health and pension reforms, the government is expected to enhance control over public finances just at the time that past bonds come for redemption in 2020-23. Correspondingly, public and publicly guaranteed debt would start declining from its peak in 2020 at 52.3 percent of GDP.

To strengthen revenue collection, the Parliament has, in December 2018, enacted the Law on Personal Income Tax to introduce progressive rate of 18 percent, remove exemption on capital income taxation and increase the rate to 15 percent, and reduce the allowed tax deductions, while increasing the personal tax allowance to protect the low-income households. The Republic of North Macedonia collects much less revenue from this tax than its Western Balkans or EU peers. Furthermore, deductions and exemptions for specific types of income were prevalent, regressive, and costly. We are expecting to collect some 0.25 percentage points of GDP more per year due to this reform. While we are going to progressively tax the income with the higher rate, we have increased the personal income tax allowance to protect the low-income households.

From January 2018, we have also increased taxes on fuel and, from May 2019, introduced excises on coal, gas and electricity. Even though initially at a zero-rate until closer to EU accession, this enables the government to prepare the administrative processes to readily collect green-taxes once a positive rate is introduced. The new excise law also expands the list of excise products to electric cigarettes, and heat-not-burn tobacco. The revenue gains from this reform would bring additional revenues to the budget of around 0.3 percentage point of GDP a year. This would put us closer to the EU levels of fuel excises, while there is further work to harmonize tobacco excise with the EU in the future. An increased excise tax on fuel discourages the consumption of a good with a

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negative externality for the environment. Going forward, we also plan to align the taxation of vehicles in line with EU Directives.

To consolidate social assistance benefits, expand the coverage of the bottom quintile and protect the energy poor, the Parliament has enacted the new Law on Social Protection and the amendments to the Law on Child Protection in May 2019. The current system of non-contributory social assistance, while targeting the poor well, had significant gaps in program coverage leaving many households stuck in poverty or vulnerable to fall back into poverty. In recent years, a categorical program, so-called parental allowance provided to all families with three and more children, crowded out resources targeted to the poor. The new laws introduced a new Guaranteed Minimum Assistance (GMA) program and consolidated existing social assistance benefits. It also introduced means-testing of the untargeted parental allowance program. The GMA is a means-tested program that will benefit some 50 percent more households than was the case before the reform. In the short term, the additional fiscal costs are projected at 0.16 percent of GDP until the parental allowance is gradually reduced. The new program embeds incentives for social assistance beneficiaries to take up employment.

Additionally, under the amendments to the Child Protection Law, the government redesigned the Child Allowance program and introduced a new means-tested Education Allowance. In the reformed Child Allowances, eligibility will be delinked from the employment requirement and the benefit will be awarded to all households with children where income falls below the established threshold. The reform supports the shift of government resources to more effective social assistance program and should contribute to the reduction in poverty rate over the medium-term.

To improve fiscal and social sustainability of the multipillar pension system, the Parliament enacted the amendments to the Law on Pension and Disability Insurance, the Law on Compulsory Capital Financial Pension Insurance, and the Law on Compulsory Social Insurance Contributions that introduced price indexation of benefits, harmonized the accrual rates, and introduced a higher pension contribution rate. Without the reform, the pension system expenditures and deficits would continue to grow, while they have already reached comparatively high levels of around 10 and 5 percent of GDP, respectively. At the same time, the multipillar system parameters have generated low multipillar pensions and created inter-generational imbalances. To remedy this, we have introduced consumer price indexation of pensions, adding supplementary real GDP wage indexation in case of real GDP growing above 4 percent per year; harmonized accrual rates by lowering the old system participants' accruals for

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post-2018 service and raising service year accruals for multi-pillar participants; repaid all missing contributions and returned older second pillar participants to the PAYG pillar; and increased the pension insurance contribution rate by 0.4 percentage points in 2019 and again in 2020. The pension system deficit will be reduced by over 0.3 percentage points with these measures. Yet, given the country's rapid aging prospects, we are cognizant of the possibility that additional restrictive measures may be needed in the future. We would be grateful for the continued World Bank support to strengthening of the pension system under the new Country Partnership Strategy. The initial discussions over the investment operations to support the strengthening of the pension system have been underway.

