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COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

NORTH MACEDONIA
(2021-2023)

COMMISSION ASSESSMENT

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1. EXECUTIVE SUMMARY

In 2020, the accelerating economic growth of the Republic of North Macedonia and positive outlook were brought to an abrupt halt by the COVID-19 pandemic. The number of cases increased rapidly. Wide-ranging containment measures, including shop closures and curfews, dampened domestic demand. The external sector was hit by lower foreign demand due to both, the global recession and supply chain disruptions affecting the production of automotive components. As a result, real GDP dropped by 4.5% y-o-y in 2020. Only public consumption contributed positively to growth, fuelled by government purchases to cover the needs of the health sector, and to implement sizeable and well-targeted measures from four successive support packages.

The Economic Reform Programme (ERP) expects a strong rebound in economic activity starting in 2021. The programme anticipates a gradual retreat of the pandemic in 2021 and the lifting of containment measures. Based on these expectations, the programme is rather optimistic: it projects growth to accelerate from 4.1% to 5.2% over 2021-2023, driven by household spending and investment, including a strong contribution from public investment.

The COVID-19 crisis left a deep mark on public finances in 2020. The fiscal deficit almost quadrupled, rising to 8.2% of GDP. This was due to the twin effects of foregone tax revenue from the decline in economic activity, and additional expenditure on anti-crisis measures to support households and companies. The programme expects a gradual recovery of public finances, driven by the projected strong growth in output and the phasing out of current support measures. The fiscal deficit is expected to narrow starting in 2021, but to remain above its pre-crisis level over the programme's horizon. Because of significant external funding to bridge the government's crisis-induced financing gap in 2020, the general-government debt level has increased sharply, rising to over 51% of GDP. It is projected to continue rising until 2023, partly in anticipation of increased lending to public enterprises to implement the government's public-investment agenda.

The main challenges facing North Macedonia are the following:

- **Transparent and targeted fiscal-policy support is still needed amid the current uncertainties.** However, once the recovery takes hold, public finances must recover and return to sustainable levels. This implies moving towards a balanced primary budget, underpinned by: (i) improvements in tax collection; (ii) a broadening of the tax base; and (iii) strengthened fiscal governance bolstered by fiscal rules and an independent fiscal council.
- **North Macedonia's poor implementation record of budgeted capital expenditure and its planned increase in capital spending show the need for significant improvements in the management of public investment.** These improvements should be based on the approved action plan. A new legal framework for public-private partnerships could facilitate public infrastructure projects.
- **The allocation of state support to companies remains opaque, which makes it difficult for aid to be well-targeted and efficient.** The transparency of company-level subsidies could be much improved by setting up a State-aid registry.
- **Domestic companies suffer from low levels of productivity. Productivity growth is also very slow. This hinders companies' competitiveness and integration in the global economy.** The COVID-19 pandemic has put significant additional burdens on companies, causing them to reduce their investment in development of human and physical capital. At the same time, the crisis has revealed vulnerabilities in global value chains, which also affected North Macedonia's companies. Improving the competitiveness of local companies and benefiting from the post-COVID-19 restructuring of global value chains will require

improvements to human and physical capital and the business environment, including better enforcement of business regulation and corporate governance, as well as better services including trade and transport logistics. Greater investment in research and innovation, as well as further regional integration, could further support competitiveness.

- **The size of the informal sector continues to be a challenge for the business environment as it creates unfair competition from unregistered companies.** Undeclared revenues and employment also harm public revenue collection, which will be particularly important for the post COVID-19 recovery. Undeclared revenues and employment also reduce levels of formal employment and its associated benefits, including job security and safety at work. Due to its complex character, reducing the size of the informal sector will require a coordinated approach across the whole of government. This approach will need high-level political steer to include all the stakeholders and measures relevant for reducing informality.

- **The education system does not equip young people with enough of the key competences – skills and knowledge – that they need to actively participate in the labour market.** While North Macedonia has progressed very well in terms of the number of people with higher educational attainment, insufficient quality of education and the structure of enterprises contribute to persistent unemployment and still a high share of young people not in employment, education or training (NEET). The country's education strategy and related action plan prioritise providing skills to young people to prepare them for the labour market. Nevertheless, state financial support for education is insufficient and coordination between different sectors (economic sectors and educational sectors) still needs improvement. Students and families receive limited career guidance information when making important choices and curricula are not in line with labour market needs.

The policy guidance jointly agreed at the Economic and Financial Dialogue of 19 May 2020 has been partially implemented. Notably, the government adopted four sets of fiscal measures to mitigate the crisis impact on the economy; it adopted the Tax System Reform Strategy; it publishes quarterly data on the finances of public enterprises on its website; it adopted an Action Plan for improving public investment management; and it adopted a new draft Organic Budget Law, that provides for fiscal rules and the establishment of a fiscal council. A list containing 377 para-fiscal charges was published. Steps towards their reduction and abolishment remain to take place. To modernise the education system, the government is implementing the 2018-2025 education strategy and action plan, which covers the six pillars of the education system. However, more own budgetary resources and capacities are required to tackle bottlenecks in implementation. The government also implemented special measures to protect jobs during the pandemic. The Law on Social Protection was adopted in May 2019 to strengthen the coverage and rights of people at risk of poverty. The guaranteed minimum assistance (GMA) scheme was implemented. The new Law on Social Protection contained 'activation' measures to encourage recipients of the GMA to enter the labour market. However, these measures are only being partially implemented.

The challenges identified in the ERP largely match those identified by the European Commission. The planned structural reform measures do not all follow a sufficiently coherent and focused vision of the objectives and targets for the country's economic development. The impact assessment of the structural reform measures could be further improved to allow prioritisation based on measures' economic, social and environmental impact. The reform of the social-protection system contributes to the social inclusion of beneficiaries of the system who are at risk of poverty. The key policy reforms and specific programs and measures including indicators and budget in the field of employment, education and social policy are presented in a strategic document called Employment and Social Reform Programme (ESRP).

A special Inter-sectoral Working Group coordinated by the Ministry of Labour and Social Policy has been established in 2016 for the preparation of the ESRP. It is composed of representatives of all relevant institutions participating in the development, implementation and monitoring of the policies in the above mentioned areas. The "Revised Employment and Social Reform Programme ESRP(r) 2020" adopted by the Government in December 2019 sets-out and presents the key policy reforms and specific programs and measures that shall be implemented in a short and medium term (until 2022).

2. ECONOMIC OUTLOOK AND RISKS

North Macedonia's economic upswing came to a sudden halt in 2020, as the pandemic hit domestic and foreign demand. Driven by strengthening domestic demand and foreign investment, North Macedonia's economy had been on a path of accelerating growth in the 2 years prior to the crisis. When the pandemic hit the country in March 2020, the government, reacted swiftly to a rapid rise in the number of COVID-19 cases, with wide-ranging containment measures. Domestic economic activity plunged in the wake of these measures, and external trade suffered from lockdowns and recessions in trading-partner economies. In addition, travel bans greatly reduced turnover in the tourism and transport sectors. As a result, real GDP in 2020 dropped by 4.5% on average, with the annual decline narrowing consecutively each quarter since the steep fall in the period between April and June. Investment spending plummeted in the second quarter of 2020, but recovered over the summer. Household disposable income suffered from a stark drop in remittances from abroad, even though the labour market proved resilient throughout the year. In response to the crisis, the government adopted four sets of measures in 2020 to support households and businesses, including subsidies, tax deferrals and interest-free loans. Implementation of these measures so far amounts to some 6.5% of GDP (2020), bolstering employment and wage growth as well as corporate liquidity.

The ERP expects growth to pick up in 2021 and to average 4.6% in 2021-2023. The programme projects real GDP to increase by 4.1% in 2021. This is unchanged from the 2021 forecasts made by the programme last year, except that the programme now expects the negative contribution from the external sector to be bigger, while domestic demand is expected to make a larger positive contribution. Household spending is expected to increase at its pre-COVID-19 rate, with growth accelerating in 2021, 2022 and 2023. Investment spending is also projected to continue growing each year. Due to the high import-dependence of investment and exports, net exports will make a negative contribution to growth in 2021. For 2022, the programme assumes real GDP growth of 4.6% (+0.3 pps. compared to the 2022 forecast in last year's programme). The pre-COVID growth trajectory is forecast to resume in the second half of 2022, and the ERP projects that the negative output gap will close in 2023, when growth is forecast to reach 5.2%. The negative contribution of net exports is expected to gradually diminish each year until 2023. The external assumptions underlying the government's projections are in line with consensus and Commission forecasts, indicating a moderate recovery in foreign demand over the programme's horizon. The programme, for the first time, contains projections beyond the three-year horizon. Hence, the government projects growth to reach 5.9% in 2025, and average year-on-year growth between 2021 and 2025 to reach 5.3%.

In light of lingering uncertainties, the projections seem overly optimistic. The macroeconomic and fiscal outlook continue to be affected by great uncertainty about: (i) the future course of the pandemic; (ii) possible further containment measures; and (iii) the impact of containment measures on the economy, both in North Macedonia and in its major trading partners. Domestically, optimistic assumptions about the disposable income of households and about public and private investment might be disappointed. On the external side, foreign

demand might be lower than expected by the ERP. In addition, new FDI and the extension of export-production capacities by established foreign companies might turn out to be lower than projected, given current uncertainties and the ongoing revision of tax benefits for foreign companies. Propelled by government subsidies and rises in both the minimum wage and public sector pay, real wage increases have recently been far in excess of the stagnant growth in productivity. This has eroded North Macedonia's external competitiveness. However, there is still room to increase fiscal and monetary support if conditions deteriorate. Nevertheless, the programme's baseline scenario seems too optimistic. The implementation of structural reforms may possibly improve growth components, but the programme does not provide any information on this. The expected development of growth components also appears to not be entirely in line with the government's plans for expenditure-based fiscal consolidation.

