PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: 136960-MK

Operation Name	The Republic of North Macedonia Public Finance and Competitiveness Policy-Based Guarantee
Region	EUROPE AND CENTRAL ASIA
Country	The Republic of North Macedonia
Sector	Central Government (Central Agencies) (100%)
Operation ID	P170473
Lending Instrument	Policy-Based Guarantee
Borrower(s)	The Republic of North Macedonia
Implementing Agency	Ministry of Finance
Date PID Prepared	April 10, 2019
Estimated Date of Appraisal	May 16, 2019
Estimated Date of Board Approval	Q1 FY20
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the appraisal of the operation.

I. Country Background

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 around stimuli for public employment, pensions, and public works–that largely mitigated the crisis impact in 2008-09 and 2011-12. These measures helped the economy to grow at an average of 2.7 percent 2012-17, increase employment and reduce poverty.

While the fiscal stimulus measures of 2009-16 helped keep growth and jobs in North Macedonia, they came with fiscal costs. The public and publicly guaranteed debt-to-GDP ratio doubled since 2008 to 47.8 percent in 2017, while fiscal deficit averaged 2.2 percent of GDP (or 3.6 percent of GDP once the off-budget road agency finances are included). Further fiscal risks stem from pressures on pensions from aging population, re-accumulation of public sector arrears and the high level of state-owned enterprise indebtedness. The efficiency of public spending as well as revenues by improving tax collection, which 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 FDI and under-execution of the public investment program that brought growth down to almost zero in 2017. Despite the country being ranked among the top 10 countries for the ease of doing business, economic activity was limited by the lack of private sector dynamics due to barriers to entry and competition in product markets and in critical backbone service sectors such as energy and education. Against this background, the authorities have started a new wave of reforms to reinvigorate economic growth and ensure sustainability of public finances.

II. Operation Objectives

This operation supports North Macedonia's efforts to strengthen public finances, improve market competition, and reduce the regulatory burden. The new government's Economic Reform Program 2018-21 aims to strengthen revenues, improve public financial management, increase market competition, further ease the environment for doing business, strengthen labor market and social protection. The PBG supported key reforms in the short term that aim to safeguard fiscal sustainability and support private sector competitiveness reforms. The operation has been closely coordinated with international partners (including the IMF, EC, USAID and other bilateral partners) to ensure complementarities in policy support and technical assistance.

III. Rationale for Bank Involvement

The proposed operation is organized under two pillars (i) strengthening public finances and (ii) improving market competition and reducing regulatory burden, that underpin and inform the government reform agenda. The proposed operation supports reforms to improve efficiency of public finances in the areas of tax policy, pensions, social benefits, and public finance management that would contribute to the medium-term fiscal sustainability. Reducing the deficit and stabilizing debt over the medium-term will reassure financial markets ahead of the 2020-23 refinancing surge at 14 percent of GDP a year. These reforms are consistent with the government's Fiscal Strategy 2019-21.

Furthermore, this operation supports reforms aiming to boost competitiveness through energy, procurement and inspection reforms.

The proposed operation is fully consistent with the FY19–23 Country Partnership Framework. The proposed policy program helps the authorities strengthening its public finance management, strengthen the macro stability, and unlock the private sector growth. By supporting fiscal sustainability and promoting market competition—among priorities identified in the 2018 Systematic Country Diagnostic—the operation enforces critical elements for sustained shared prosperity. Such reforms are necessary to avoid abrupt adjustments that could reverse welfare gains for the population.

IV. Tentative financing: EUR225 million, Policy Based Guarantee

V. Institutional and Implementation Arrangements

The Ministry of Finance is responsible for the overall coordination of the proposed operation. While the Ministry of Finance is the main policy counterpart for the Bank team, the broad-based program involved several line ministries.

VI. Risks and Risk Mitigation

The assessed risk for the proposed operation is substantial. These risks stem from political pressures associated with the implementation of the supported reforms in a current minority coalition government that came in power in July 2017. The resolved country name dispute in February 2019 opened up NATO accession process and unlocked the EU accession negotiation process stalled since 2009. These processes should alleviate political risks. Despite the country's relatively moderate indebtedness, macroeconomic risks are substantial and include: (i) expected tightening of financing conditions and EUR depreciation due to further tightening of US monetary policy; (ii) growth shock related to the deterioration in the external (including EU) prospects and political tensions; and (iii) potential delays in the implementation of consolidation measures, and accumulation of new contingent liabilities. Support provided by all international partners should help ensure commitment for implementing the ambitious reform program.

VII. Poverty and Social Impacts and Environment Aspects

This operation is expected to have high social and gender, and strong positive environmental impacts. The social benefit reform will have the highest positive impact. The introduction of the better-targeted Guaranteed Minimum Income with an increased threshold and a benefit will have positive direct social impact on the poor. The expansion of the child allowance program will be complemented with the strengthened targeting of the parental allowance program for families with three children. The energy law introduces the obligation to the government to develop annual energy poverty programs, while pension reform aims to safeguard replacement rates from declining in the future. The personal income tax reform will have positive, though very small impact on reducing income inequality. The proposed introduction of progressive rate will affect only top 1 percent of tax payers, while the increase in the non-taxable part of the income will boost incomes of the bottom 40. In addition, reforming social benefits that discourage employment is expected to have positive impacts in particular on female labor market engagement and labor income, the most important channel for sustainable poverty reduction. This operation is expected to have high positive environmental impact. Direct positive impact on the environment is expected through three prior actions related to the introduction of the excises on fuel, coal, coke, gas and electricity, social benefit reform, and the energy law. The reforms supported by the PBG will have high positive environmental impacts and will contribute to mitigation and adaptation measures to combat adverse climate impacts.

VIII. Contact point

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