To effectively identify and monitor arrears of the general government, in April 2018, the Parliament enacted the Law on Reporting and Monitoring the Liabilities. The fast accumulation of arrears, estimated at up to 3.5 percent of GDP in early 2017, revealed weaknesses in the Republic of North Macedonia's public finance management system. These weaknesses increase the uncertainty for private investors and undermine the control and accountability of public spending. We are implementing an ambitious and comprehensive PFM Reform Program 2018-20, anchored around the new Organic Budget Law. In the short term, through the Law on Reporting and Monitoring the Liabilities, we introduced a new arrears reporting system through a new software aiming to identify and take stock of arrears. As part of this new system, all public entities started reporting their liabilities and arrears on a monthly basis and we are publishing the reported arrears on a quarterly basis on our website. The overall amount of arrears has already declined to 2.7 percent of GDP in early 2019. This measure enables the government to effectively identify, monitor, and potentially prevent arrears across the general government in the short-term, bridging the period until the new Organic Budget Law is enacted and become effective and the new functionality of the treasury system is fully implemented.

To that extent, we have launched the preparation of the new Organic Budget Law that is under the stakeholder consultation process. Specifically, the new draft law aims to improve the institutional coverage of the central and general government budgets and broaden the definition of the budget to cover all types of funding sources. It further foresees the introduction of a Fiscal Council, a fiscal rule, and the inclusion of fiscal risks in the Fiscal Strategy. Moreover, the new law will broaden the functionalities and introduce a commitment module in the Single Treasury Account system. Fiscal transparency and accountability are also directly improved by enhancing the quality of fiscal accounting and reporting in line with international standards and extending the

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coverage of external audits of the final budget account. The draft law has received the TA support from the World Bank through the Good Governance Fund with the UK.

Boosting market competition and regulatory reforms

While the Republic of North Macedonia belongs to the top 10 performers on the Doing Business ranking, still private sector lacks dynamics due to barriers to competition in product markets and in critical backbone service sectors such as energy. We have taken initial reforms under this DPL and aim to broaden them going forward. There is a need to further support our private sector to generate new jobs and compete on an open European market through strengthening its competitiveness with a full respect of market competition rules.

To deregulate electricity generation, open the electricity supply market for all customers, and introduce competitive-based support mechanism for renewable energy generation, in May 2018, the Parliament enacted the new Energy Law. Until 2018, only about half of the electricity market was liberalized, mostly industrial and large commercial consumers. All of the residential sector and small businesses were still supplied through a regulated market, and most of the power generation for the regulated market comes from the state-owned company ESM. With this reform, we have transposed the EU directives related to the internal electricity and gas market, or the so-called Third Energy Package. The new Energy Law foresees several reforms, including deregulation of the generation and the supply markets which will allow all electricity and gas customers to freely select their supplier. While the electricity supply market will be fully open to all consumers, including households, it is envisioned that the supply for the Universal Service Supplier will be gradually deregulated over the course of seven years. In 2019, the largest electricity generator (ESM) is bound to provide at most 80 percent of the total annual needs of electricity to the universal supplier, with a gradual reduction to 30 percent by 2025. The new law also foresees that the government needs to develop annual programs to protect the energy poor (vulnerable consumers), which has been done through the social assistance system. The opening of the market is expected to ensure competitive pricing of electricity for firms and fulfill the targeted shares of the renewable energy sources shares in final consumption.

To strengthen transparency and increase private sector competition in public procurement, the Parliament enacted the Public Procurement Law in January 2019. Previously, the legislative framework for public procurement included several elements that were a regulatory burden for bidders, especially smaller companies, undermining competition. The public procurement reform aims to establish an effective procurement

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system in line with the EU *acquis*. It among others introduces the Most Economically Advantageous Terms in procurement system in addition to the lowest price as a criterion for contract awards. The latter was misused in many occasions in the past to set very low bidding prices and re-negotiated at a higher price in an ex-post annex to the contracts. The new law encourages the participation of more bidders by introducing an e-marketplace and e-catalogue for small value procurements, the mandatory publication of annual public procurement plans, an e-appeal system, and an ex-ante control role of the Public Procurement Bureau. The e-appeal system is already functioning which led to a major reduction of transaction costs and increased transparency. We hope to boost the number of bidders per competitive procurement procedure by creating more competitive environment for government contracts.