The programme presents two alternative macroeconomic scenarios based on identified risks to the baseline projection. The first scenario assumes lower export growth due to lower foreign demand, which also leads to lower FDI inflows. As a result, economic growth in 2021 would be lower by 1 pp., and average annual growth in 2021-2025 would be 4%. The second scenario assumes lower-than-anticipated investment, in particular public investment. Growth in 2021 under this second scenario would be 3.7%, and average annual growth would be 4.6% between 2021-2025. Both of these scenarios still seem rather benign.

Consumer prices are expected to rise due to all components. Despite an accommodative monetary-policy stance, and the cut in the policy rate to a record low of 1.5%, average annual inflation remained below official projections at 1.1% in 2020. Moderate inflation pressures arose from food prices and core inflation, while falling energy prices acted in the opposite direction. In line with assumptions about a global economic recovery and a renewed rise in oil prices, the programme expects consumer prices to rise over the programme's horizon, driven by a gradual increase in foreign inflation. Consumer prices are therefore forecast to increase by 1.5% in 2021, (which is 0.5 pps. lower than expected in the previous year's ERP), and further to around 2% in both 2022 and 2023. The programme considers that risks to the inflation forecast arise especially from uncertain dynamics in commodity prices, in particular oil. The programme's inflation forecast is plausible. As a small, open economy with a de-facto currency peg, the country's price level is largely determined by international price developments. However, the ERP's presentation might have benefited from a more thorough analysis of potential pressures from domestic demand, given the expectation that output growth will perform beyond potential in 2023, and also given the further rise in nominal wages in 2020.

Table 1:

North Macedonia - Comparison of macroeconomic developments and forecasts

	2019		2020		2021		2022		2023	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	3.6	3.2	-4.9	-4.4	3.8	4.1	3.5	4.6	n.a.	5.2
<i>Contributions:</i>										
- Final domestic demand	4.3	5.3	-4.8	-5.8	5.8	5.4	6.2	5.2	n.a.	5.6
- Change in inventories	0.8	n.a.	0.0	n.a.	0.0	n.a.	0.0	n.a.	n.a.	n.a.
- External balance of goods and services	-1.5	-2.1	-0.1	1.3	-2.0	-1.3	-2.8	-0.6	n.a.	-0.4
Employment (% change)	5.0	5.1	-0.3	0.4	0.5	1.9	2.4	2.1	n.a.	2.3
Unemployment rate (%)	17.3	17.3	17.3	16.6	17.1	15.8	16.6	15.0	n.a.	14.1
GDP deflator (% change)	2.3	1.1	-0.7	1.0	0.9	2.0	2.1	2.0	n.a.	2.0
CPI inflation (%)	0.8	0.8	0.9	1.1	1.2	1.5	1.5	2.0	n.a.	2.0
Current account balance (% of GDP)	-3.3	-3.3	-4.2	-3.7	-3.9	-2.6	-3.8	-1.6	n.a.	-1.5
General government balance (% of GDP)	-2.1	-2.2	-8.6	-8.4	-4.5	-4.9	-3.2	-3.8	n.a.	-3.2
Government gross debt (% of GDP)	40.2	40.6	51.1	51.2	53.2	53.2	53.6	53.3	n.a.	53.7

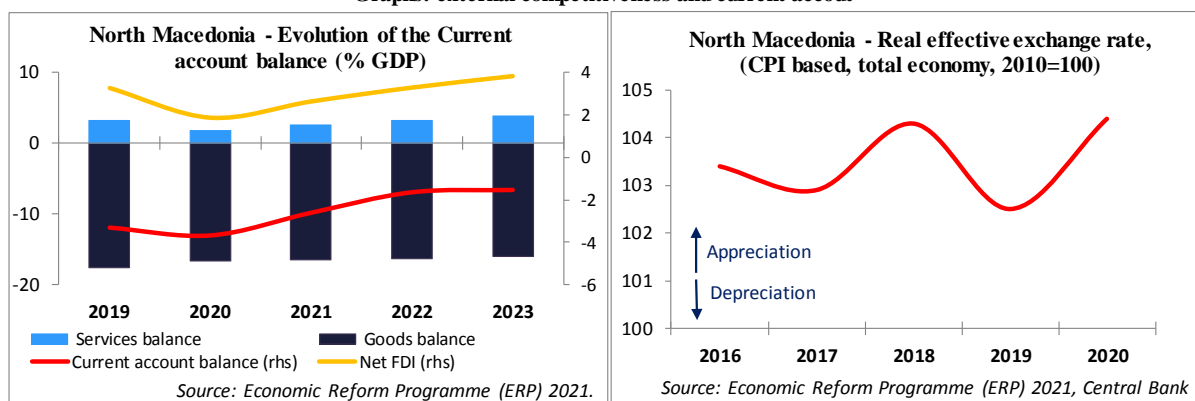
Sources: Economic Reform Programme (ERP) 2021, Commission Autumn 2020 forecast (COM).

External vulnerabilities increased somewhat in 2020, but the outlook is positive.

Extended lockdowns and recessions in trading partner economies left a mark on export performance in 2020, in particular of intermediate goods from established foreign companies in automotive supply chains. The merchandise trade deficit in 2020 remained at 16.8% of GDP, as in the preceding year. Inflows of private transfers from abroad declined, by 1.6 pps. y-o-y to 13.2% of GDP. Altogether, the current account deficit widened by 0.2 pps. y-o-y to 3.5% of GDP, slightly below the ERP estimate. The shortfall was not covered by net FDI inflows, which were some 43% lower y-o-y in 2020, on account of significant outflows of intercompany debt, and amounted to only 1.9% of GDP, compared to 3.2% one year earlier. The programme expects the current account deficit to gradually narrow to 1.5% of GDP in 2023 due to a smaller goods trade deficit and a return of current transfers to their long-term average of about 15.3% of GDP in 2023. The primary income balance is expected to worsen, in terms of GDP, by 1 pp., to 3.8% of GDP between 2020 and 2023.

Government financing requirements drove the sizeable rise in external debt. Foreign debt rose by markedly more in 2020 than anticipated in the previous year's programme. This was the result of foreign financing for crisis-induced additional requirements faced by the central government, and was complemented by a small rise in external private sector debt (intercompany loans). External debt (both public and private) amounted to 80.2% of GDP (+7.3 pps. compared to end-2019, and +3.8 pps. compared to projections in last year's ERP). The government also bolstered its foreign exchange reserves, which covered some 4.6 months' worth of prospective imports at end-2020. The share of intercompany debt and trade credits, which constitute less volatile components of foreign debt, remained high and unchanged compared to the previous year, at some 40% of total external debt. In 2021, the programme expects external debt to rise further, mainly due to the public sector (central government borrowing, but also disbursements of foreign loans to public enterprises carrying out public investment). Between 2021 and 2023, on a cumulative basis, gross external debt would rise by 0.4 pps., according to an external debt sustainability analysis presented in the programme. The private sector would contribute 1 pp. to this rise, while the public sector's external debt would drop by 0.6 pps. over this period. Stress-test results presented in this analysis point to limited vulnerability in the event of shocks to GDP, the primary deficit or interest rates.

Graphs: external competitiveness and current account



The central bank ensured that banks remained resilient during the crisis. Banks continue to dominate North Macedonia's financial sector, accounting for some 82% of sector assets. Banking sector concentration remains moderate and was almost unchanged compared with previous years, with some 57% of assets held by the three biggest banks in 2020. Ten out of the sector's fourteen banks are predominantly in foreign ownership. In August, the central bank revoked the license of one (small) bank, which, however, had a very limited impact on the sector's performance. The banking system remains well-capitalised, but there is a need to preserve capital in view of the likely future rise in NPLs, following regulatory normalization. The share of own funds allowed to serve as buffers remains high overall in the sector. Capital adequacy (Tier-1 capital to risk weighted assets), rising to some 15.5% at the end of 2020, compared to a year earlier (14.7%). The programme said that capital adequacy remains above regulatory requirements even in extreme stress simulations. Supported by central bank action, banks hold abundant liquid assets (in March, the central bank lowered reserve requirements for loans to the most affected sectors, and in May it expanded the range of securities accepted from banks as collateral in liquidity-increasing operations). The loan-to-deposit ratio increased only marginally in 2020 compared to a year earlier. Despite two temporary periods in which deposits declined, deposit growth remained strong in 2020 overall, with a (crisis-induced) preference among savers for more short-term, liquid, and, to some extent foreign exchange-denominated deposits. Importantly, it is essential that the independence of the central bank is maintained, combined with accountability and transparency, so it can continue to fulfil its mandate of maintaining price stability and the overall stability of the financial system.

Regulatory easing bolstered bank lending, but asset deterioration is expected when measures are phased out. In March, the central bank allowed commercial banks to temporarily ease credit standards, including through two payment moratoria allowing for the temporary deferral of loan repayments. The first moratorium, running from April to September 2020, was taken up by about half of the household loan portfolio, and by about one third of companies. Also, banks could raise the threshold for loans to reach non-performing status (from 90 to 150 days). These measures helped strengthen credit growth and contain the non-performing loan (NPL) ratio: at the end of 2020, the NPL ratio fell to 3.4%. Credit growth to the non-governmental sector amounted to 6.5% in 2020 (2019: 7.3%). After the end of the second moratorium in the spring (for households in March, staggered for companies as of May), and accounting for the 90 days grace period, a rise in the NPL ratio is to be expected. Given the likely increased needs for provisioning after the end of the moratorium, some banks may need to strengthen their capital buffers. The phasing out of regulatory easing also requires a legal framework to be put in place, to deal with a potential deterioration in asset quality. For example, this legal framework could facilitate the transformation and sale of NPLs. In this regard, a swift adoption of the draft Law on bank resolution will be important.

