



Republic of North Macedonia

Ministry of Finance

OFFICIAL
DOCUMENTS

- International Financial Relations and Public Debt Management Department -

No. 15 - 7436 / 1

Date: 14-06-2019 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



Republic of North Macedonia

Ministry of Finance

- International Financial Relations and Public Debt Management Department -

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



Republic of North Macedonia

Ministry of Finance

- International Financial Relations and Public Debt Management Department -

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



Republic of North Macedonia

Ministry of Finance

- International Financial Relations and Public Debt Management Department -

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



Republic of North Macedonia

Ministry of Finance

- International Financial Relations and Public Debt Management Department -

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



Republic of North Macedonia

Ministry of Finance

- International Financial Relations and Public Debt Management Department -

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.



Republic of North Macedonia

Ministry of Finance

- International Financial Relations and Public Debt Management Department -

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.