To introduce risk-based inspections and reduce the administrative burden on firms in May 2019, the Parliament enacted the new Inspection Supervision Law. The previous system of inspections led to excessive inspection visits and sampling by inspection authorities. As a result, firms with low risk profiles were often subject to greater inspections than economically beneficial, implying high cost of management and staff time to deal with inspectors' requests and high reported sanctions for minimal infractions. Moreover, the previous legal framework was inconclusive with regard to issuing a warning that led to firms being in most cases immediately sanctioned. The new Law introduces risk-based planning of inspections to be implemented by different inspectorates, checklists and other mechanisms that substantially increase the predictability and transparency of inspections so that businesses are aware of the inspection requirements. Importantly, it also requires inspectors to issue warnings except in exceptional cases, and to provide a grace period for corrective actions. We are substantially strengthening the Council of Inspection Authorities that will supervise the inspectorates and will help with the adoption of specific methodologies and operating procedures in individual inspectorates, as well as create capacities for data collection and risk assessment, such as IT systems or firm and product risk profiles. Over the medium term, we aim to consolidate a number of the current 27 different inspectorates to strengthen the coordination and better organize the administrative processes. The ongoing functional review of government administrative structures, including of inspections, suggests that if fully implemented the number of inspectorates could be substantially downsized. This will be implemented as part of our overall public administration reform program. More transparent and business-friendly inspection system should reduce the uncertainty and operating costs of existing firms.

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Economic development, the increase of productive employment and higher living standards for citizens are among the top priorities of the Government Program. The Program seeks to improve the welfare of all citizens by strengthening economic growth and competitiveness, rule of law, governance and improvements in the business climate, infrastructure and human capital. In parallel, the Government will focus on a decisive fight against organized crime and corruption, informality, strengthening of the rule of law and reforms in the judiciary, in line with recommendations of the EU and other relevant international organizations. In order to achieve its priorities, the Government will be focused on maintaining macroeconomic stability, with a fiscal policy oriented towards gradual fiscal consolidation and maintaining sustainability of public finances, while at the same time providing higher public investment and better public services. Our program for fighting informality, assessed at 30-40 percent, will pilot two programs (a 15-percent VAT rebate to citizens upon submission of tax receipts, as well as co-financing of social security contributions to firms) over the next two years with an attempt to increase awareness and control of tax compliance and the formalization of wages. The cost borne for these programs will be accommodated within the current fiscal plans as envisaged in the 2020-22 Fiscal Strategy.

In closing, I would like to reiterate the strong commitment of the Government of the Republic of North Macedonia to these reforms which will help safeguard fiscal sustainability and make our private sector more competitive. We recognize that this represents a subset of the needed reforms in the country to address skills, further boost private sector competitiveness, improve public service provision, and align laws and standards with the EU *acquis*. Not least, macro-fiscal sustainability is a key precondition for long-term sustainable growth, and we remain committed to preserve it. We would like to reiterate that the continued support of the World Bank will be essential for achieving these goals and trust that this request for the World Bank support through a Development Policy Loan will receive your endorsement.

Sincerely,

Deputy Minister of Finance
Shiret Elezi, Ph.D.

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ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Operation Pillar 1: Strengthening public finances		
Prior action #1	No.	Yes, positive. The proposed pension reform will have positive impact on poverty, although the small increase in pension contribution will slightly offset it in the near term. However, the rise in contribution as it is small will not significantly worsen the labor tax wedge and therefore incentives for formal employment.
Prior action #2	Yes, positive. The energy poor program will have positive adaptation impact.	Yes, positive. The rise in benefit and extended coverage of both social assistance, energy poor program and child benefits will lead to reduced poverty and improved equality.
Prior action #3	No.	No.
Prior action #4	No.	Yes, positive. The personal income tax reform has positive, though very small impact on reducing income inequality. The proposed introduction of progressive rate will affect only top 1 percent of tax payers.
Prior action #5	Yes, positive. The introduction of the excises on coal, gas and electricity, even though initially at a zero-rate will create awareness of consumption externalities.	No, given the delayed increase in excises at the time of EU accession.
Operation Pillar 2: Improving market competition and reducing regulatory burden		
Prior action #6	Yes, positive. The new law regulates the renewable energy and thus supports mitigation of climate change by reducing emissions through support for cleaner sources of energy.	Yes, positive. The new law foresees a development of annual programs to protect the energy poor (vulnerable households) and thus strengthening the adaptation to climate change. On the other hand, the deregulation of residential tariffs is gradual, and the eventual impact on prices is not expected to be as high as in neighboring countries since wholesale prices are closer to the market prices.
Prior action #7	No.	No.
Prior action #8	No.	No.