Table 2:

North Macedonia - Financial sector indicators

	2016	2017	2018	2019	2020
Total assets of the banking system (EUR million)	7 233	7 513	8 187	8 945	9 490
Foreign ownership of banking system (%)	69.4	70.1	71.4	72.8	75.0
Credit growth	6.5*	5.9	7.6	6.1	4.1
Deposit growth	5.4	5.1	9.4	9.2	6.2
Loan-to-deposit ratio	87.0	87.7	86.2	83.8	82.0
Financial soundness indicators (end of period)					
- non-performing loans**	6.6	6.3	5.2	4.8	3.4
- net capital to risk-weighted assets	14.0	14.2	15.0	14.8	15.3
- liquid assets to total assets	30.9	29.8	30.6	31.9	32.5
- return on equity	13.6	13.5	16.0	11.7	11.3
- forex loans to total loans (%)	44.9	42.5	41.4	42.3	42.3

* corrected for the write-offs

** including the impact of write-offs.

Sources: National Central Bank, IMF, Macrobond.

3. PUBLIC FINANCE

In 2020, North Macedonia's public finances deteriorated greatly due to the COVID-19 crisis. The slowdown in economic activity left its mark on public finances, resulting in a 6.9% y-o-y decline in government revenue for the full year, while current expenditure increased by 13.9%. Income from direct and indirect taxes fell, compounded by VAT reductions and deferred tax payments as part of the government's relief measures. The strongest drop in revenue came from VAT income (-26% y-o-y), while revenue from social contributions (+7% y-o-y) was boosted by government subsidies to employers' contributions. On the expenditure side, the government increased spending on the health sector and on statutory transfer payments. In addition, the government needed to budget for four sets of economic measures adopted between March and October, which provide fiscal and liquidity support to households and companies. In order to finance the first set of measures, a budget reallocation in April cut the amount originally planned for capital expenditure in 2020 by 15%. Capital spending therefore dropped by 9.5% y-o-y, to 3.1% of GDP in 2020 (compared to 3.2% in 2019). Following two further budget revisions, in May and in October, allocations for transfer payments increased by 13%, and the fiscal deficit target for 2020 was successively raised, from 2.3% of GDP in the initial, pre-crisis budget plan, to 8.4%. Ultimately, the general government fiscal deficit for the full year 2020 amounted to 8.1% of GDP. The programme estimates that the fiscal impact from automatic stabilisers due to the slowdown in economic activity amounted to some 3.4% of GDP in 2020. The remainder of the estimated increase in the deficit target, compared to the initial plan, is due to discretionary support measures.

Government anti-crisis measures supported households and companies. The programme provides an estimate of the overall total fiscal impact of discretionary measures (2.9% of GDP). Expenditure on wage subsidies, as the fiscally most significant measure, amounted to 1.1% of GDP. The eligibility criteria for wage subsidies include a revenue drop of at least 30% compared to pre-year. Support measures not directly reflected in the budget include liquidity support via interest-free credit lines of the Development Bank of North Macedonia (guarantees constituting contingent liabilities for the government), amounting to 0.6% of GDP.

Table 3:

North Macedonia - Composition of the budgetary adjustment (% of GDP)

	2019	2020	2021	2022	2023	Change: 2020-23
Revenues	31.5	32.1	32.6	32.0	31.8	-0.3
- Taxes and social security contributions	27.0	27.7	28.1	27.8	27.7	0.1
- Other (residual)	4.5	4.4	4.5	4.2	4.0	-0.4
Expenditure	33.7	40.5	37.6	35.8	35.0	-5.5
- Primary expenditure	32.5	39.2	36.2	34.5	33.7	-5.6
<i>of which:</i>						
Gross fixed capital formation	3.4	3.6	4.3	4.3	4.8	1.2
Consumption	10.0	11.7	11.6	11.0	10.4	-1.2
Transfers & subsidies	18.9	24.0	20.3	19.2	18.4	-5.6
Other (residual)	0.2	0.0	0.0	0.0	0.0	0.0
- Interest payments	1.2	1.3	1.3	1.4	1.3	0.1
Budget balance	-2.2	-8.4	-4.9	-3.8	-3.2	5.2
- Cyclically adjusted	-2.6	-6.5	-3.9	-3.5	-3.6	2.8
Primary balance	-1.0	-7.2	-3.6	-2.5	-1.9	5.3
- Cyclically adjusted	-1.4	-5.2	-2.5	-2.2	-2.3	2.9
Gross debt level	40.6	51.2	53.2	53.3	53.7	2.5

Sources: Economic Reform Programme (ERP) 2021.

The government plans to return to expenditure-based fiscal consolidation starting in 2021. Following a 3.5 pps. improvement in 2021 as crisis support is gradually withdrawn, the general government deficit is expected to decline by a further 1.7 pps. between 2021 and 2023, to -3.2%. However, the government forecasts that it will only reach and fall below its pre-crisis level (2019: -2.2%) in 2025. The primary balance will improve from -3.6% of GDP in 2021 to -1.9% in 2023, and further to -0.9% in 2025. Consolidation will be entirely based on a reduction in the expenditure ratio (-2.6 pps. between 2021 and 2023 to 35%). This relies on containing current expenditure, mainly transfers and subsidies. Capital expenditure, on the other hand, is expected to increase significantly, both in nominal terms and as a share of GDP. After a temporary rise in 2021, the revenue ratio, already low by regional comparison, is projected to decline by 0.8 pps. to 31.8% in 2023. This puts into focus the country's restricted tax base and its persistent problems with revenue collection. These two issues prevent a better balanced fiscal consolidation and a swifter achievement of a balanced primary budget. The ERP's projection for the cyclically-adjusted primary balance points to a significant tightening in 2021 and a broadly neutral stance afterwards. Overall, the projected mid-term return to fiscal consolidation is not underpinned by explicit savings measures. Rather, it relies on projected strong growth; phasing out of anti-crisis support measures; and (not quantified effects from) improvements in public financial management.

In 2021, the government expects the fiscal deficit to narrow as support measures are phased out. The 2021 budget projects a general government deficit of 4.9% and is based on expectations of 4.1% real GDP growth and 1.5% inflation. Under this scenario, revenue would rise by 0.5 pps. y-o-y to 32.6% of GDP, and expenditure would drop by 2.9 pps. to 37.6%, mainly due to a large decline in subsidies and social transfers which had increased greatly in 2020 through government anti-crisis support. Still, capital expenditure is expected to increase by 50% and to amount to 4.3% of GDP. Almost 45% of tax revenue would be generated from VAT, which is about the average of the past 5 years. Financing needs in 2021, including foreign debt repayments totalling 5.3% of projected GDP, and domestic debt repayments in the amount of 0.9% of GDP, are estimated at some 11% of GDP. They would

be funded through domestic (3.3% of projected GDP) and foreign borrowing, including a Eurobond¹.

Fiscal measures planned by the government for 2021 are tilted towards temporary crisis mitigation through income and liquidity support for households and companies.

Government support remains focused on those sector that are particularly hard hit by the crisis. Moreover, most government measures for 2021 are being continued from the previous year without a proper impact assessment having taken place. This is also true of the government's liquidity measures, such as credit guarantees for the private sector, that require a thorough analysis of fiscal risks and options for mitigating these risks. Crisis-mitigating support measures certainly need to be phased out carefully, to avoid a sudden, large-scale failure of companies that are no longer viable without the support. Nevertheless, to bolster the recovery, firm-level support needs to become more targeted towards companies that were financially solvent before the crisis. In this regard, improving the effectiveness of state aid policy through a functioning state aid registry including performance indicators informing the state aid program designs would be useful. Support to private investment should have productivity-enhancing potential, focus on "green" technologies and digitalisation, and export diversification. The government can also bolster the economic recovery through its ambitious public investment agenda. To this end, projects must be more clearly focused on productivity-enhancing investment. They should be prioritised according to transparent criteria and possible obstacles to their timely implementation must be removed. Equally, the possibility of tax deferrals for companies (and households) should be carefully calibrated as the recovery progresses. This will help to avoid the accumulation of tax arrears that might ultimately create sizeable liquidity problems and result in default.

¹ On 3 March 2021, the government placed a seven-year Eurobond worth EUR 700 million due in March 2028. It is its 8th Eurobond.

Box: Debt dynamics

After a large increase in 2020, general government debt is projected to broadly stabilise by 2023. General government debt rose markedly due to significant external and domestic borrowing in 2020, and amounted to 51.3% of GDP at the end of 2020 (+10.6 pps. compared to end-2019). Apart from the large foreign inflows needed to fill the crisis-related financing gap², the government also needed to roll over EUR 180 million of the 2015 Eurobond maturing in 2020³. After rising by 2 pps. y-o-y in 2021, because of the primary balance and interest payments, the debt ratio is projected to remain stable in 2022 and rise further, by 0.5 pps., in 2023. From 2022, the government forecasts that the debt-reducing real-growth effect would supersede the debt-driving impact of the primary deficit, which is expected to decline gradually. In 2023, the increase in the debt ratio would come mainly from increased borrowing for replenishing government deposits (stock-flow adjustment), according to the government.

North Macedonia					
Composition of changes in the debt ratio (% of GDP)					
	2019	2020	2021	2022	2023
Gross debt ratio [1]	40.6	51.2	53.2	53.3	53.7
Change in the ratio	0.2	10.6	2.0	0.1	0.5
<i>Contributions [2]:</i>					
1. Primary balance	1.0	7.2	3.6	2.5	1.9
2. "Snowball" effect	-0.5	2.7	-1.7	-2.0	-2.4
<i>Of which:</i>					
Interest expenditure	1.2	1.3	1.3	1.4	1.3
Growth effect	-1.2	1.9	-2.0	-2.3	-2.6
Inflation effect	-0.4	-0.4	-1.0	-1.0	-1.0
3. Stock-flow adjustment	-0.3	0.7	0.1	-0.4	0.9

[1] End of period.

[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

Source: Economic Reform Programme (ERP) 2021, ECFIN calculations.

Debt financing of public investment is expected to peak in 2023. Although the dynamics of general-government debt are driving the overall rise in public debt (overall public debt was 60.2% of GDP in 2020, including the debt of public enterprises), government-guaranteed public debt is also likely to rise further. The government forecasts that government-guaranteed public debt will peak in 2023, as loans are released to finance public-investment works carried out by state-owned enterprises. This is in contrast to the projection of last year's programme, which expected loan disbursements for these purposes to end after 2021, but may be explained by the postponement of a number of public works projects in 2020, as crisis-related needs prevailed.

The structure of government debt contains moderate risks. Maturities of domestic issues (share of 30-yr bonds in the portfolio) have lengthened further in 2020. There was also an increase in the average time to maturity (7.3 years for domestic debt, and 5.5 years for total debt). However, given the large inflows of foreign financing in 2020, the share of foreign currency debt increased in 2020 compared to a year earlier. This highlights vulnerabilities in the event of exchange rate depreciation (mitigated by the de facto currency peg to the euro). The share of euro-denominated in total foreign currency debt declined somewhat in 2020 (-1.8 pps. y-o-y to 91%), yet it is still comfortably above the minimum threshold set by the

² The government issued a six-year EUR 700 million Eurobond, and received external loans from the IMF (EUR 176 million), the World Bank (EUR 140 million) as well as a first tranche (EUR 80 million) of Macro-Financial Assistance from the EU (October).

³ In 2023, the 2016 Eurobond (EUR 450 million) matures, followed by the 2018 Eurobond (EUR 500 million) in 2025.

government (85%). The debt portfolio also remains exposed to risk from interest rate developments, given the considerable (and, in 2020, increasing) share of domestic currency debt at variable rates (yet, at 22% much below the government's maximum threshold of 40%). The programme considers these risks by testing the sensitivity of public debt to interest and exchange rate risk. Over the medium-term horizon, the government is likely in a position to refinance more of the maturing external debt by new domestic issuance, given the recent extension of the maturities of domestic issues. The improved structure of public debt is likely to ease financing conditions for the government. This will allow the government to meet its considerable requirements to finance the deficit and roll over maturing domestic and foreign debt in 2021-2023 (the programme calculates that the combined value of deficit finance and rolled-over debt that must be financed is about 10% of GDP on average per year). The government plans to meet these requirements by turning to domestic and foreign sources, including another Eurobond in 2021.

Box: Sensitivity analysis

The programme includes a sensitivity analysis of the fiscal deficit based on three parameters. The first parameter is GDP growth. If average annual real GDP growth is lower than projected, by 1.3 pps. in 2021-2025, the budget deficit would increase by an average of 0.7 pps. per year. The second parameter is capital expenditure. Lower capital expenditure (about two thirds realisation) would imply a reduction in GDP growth by 0.7 pps. per year and an increase in the deficit by 0.3 pps. on average annually. The third parameter is tax collection. If tax collection drops by 5% per year, this would imply a budget deficit of 4.2% on average in 2021-2025 (compared to 3.3% in the baseline scenario, and to 3% in the same risk scenario in last year's programme for 2020-2022). The programme also assesses the potential impact on debt-servicing costs of external government debt arising from higher interest rates (+1 pp. compared to the baseline) and a 10% appreciation against the euro of other currencies in the portfolio.

Fiscal consolidation plans are subject to implementation risks, including only timid efforts to increase tax revenue. The government could strengthen its commitment to fiscal consolidation by making fiscal policy initiatives more consistent, and by pursuing its declared intention to improve revenue collection in a more determined manner. Recent policy measures and announcements of new policy initiatives have been ambiguous, as they frequently involve further fiscal expansion (privileged pensions, public sector wage growth, subsidies, capital spending, bailout of local government units) or erosion of revenues (discussion about a zero personal income tax rate for the ICT industry, widened application of a preferential VAT rate in the catering and craft sector and discussion of preferential regime for the agriculture sector and for export-oriented companies, a discussion about tax amnesty, for example). In December, the government adopted the Tax System Reform Strategy which foresees measures to strengthen revenue collection i.e. by broadening the base through the elimination of tax expenditure. However, at the same time, the Reform Strategy foresees further tax incentives for companies and households through the tax base of CIT and PIT. The introduction of new permanent tax incentives goes against the government's declared objective of broadening the tax base and the need to increase the revenue-to-GDP ratio, and also raise concern with regard to fiscal discipline and debt sustainability.

The programme anticipates a medium-term shift towards growth-enhancing public expenditure and measures to address weaknesses in the management of capital spending. Partly because of crisis-related needs, current expenditure was even more tilted towards transfers in 2020, including pensions, and subsidies than in previous years (transfers accounted for 72% of total expenditure). Capital expenditure was again significantly under-executed, also to finance the additional transfer spending. In general, the government is aware of impediments to raising the execution rate of budgeted capital expenditure, and has started to initiate reforms. For example, in the 2021 budget, it introduced a new capital expenditure rule, which provides for reallocation of budgeted funds among budget users if a certain amount of the budget has not been used within a set period of time. In addition, the government adopted an action plan in December, containing measures to improve the management of public investment, based on the 2020 Public Investment Management Assessment (PIMA) by the IMF. However, overall there is limited progress so far in implementing the PIMA recommendations. Looking forward, the government expects capital expenditure to increase from 4.3% of projected GDP in 2021 to 4.8% in 2023. On the other hand, public consumption, as a share of GDP, is projected to decline after 2021, mainly as a result of lower growth in goods and services expenditure post-crisis. It is important that that a drop in current expenditure consists in permanent savings, unlike in previous years, when a decline in collective consumption remained based on temporary cuts. If realised, these dynamics would improve the quality of public spending, but this is subject to the aforementioned risks.

Improving the legal framework for public–private partnerships (PPP) would be a first step towards alternative ways of implementing public investment. Fiscal constraints and marked weaknesses in project implementation by state enterprises increasingly necessitate additional solutions to close the large public infrastructure gap. The current law on PPPs and concessions is marked by a number of weaknesses which often prevent desirable outcomes of projects. Municipalities, which are the most active users of PPPs, lack financial flexibility and technical expertise. Public bodies that wish to use PPPs for major projects complain about a lack of detailed administrative guidelines on selecting, implementing and managing PPP projects. There is often limited central oversight, as each contracting authority sets its own contract formats and terms and conditions. The monitoring of fiscal risks is also not sufficiently ensured: contingent liabilities arising from PPPs and from capital projects financed by the municipalities are not reported to the government. The government has finalised a first draft of the new PPP law, to introduce amendments that would address these shortcomings and ensure that PPPs would become an efficient vehicle for implementing public infrastructure projects, while mitigating potential fiscal risks involved in these contracts. However, severely limited capacities at ministerial level to administer PPPs remain a major bottleneck to their extended use.

The government further improved the fiscal framework and transparency of public finances, but systematic information on enterprise-level support is missing. In December, the government adopted a new draft Organic Budget Law (OBL), which provides for the introduction of fiscal (deficit and debt) rules and an independent fiscal council, as well as for a proper medium-term budget framework. This would bring significant improvements to the way public finances are managed, despite some shortcomings related for instance to the too broadly defined escape clauses of the fiscal rules. However, the law still needs to be passed by parliament and accompanied by secondary legislation, which could lead to protracted implementation. In addition, the government made public finances more transparent by publishing quarterly data on the finances of public enterprises and municipalities. Fiscal documentation does not yet include those public entities that would, under international accounting standards, be classified as belonging to the government sector. However, the fiscal

rules in the new draft OBL would apply to the general government whose definition is planned to be based on ESA 2010 requirements. Although the government has a dedicated webpage listing beneficiaries of COVID-19 related support, the allocation of subsidies at company level generally remains opaque with regard to both the sums received by beneficiaries and the criteria for allocating support. Transparency is essential with a view to using funds in a targeted, efficient, and growth-enhancing manner, and could be much increased through the setting up of a proper registry of state aid.

4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

This chapter sets out the Commission's independent analysis of North Macedonia's economy and identifies the main structural challenges the country faces. Addressing the immediate impact of the COVID-19 pandemic has been a priority for the government. However, medium- to longer-term prospects for both economic growth and resilience to external shocks will depend on North Macedonia's ability to implement structural reforms. Each of the main challenges faced by the country influences overall competitiveness in its own way. However, because these challenges are very often mutually reinforcing, it will be essential to address them to boost productivity and inclusive growth in the medium-to-long term. The three most significant challenges the Commission identified are: (i) improving the quality and relevance of the education system to increase employment and mitigate skills mismatch levels, (ii) increasing the competitiveness of domestic companies and their integration into global value chains (iii) formalisation of the economy.

Education outcomes are not sufficiently linked with the needs of the labour market which prolongs the transition from school-to-work, feeding the informal economy, out-migration and poverty. The informal economy distorts competition, decreases the quality of the business environment, leads to shortfalls in public revenue, and leaves some workers without social protection or with only limited rights. Accompanied by COVID-19 induced disruptions, failure to address the underlying obstacles that drag down the competitiveness of domestic companies will damage the country's growth prospects and trade balance. Disruptions to global value chains caused by the pandemic require actions to retain, strengthen and expand North Macedonia's attractiveness as a participant in these value chains.

North Macedonia also needs to continue to tackle corruption, improve the rule of law and strengthen institutions in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for successfully transforming the economy. The Commission is closely following the issues concerning the strengthening the rule of law and the fighting of corruption in its *Enlargement Package North Macedonia* report.

Key challenge #1: Improving the quality and relevance of the education system to increase employment and mitigate skills mismatches

The persistent structural challenges in the labour market have been further exacerbated by the COVID-19 pandemic. The labour market has improved in the past decade, and this has been reflected by an increase in the average salary. But this improvement was slowed by the unpredictability of the political situation in 2017. Improvements in the labour market were finally halted altogether by the COVID-19 pandemic. The employment rate (20-64) decreased slightly by 0.7 pps. during the year (falling from 59.2% in 2019 to 58.5% in the third quarter of 2020). The labour force participation rate (20-64) decreased even more, falling from 71.5% in 2019 to 69.8% in the third quarter of 2020, showing that people have tended to withdraw from the labour market rather than look for a job. This is corroborated by the slightly shrinking unemployment rate (among 15-74 year olds), which fell from 17.3% in 2019 to 16.5% in the third quarter of 2020 – well above the EU-27 average. The impact of the

COVID-19 pandemic, as demonstrated by the main socioeconomic indicators, has so far been partially mitigated by the package of measures adopted by the government and a larger negative impact of the crisis is only expected to become apparent in 2021. North Macedonia's economic reform programme acknowledges the deficiencies of the labour market, but does not propose measures to address them.

Some fundamental structural weaknesses of the labour market remain. Women and young people are particularly exposed to unemployment and inactivity, as are people with disabilities and the low-skilled, particularly Roma. The population is also ageing: the share of the population aged 0-14 decreased from 19.4% in 2005 to 16.4% in 2019), while the share of older people (aged 65 and above) increased from 11.1% to 14.08% during the same period. The long-term unemployment rate stood at 12.4% in 2019 (15-74) and continues to account for most of the overall unemployment rate. The quality of available jobs remains an important issue fuelling the emigration ('brain-drain') of talented people: 1 in every 4 (27.6%) employed young people works in a field that does not correspond to their level of education (World Bank, 2020). The regional disparities are strong, as the employment gap between the southeast (the best-performing region) and the northeast (the worst-performing region) remains around 25 percentage points.

Young people in particular continue to face difficulties in entering the labour market. 45% of young people stay unemployed for 4 years or longer after finishing school, while only 7.3% are unemployed for less than 1 year (Labour Force Survey, 2019). The countrywide implementation of the Youth Guarantee in all 30 employment centres in 2019 led to a reduction in youth unemployment (those aged 15-24) from 45.4% in 2018 to 35.6% in 2019, but youth unemployment still remains high. Similarly, the share of young people not in employment, education or training decreased from 24.1% in 2018 to 18.1% in 2019. However, this share still remains substantially above the EU average for the same period (10.1% in 2019). The report evaluating the effectiveness of the Youth Guarantee in the country has still not been released. Importantly, looking at the larger group of people aged 20-34, the broad gender gap (25.3% of men not in employment, education or training (compared to 37.4% of women) indicates the social conventions or pressures which place higher importance on women's roles within the family (OECD, 2020).

Active labour market policies are still not sufficient to help jobseekers find sustainable employment, while employment activation remains weak. Despite the countrywide implementation of the Youth Guarantee, there has been no comprehensive monitoring and impact assessment of the effectiveness of active labour market policies for many years. The impact of revised legislation on these policies is also not clear. Active labour market policies have a limited scope, as they cover less than 10% of the unemployed and less than 25% of the poor. The capacity of the public employment service to give job mediation and implement active labour market policies is also weak due to lacking human and financial resources.

The insufficient relevance and quality of education, combined with the structure of the enterprise sector, contributes to skills mismatches. This leads to persistent unemployment and underuse of young people's potential. The education system contributes to the lengthy school-to-work transition by failing to identify and meet the needs of the labour market. The skills mismatch continues to be a major impediment to people finding work. This is because of the discrepancy between the curriculum of secondary schools offering vocational education and training (VET) and the demands of the labour market (ETF, 2020). It is recommended to improve career guidance and establishing a mechanism for monitoring quality and relevance of curricula, including in private universities. North Macedonia is putting in place an institutionalised process and tools for monitoring/forecasting skills needs to adequately align VET, higher education, and up- and re-skilling offers to

labour market needs. The national qualification framework, that was referenced to the European Qualifications Framework in 2016, was designed to support modernisation of education and training, with a view to improving quality and adaptability of education to labour market needs, and promoting lifelong learning and mobility.

North Macedonia's education system does not give young people enough of the key skills and knowledge they need to actively participate in the labour market. This continues to hinder companies' competitiveness and their deeper integration into the global economy. Despite substantial improvements in the 2018 Programme for International Student Assessment (PISA) compared to the 2015 study, North Macedonia still ranks low among the other participants (68th place out of 78 participating countries) and compared to its regional peers. Even the highest-performing students scored only around the OECD average. The gender gap is a particular issue, as boys perform worse than girls. This gender gap is far greater than international averages (North Macedonia has the third largest global gender gap in reading performance). Other significant gaps are linked to students' socioeconomic status, educational track, and language of instruction. The OECD has signalled that there is a specific problem in fostering the 'growth mind-set'. For example, more than 60% of the country's students agreed with the statement that 'intelligence is something about them that they can't change very much'. This means that many students are unlikely to make the investments in themselves that are necessary to succeed in school and in life. PISA data also highlight the need for improvements in the quality of teaching, since half of all students have not achieved basic literacy and numeracy skills by age 15.

A reform of the education system was planned in the 2018-2025 education strategy, but this reform requires greater funding. The education strategy and the related action plan both prioritise providing quality skills to young people to prepare them for society and the labour market. However, these two documents also both state that financial support is insufficient and that inter-sector coordination is lacking. If the country's Agency for Quality Assurance could function more satisfactorily, this would also help. Public spending on education is clearly insufficient. North Macedonia has steadily reduced its spending on education from 4.62% of GDP in 2011 to 3.7% in 2019. This level is currently below the EU-27 average of 4.7% in 2019 and also below peer-country averages. The education system is also undermined by the inefficiency of public spending (World Bank, 2019).

Major reforms are being made in VET, but the quality of teaching is still an obstacle. Approximately 56% of upper secondary students in North Macedonia follow a vocational pathway (42 641 students in 2019/2020) – a proportion comparable to the rest of the Western Balkans and higher than the EU average by 13 pps. (EU average is 43%). In 2019, 79% of the country's VET graduates subsequently enrolled in tertiary education, compared to 53% of students from general schools (World Bank, 2019). The low transition of students from general upper secondary education to higher education means that almost half of those who leave secondary school without further education have not acquired a specialisation to participate in the labour market. The three-year and four-year VET curricula were revised in 2019, and the development of the three regional VET centres (Tetovo, Kumanovo, Ohrid) is under way. The lack of technical skills among vocational-school graduates is considered a major bottleneck by companies in North Macedonia. This is because the teaching and learning methods in VET schools are largely theoretical, offer limited practical training, and suffer from a lack of teaching and learning materials (OECD, 2020). There is a need to further invest in the professional development of VET teachers and introduce a more flexible, modularised VET curriculum with the direct involvement of employers.

Participation in lifelong learning has increased slightly. The percentage of adults participating in learning (2.8%) is significantly lower than the corresponding EU-27 average

of 10.8% (2019). Based on the strategy for adult education 2019-2023, a pilot project with the Adult Education Centre saw the introduction of two qualifications, although these were only made available in Skopje. Further development of qualifications and up-skilling/re-skilling programmes throughout the country are key to integrate medium-skilled and low-skilled people into the labour market. Furthermore, promoting lifelong learning and the strengthening of informal education should help to improve workers' technical and managerial skills. This is needed to raise productivity in companies and industry.

The continuing gender gap undermines North Macedonia's overall economic potential.

The gender employment gap (the percentage-point difference in the employment rate of men and women aged 20-64) stood at 18.9 pps. in the third quarter of 2020, while 68.6% of the inactive population (20-64) in the same period were women. This is partly due to: (i) women's traditionally lower presence in the labour market; (ii) previous disincentives for women to work; and (iii) the burden of childcare and family care. Women are much more likely to be low paid. Estimates of earnings indicate a significant gender pay gap and the potential for discrimination in the labour market against women. Women in North Macedonia also have a working life that is on average 12 years shorter than that of men (Gender Equality Index, 2019).

The emigration of workers is a serious impediment to business, and poses a substantial risk of brain-drain for North Macedonia. The shortage of jobs – and secure, well-paid jobs in particular – is the biggest challenge. This makes it especially difficult to prevent young people from leaving the country. The inability to predict the country's economic prospects is also considered a key factor that is fuelling the emigration of young and skilled workers. According to projections, the share of the population aged 65 and above will double from 12.5% in 2015 to 25.4% in 2050, placing significant strain on the social-protection system. This trend will gradually reduce the share of the working-age population (those aged 15-64) from 70.6% in 2015 to 60.4% in 2050 (ILO, Decent Work Programme, 2019). About 59% of businesses struggle (OECD, 2020) to find workers with appropriate skills.

Informal employment has decreased, but remains at a high level. The informal employment rate fell to 13.8% in 2019, but remains structurally high (Labour Force Survey, 2019). Most informal work is concentrated in agriculture, where 52.3% of work is informal. However, other sectors such as construction, manufacturing and wholesale trade also have high levels of informal employment. The government's focus on reducing the informal economy is in accordance with its 2018-2022 strategy and its 2018-2020 action plan (EBRD, 2019).

Reform Measure 18 of the ERP "Further development of the qualification system", is rolled over from the last year. The measure reflects the key policy reforms presented in the ESRP adopted by the government. The measure addresses the key bottleneck of the education system and builds on the activities implemented in 2020. To implement this measure, the modernisation of three regional VET centres is key, and further development of such centres of excellence is needed throughout the whole country. The measure presents indicators and a budget in the fields of employment, education and social policy. Although both the ESRP and the inclusion of the measure in the ERP signals that education is among the top priorities of the government, the measure's expected impact on competitiveness could be further strengthened.

Key challenge #2: Improving the competitiveness of domestic companies and integration in global value chains

Domestic companies' low and slow-growing productivity hinders their competitiveness.

North Macedonia's businesses suffer from unsophisticated technology, limited capacities of production and innovation, inconsistent quality of goods and services, deficient managerial skills and competition from a large informal sector. Further constraints to modernisation of technologies and business processes as well as to expanding manufacturing and internationalisation capacity result from the skills mismatch in the labour market on both managerial and operational level, caused by weaknesses in the education system and a complex application of business regulations.

The COVID-19 pandemic has put a significant additional burden on companies, causing them to cut their investment in development of human and physical capital.

The pandemic is expected to exacerbate the slowdown in regional productivity (World Bank, 2020). It has negatively affected profitability and turnover in 90% of companies and caused a drop in their productivity (International Labour Organisation, 2020). The highest share of enterprises reporting a drop in revenues operate in sectors affected by the government ban on business operations and curfew restrictions, specifically transportation, storage, accommodation and food services, construction, trade, and professional, scientific and technical services (ILO, 2020).

The COVID-19 crisis has also shown the vulnerability in global value chains, which represented 80% of global trade before the crisis (IMF, 2019).

North Macedonia's links to global value chains are still predominantly concentrated in services and low- to medium-value manufacturing (IMF, 2019). Following the outbreak of the crisis, 45% of the country's businesses reported a decline in demand for products and services, 38% reported weaker confidence in supply chain partners, and 35% reported disruptions in the sourcing of raw materials (ILO, 2020).

Although tackling the immediate challenges of the COVID-19 crisis has been an immediate priority, reform measures to foster the competitiveness of domestic companies need to be strengthened further.

Raising the competitiveness of local companies will require higher investments in human and physical capital and improving the overall business environment, including better enforcement of business regulations and corporate governance, as well as better services including trade and transport logistics. Productivity could be further improved by more investment in research and innovation, further cooperation between SMEs and stimulating their geographic agglomeration and interconnectedness, as well as with further regional integration.

Especially in this challenging period, businesses need a fair, predictable and functional regulatory framework, with an effective and increasingly digital public administration (ILO, 2020).

The pandemic has amplified the need for an enabling business environment, with low administrative burden and improved access to public services, allowing businesses to cope with the new challenges of the pandemic. Consequently, full implementation of the 2019 Law on inspection supervision and implementing transparent and consistent procedures for inspections would increase the ease of doing business. The COVID-19 pandemic has also demonstrated an urgent need to further simplify access to public services, in particular by digitalising the public administration. Setting up a fully-operational online 'one-stop-shop' system for all business-related permits and licences could have an additional benefit for on the business environment.

In recent years, authorities have been focusing on attracting FDI, which in 2019 amounted to 3.8% of GDP, as a way of increasing competitiveness of domestic companies. However, the COVID-19 pandemic has made it much more difficult to attract or even retain FDI. Initial estimates suggest that the decline in global FDI caused by COVID-19 will range from 30% to 50% in 2020-2021 (World Bank, 2020). Therefore, attracting and retaining FDI will require prioritisation and the strengthening of targeted public policies to address the underlying structural obstacles affecting domestic companies' competitiveness. In particular, attracting FDI to higher-value segments of international value chains will depend on North Macedonia's ability to reform its education system and labour market. Attracting FDI could further benefit from opportunities to co-operate with local economy on innovation activities.

As attracting new FDI is becoming more challenging, it is a priority to use multinationals already present in the country as a vehicle for productivity growth. Multinational companies operating in the country perceive insufficient technological development, weak adherence to quality requirements, lack of compliance with international standards and certificates as well as limited production capacity of domestic partners as the main weaknesses constraining their integration with domestic industry (Finance Think, 2019). This requires that the authorities should take measures to facilitate technological upgrading and investment in reliability and quality of production, and help domestic companies to develop their technological capacity. In addition, digitalisation of industry is a major driver of productivity gains and should be further strengthened. North Macedonia is currently preparing its smart specialisation strategy, which will be based on the mapping of economic, innovative and scientific potential in the country. This strategy should therefore consolidate the country's economic policy priorities and support the further development of sector-level strategies in the relevant fields such as education and skills, industry, research and innovation, as well as attracting FDI.

Instead of tackling the country's underlying structural challenges and business environment issues, the government's flagship policy to attract FDI and improve domestic firms' competitiveness relies on providing various forms of State aid to businesses. The special temporary framework for State-aid measures to support affected businesses and the economy during the COVID-19 crisis was justified. However, further extended use of State-aid schemes as a measure to support domestic companies must be based on close, continuous assessment of the business environment issues and clear policy objectives. The Law on financial support of investment, based on which part of state aid is being distributed, retains certain features that are problematic in view of the EU *acquis* on State aid. The Law on strategic investments adopted in 2020 with the aim of supporting so-called strategic projects, lacks a well-elaborated policy framework and implementing regulations. There is an urgent need to develop a comprehensive and transparent registry of State aid and to create a more effective State aid notification system. More action is needed to monitor the cost-effectiveness of these schemes and their impact on competitiveness, to ensure coordination of different programmes, and to strengthen the capacity of the Competition Agency and of institutions providing State aid.

The regulatory framework's lack of transparency and predictability continues to negatively affect the business environment and the competitiveness of domestic companies, in particular SMEs. Increasing the efficiency and transparency of public administration, reducing the time and costs of commercial disputes and promoting alternative dispute resolution mechanisms would address some of the factors limiting the competitiveness

of domestic companies. In 2020, North Macedonia drew up initial list of 370 para-fiscal charges at central and local levels, but further steps are now needed to rationalise them.

Further developing certain service sectors could be an opportunity for domestic companies. Services such as logistics, transportation, and information and communication technologies are fairly unsophisticated at present. This forces foreign companies to use alternatives outside the country. According to multinationals operating in the country, 91% of services they need can be found in North Macedonia. However, 30% of the companies surveyed found these services not to be of the required quality standards (Finance Think, 2019). This assessment is also reflected in the relatively small export share of service industries. A shift in public policies in support of upgrading services closely linked to the creative and production industries could allow the country to increase the role played by services in improving productivity and creating value.

The COVID-19 crisis may also offer opportunities for domestic companies. Further efforts should be made to integrate the country's companies into global value chains in a sustainable way, so that domestic companies can further diversify their export structure and mitigate future shocks. North Macedonia needs to consider how to better position itself on the global market, if the pandemic leads to a further retreat from trade integration, with higher trade barriers and re-shoring of production. The country should act to ensure that it can retain, strengthen, or expand its attractiveness as a participant in the global value chain by ensuring the free flow of manufactured goods across borders to ease the pathway to greater integration and diversification. To benefit from these opportunities, North Macedonia should reduce trade costs by streamlining its non-tariff measures and closing the remaining gaps in the main transport corridors. Reducing entry barriers in network industries such as electricity and telecommunications and undue restrictions on professionals like attorneys, accountants, and engineers would further enhance the trade in services. The gaps in national and international digital infrastructure should be bridged and digital cohesion enhanced.

The Economic and Investment Plan for the Western Balkans will help increase the competitiveness of North Macedonia's economy backed by a green and digital transition. A substantial investment package, which is at the heart of the Economic and Investment plan, will direct a large majority of support towards key productive investments and infrastructure. This will support the twin green and digital transition and the development of connected, competitive knowledge-based, sustainable, innovation oriented and thriving economy, with an increasingly dynamic private sector. Circular-economy principles, as a basis for the Economic and Investment Plan and defined in the green agenda for the Western Balkans. The principles could significantly foster sustainable production and consumption. Increasing resources productivity within the economy would allow local SMEs to benefit from the business opportunities of increased resource efficiency and by further access to innovative technologies.

Building a common regional market has the potential to further enable competitiveness and growth. The common regional market is based on EU standards and will help the country integrate in regional and European value chains. It will also help make the economy more attractive for FDI in tradable sectors, notably by increasing the size of its market. Further connectivity with neighbouring countries in transport and energy will strengthen access to, and integration into, the regional market. The new Additional Protocol 6 of the Central European Free Trade Agreement (CEFTA) to liberalise trade in services also opens new opportunities in the dynamic service sectors, and therefore should be implemented

swiftly. Regulatory and investment moves to create a regional digital space and more integrated labour markets with neighbouring economies will offer new possibilities for the country's young people. This is especially important given the high rates of youth unemployment.

Key challenge #3: Formalisation of the economy

The informal economy remains deeply entrenched, accounting for a large share of total output and a large share of total employment. Although the State Statistical Office estimates that the informal economy accounts for 17% of GDP and 18% of total employment, other estimates suggest that it could account for as much as high as 37.6% of GDP (IMF, 2019). The country's informal sector takes various forms, of which the most prominent are unregistered labour, partially undeclared wages and other irregularities in the enforcement of the Labour Relations Act. Other practices common to the informal economy include not issuing tax receipts or invoices, or underreporting turnover. The growing prevalence of freelance work and personal services provided at home or via the internet often go unregistered.

Undeclared employment remains a persistent issue and could be exacerbated by the COVID-19 pandemic. The sectors with particularly high labour informality are agriculture, construction, household services and wholesale and retail trade. A large proportion of the population continues to declare itself inactive while likely earning some income from an undeclared activity. In 2019, 42.8% of the population was classified as inactive, almost 16 percentage points higher than the average EU rate. The COVID-19 pandemic could also have an impact on informal employment. Given that many of the sectors most badly hit have a high share of informal workers there could be a drop in informal employment. On the other hand, workers might have switched from formal to informal labour, partly by falsely declaring fewer working hours.

Partially unregistered employment and undeclared wages are also widespread. Income is estimated to be partially or completely undeclared by almost 44% of employees. According to estimates, 27.6% of employees' social security contributions are paid at a level lower than the actual salary received (Centre for Research and Policy Making, 2019). Almost 74% of individuals engaging in additional work to their primary source of employment do so without a formal contract (CRPM, 2019). These workers' social and health benefits are not paid in full, and their rights as workers are not fully protected.

The widespread acceptance of this phenomenon contributes to the persistence of informality. A recent population survey indicates that only 1.6% of individuals in the country highlighted the informal economy as one of the three basic problems in North Macedonia (CRPM, 2019). Furthermore, 21.1% of individuals are willing to participate in undeclared work to get a higher wage (CRPM, 2016). Both employees and employers see benefits in the arrangement: the employer makes savings by not paying social contributions for the real amount they pay exceeding the fictitious reported wage, and the employee receives a higher net salary, albeit by foregoing rights to pension and social protection. The perception that public services such as healthcare and education are of insufficient quality also discourages voluntary tax compliance. Because the system designed to protect employees' rights is not perceived as efficient and just, many employees are likely to willingly forego institutional protection of their legal labour rights.

The high proportion of cash transactions and the related practice of not issuing tax receipts remain an issue. Based on the 2018 Law on anti-money laundering and preventing financing of terrorism, the maximum amount allowed for cash payments had been gradually reduced to EUR 500. However, the government abruptly changed the law in 2019 and increased the maximum allowable cash payment to EUR 3 000. Promoting electronic payments and limiting the use of cash, in particular for higher-value purchases, would likely help reduce activity in the shadow economy.

The size of the informal economy may exacerbate the negative impact of the COVID-19 crisis on the economy. The large informal sector narrows the tax base in a context of already falling tax revenues due to the pandemic. Production in the informal sector is often inefficient, either because companies remain small enough to avoid being detected or because they use outdated technology, thus contributing to the lower productivity and competitiveness of the economy. Companies operating in the informal sector also have more limited access to finance (which constrains investment) and to qualified workers. Moreover, businesses operating completely in the informal economy have had no access to government support schemes in the context of the COVID-19 crisis.

The COVID-19 pandemic has disproportionately affected informal workers. Global estimates show that informal workers' monthly average labour income could fall by 27% in upper-middle-income countries such as North Macedonia as a result of the pandemic. Relative poverty for informal workers and their families is set to increase by more than 21 pps. (ILO, 2020). Informal workers are deprived of social rights and access to unemployment benefits. Even though they do have some access to social protection, the COVID-19 pandemic has confirmed that informal employees are more vulnerable in the event of work-related injury, when they lose their job, or when they retire. High levels of informality also affect the overall level of skills in the economy, as informal workers have less access to training, exacerbating skills shortages. This ultimately generates greater inequality.

The government support measures at the onset of the COVID-19 may have had an impact on the informal sector. Following the outbreak of the pandemic, the government introduced employment-retention measures for the most affected sectors including restaurants, catering services, tourist agencies and transport. To benefit from the employment retention measure, the companies needed to prove a decrease in revenue of at least 30% compared to the previous year. Although the revenues in various sectors have declined the measure may have motivated some companies to understate their revenues at the onset of the crisis. However, the measure was also accompanied by more stringent tax inspection. The government softened the eligibility requirements for the potential beneficiaries of the measure who were self-employed. A cash allowance of 7 000 dinars per household was provided for the most vulnerable households, including those whose members worked in the informal economy. The impact of these measures on incentives for companies and individuals to formalise their business activities is unclear.

Even though COVID-19 poses many challenges, registered businesses still consider competition from the informal economy to be one of the main obstacles for doing business in North Macedonia. According to the latest available business environment and enterprise performance survey (BEEPS, 2019), the activities of competitors in the informal sector are seen as one of the main obstacles for businesses in the country: 14% of companies say that competing against companies in the informal sector is one of their main challenges.

Reducing the size of the informal economy requires appropriate institutional structures. Strengthening the skills, expertise and powers of tax officials, emphasis on voluntary compliance, improving judicial efficiency and ensuring inspectors have greater independence are key in the fight against the informal economy. Appropriate and timely enforcement of

contracts along with more the transparency of legal changes will have two beneficial effects. It will increase predictability in the business environment and reduce incentives to participate in informal activity. Clarifying the mandates of various inspection bodies, increasing their skills, and further digitalising processes (notably on labour law and occupational safety) would also help to reduce informality. The COVID-19 crisis has shown the need for and benefits of further digitalising the public administration, which could also further reduce the size of the informal economy.

The impact of economic policies and COVID-19 support measures on the informal economy should be continuously monitored. Continuous increase in the statutory minimum wage and the introduction of subsidies for employers' social security contributions to mitigate the impact of wage increases as well as subsidising social security contributions in certain sectors, during the pandemic could change the incentives of the in informal economy. Furthermore, frequent and sudden policy changes related to taxation, such as suspending the application of progressive taxation, as well as the high level of tax exemptions, create distrust among taxpayers over whether they will receive equitable treatment, and have an adverse effect on voluntary tax compliance. Further simplifying the tax and social benefits system to reduce the number of exemptions, and not necessarily the tax rate, could reduce tax compliance costs and reduce informality.

In an effort to address the informal economy, North Macedonia developed a 2018-2022 medium-term strategy and an action plan. The strategy was developed using a participatory approach and reflects the latest OECD recommendations. It recognises that deterrent measures alone are not enough to effectively reduce the informal economy, and that the country should address underlying causes such as weaknesses in the labour market and business environment. However, only limited progress was made in 2020 in implementing the measures set out in the action plan. The impact of the measures undertaken needs to be regularly assessed and the measures adjusted accordingly. To ensure that the full set of measures in the strategy are implemented and to address the underlying causes of informality, the measures must be further integrated in other sectors' policies and action plans. The 2018-2023 SME strategy included measures to combat the informal economy. This is a good example, and measures to combat the informal economy should be included in other strategies.

In November 2020, the voluntary disclosure programme was announced, intending to encourage tax payers to register undisclosed cash. Without an efficient auditing programme, or robust sanctions against tax evaders, this programme would do little to tackle informality. It might even increase the risk of eroding tax morale and collection in the future, undermining the effectiveness of revenue administration and tax policy more broadly. Before opting for such a programme, North Macedonia should implement a comprehensive action plan to modernise the country's tax administration and improve tax morale and awareness. The role of the Public Revenue Office should be further strengthened, as it currently has no ability to conduct market inspections or field inspections. There are also no measures to encourage voluntary tax compliance as the cornerstone of modern revenue administration.

A fully coordinated government approach, with high level political steering, is needed to successfully develop and implement the action plan in 2020-2022. The government is yet to prepare a comprehensive evaluation of the implementation of the first action plan for the 2018-2020 period. The subsequent action plan that is yet to be drawn up should contain the lessons learned from the previous plan. The updated action plan should be wider in scope and consider all the relevant areas and stakeholders for tackling the informal economy. This updated action plan should include further measures to address the overall societal acceptance of informality given that 52.4% of the population considers this as an inevitable part of their

life. Voluntary tax compliance should also be considered. In addition, all fiscal initiatives relevant for the informal sector, such as changes in minimum wages, social security contributions and taxation should be taken into account. Furthermore, the action plan should consider measures to digitalise processes in public administration and introduce risk-based audits, as both of these initiatives would reduce bureaucracy and the opportunity for corruption. Given that e-commerce is a growing industry with a high potential to facilitate informality, the subsequent action plan could also benefit from actions in this field. The strategy and the action plan should also require an analysis to be made of the impact on the informal economy of the anti-pandemic economic support measures.

Reform Measure 12 in the ERP “Introducing mechanisms for formalising informal work in sectors with high incidents of undeclared activities”, is rolled over from the previous year. The measure aims to implement the 2018-2022 strategy for formalising the informal economy. The 2018-2022 strategy identifies three salient motives for engaging in informal business activities, but these motives are not properly addressed by the activities under Reform Measure 12. The measure focuses mainly on employment policies while ignoring other important aspects contributing to the informal economy, such as the overall business environment or taxation, including social security contributions. For the area of taxation, the Ministry of Finance drafted an ad hoc action plan in 2019 to address the fiscal aspects of informality, but this ad hoc action plan should be integrated in the overall revised 2021-2022 action plan. Most of the activities in the ad hoc action plan are based on more stringent monitoring and inspection. The measure also suggests implementing awareness-rising activities on the benefits of the transition to the formal economy, and introducing a voucher-based system to promote better working conditions. However, it remains unclear how these activities of the voucher system will be put in place or implemented. The hoped for positive impact of the measure on competitiveness is not sufficiently quantified and the impact on employment and gender is not sufficiently considered. In addition, the measure does not take into account the impact of COVID-19 on the labour market and undeclared work.

Box: Monitoring performance in light of the European Pillar of Social Rights

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights concerning equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion for the benefit of citizens in the EU. Since the 20 principles are essential for countries if they are to achieve fair and well-functioning labour markets and welfare systems, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers’ Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the alignment of their labour markets and welfare systems with those of the EU.

North Macedonia faces challenges for a number of indicators of the Social Scoreboard⁴ supporting the European Pillar of Social Rights. Despite favourable trends in employment over recent years, the country’s unemployment rate remains high and has several distinctive structural characteristics, including long-term unemployment, inequality, and large regional disparities. Because the impact of the COVID-19 pandemic has been cushioned by the government’s support package, the real impact of the crisis will be seen in 2021.

NORTH MACEDONIA		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Worse than EU average, improving
	Gender employment gap	Worse than EU average, improving
	Income quintile ratio (S80/S20)	Worse than EU average, improving
	At risk of poverty or social exclusion (in %)	Worse than EU average, improving
	Youth NEET (% of total population aged 15-24)	Worse than EU average, improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-74)	Worse than EU average, improving
	GDHI per capita growth	N/A
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU average, improving
	Children aged less than 3 years in formal childcare	Worse than EU average, improving
	Self-reported unmet need for medical care	Worse than EU average, no change
	Individuals’ level of digital skills	Worse than EU average, no change

Women and young people are particularly exposed to the risk of unemployment and inactivity. Despite significant improvements due to the successful implementation of the Youth Guarantee, youth unemployment (15-29) was 20.3% in 2019, while the rate of young people (15-24) neither employed, nor in education or training (NEET) in 2019 was 18.1%. The rate of inactivity in the labour market is particularly high for women. In Q3 2020, 42% of women aged 20-64 were out of the labour market.

Government measures to help people find work or training are insufficient in scope and volume to substantially improve the situation. A new legislative framework and measures to get more people into the job market is a step in the right direction. However, the resources allocated for this measure remain scarce (EUR 11 million for 3 years). The public employment service could make better use of its well-developed IT system to track the employment status of participants in programmes to help people find work or training over the

short and medium terms.

The reform of the social-protection system aims to better target those in need. Social assistance has a very small effect on the poverty reduction. This is due to both the very small amounts of the benefits that are paid out and insufficient effectiveness in targeting these benefits at the most needy. The new legislative framework includes the Law on Social Protection, Law on Child protection, and Law on Social Security of Elders, as well as related bylaws. The framework served as the impetus for the stronger policy response during COVID-19, since the number of GMA beneficiaries has increased. Those most at risk of poverty continue to be: (i) young people; (ii) the uneducated; and (iii) ethnic communities such as the Roma.

North Macedonia has a well-developed statistical system. The State Statistical Office is the primary producer and coordinator of the statistical system of the country. Since 2004, the Labour Force Survey has been carried out as a continuous quarterly survey throughout the year, providing quarterly and annual statistics. The Survey on Income and Living Conditions (SILC) is conducted as a regular annual survey and has been implemented since 2010.

⁴ The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States’ performance (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The 12 indicators are also compared for the Western Balkans and Turkey, with one small adjustment for the age bracket for the unemployment rate (reducing the upper age bracket to 64 instead of 74 years) for Albania and Kosovo* due to data availability. The assessment includes the country’s performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2019 data are used for this comparison) and a review of the trend for each indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2017-2019 are used and can be found in Annex A.

5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2020

Overall: Partial implementation (61.1%) ⁵	
2020 policy guidance	Summary assessment
<p>PG 1</p> <p>Use fiscal policy to mitigate the crisis-induced impact on growth and employment.</p> <p>Adopt the Tax System Reform Strategy 2020-2023 and improve revenue collection capacities in line with the strategy.</p> <p>Further improve the transparency of public finances by publishing regular fiscal reports on public enterprises and taking steps towards incorporating them in the general government statistics in line with the excessive deficit procedure methodology.</p>	<p>There was partial implementation of PG 1</p> <p>1) Substantial implementation. The government has used fiscal policy to mitigate the crisis-induced impact on growth and employment. It has adopted four sets of measures addressing households and companies (i.e. subsidies to wages and employers' social contributions), totalling EUR 1 billion in 2020, and adopted a fifth set in February. To provide financing for these measures, two Supplementary Budgets were adopted in 2020, as well as two decisions for redistribution of funds between budget users and funds.</p> <p>2) Partial implementation. On 29 December 2020, following two public consultations, the government adopted the 2021-2025 Tax System Reform Strategy and began with the implementation of measures that address the PG subpart appropriately. The country has adopted measures to improve revenue collection, but only a few of them have been implemented yet as the Strategy was adopted in December 2020 only. The capacities of the two key revenue collection administrations, the Public Revenue Office and the Customs Administration, have increased consistently, both through national funds and sizeable EU assistance. The biggest challenge ahead is the modernisation of the ICT system of the PRO.</p> <p>3) Partial implementation. The country has adopted and implemented measures that address the PG subpart appropriately. Public enterprises are now obliged to publish their reports on the website. As from October 2020, the MoF started publishing revenues, expenditures and profit / loss for public enterprises, quarterly at the enterprise level. This PG subpart is also the subject of MFA conditionality. The country has adopted measures to include some public enterprises in the general government fiscal documentation. The SSO is responsible for EDP notifications, which are regularly submitted to Eurostat. The data for some public enterprises are also part of the notifications according to the published list of units of S13 Government sectorised by the Commission for Sectorisation (SSO, MF and NBMK). In the new OBL, the fiscal rules apply to General Government (GG) and the definition for GG refers to the list of units published by the SSO for S13 based on ESA2010.</p>

⁵ For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en.

<p>PG 2</p> <p>To support the economic recovery, improve public investment management to mitigate technical obstacles to implementation of capital spending.</p> <p>Establish a comprehensive registry of state aid and review firm-level subsidies based on their cost-effectiveness.</p> <p>Take initial legal and operational steps to establish fiscal rules and a fiscal council with a view to strengthening fiscal sustainability in the medium term.</p>	<p>There was partial implementation of PG 2</p> <p>1) Partial implementation. The country has adopted measures to address the PG subpart. The MoF developed a PIMA Action Plan (adopted in December 2020) in order to facilitate the implementation of the recommendations of PIMA conducted by the IMF. In order to improve the realisation of capital expenditures, the 2021 Annual Budget Law introduced a new mechanism. Budget users are now obliged to realize 15% of capital expenditures by the first quarter, 40% of capital expenditures by the second quarter and 65% of capital expenditures as of the third quarter. In case of non-fulfilment of this obligation, the unused funds up to the prescribed limit, are re-distributed by the Ministry of Finance to the reserves for capital expenditures of the same budget user, without the right to spend.</p> <p>2) Limited implementation. The country has announced some measures to address the PG subpart, but their implementation is at risk. The country has expressed interest in asking support from the international community with regard to providing assistance in developing the state aid registry, but so far the only progress was initiating a consultation process through the Department for Competitiveness and Innovation. The role and involvement of the Commission for Protection of Competition (CPC) is marginal. A state aid registry already exists within the CPC, but it is outdated. It remains unclear who will be in the leading role with regard to state aid: the Cabinet of the Deputy PM, the CPC, the Department for Competitiveness and Innovation. Under the Stabilisation and Association Agreement SAA, it should be CPC in the lead. Issues related to the Law on strategic investments with regard to support to strategic projects remain. There was no implementation regarding the review of firm-level subsidies. The country has neither announced nor adopted any measures to address this PG subpart. The number of state aid providers remains high and without coordination, particularly with regard to the cost effectiveness of the granted aid.</p> <p>3) Partial implementation. In December 2020 the Government adopted the Organic Budget Law that includes provisions for fiscal rules and a fiscal council. The OBL was published on ENER and subject to wide consultation, including the EUD, ECFIN and the WB. It is now in the parliamentary procedure. It is not clear yet whether the law will enter into force in 2023 or whether some articles (including those on fiscal rules and fiscal council) will be enforced from 2022 as committed by the Minister of Finance. Secondary legislation on the establishment of the fiscal council is not yet elaborated.</p>
<p>PG 3</p> <p>Closely monitor financial stability challenges arising as a result of the coronavirus pandemic and take appropriate action if needed.</p> <p>Operationalise the reconstituted</p>	<p>There was substantial implementation of PG 3</p> <p>1) Substantial implementation. Forceful monetary and financial sector measures have been adopted to cushion the short-term impact of the crisis, including inter alia borrower relief measures such as loan repayment moratoria and loan restructuring, while monitoring has remained strong. The full impact of the crisis in particular on asset quality is yet to become visible, likely requiring further adjustments.</p> <p>2) Substantial implementation: An MoU has been signed</p>

<p>Financial Stability Committee and ensure the legal clarification of the central bank's macro-prudential mandate.</p> <p>Work towards a further implementation of the denarisation and NPL resolution strategies, ensuring the effectiveness of the measures taken and making any adjustments deemed necessary.</p>	<p>across regulators and enabled the Financial Stability Committee to start operations, while the draft Law on Financial Stability that provides the required legal clarifications is expected to be adopted by the first half of 2021.</p> <p>3) Partial implementation: Further efforts were made to implement the denarisation strategy, but the crisis impact resulted in a partial reversal of the earlier progress. Measures were also taken to implement the NPL strategy, with the new insolvency law in early drafting stage with possible adoption by end-2021.</p>
<p>PG 4</p> <p>Ensure a whole-of-government approach and cross-sectoral coordination across public administration to effectively respond to COVID-19.</p> <p>Maintain continuous dialogue with business organisations, social partners and civil society on all measures in response to the crisis.</p> <p>Take necessary actions to ensure easy access to digital public services for citizens and businesses.</p>	<p>There was substantial implementation of PG 4</p> <p>1) Full implementation: A crisis coordinative headquarters was formed chaired by the prime-minister. Other coordinative bodies were also established such as: (i) the managerial committee for coordination and management of crises; and (ii) the appraisal group that assesses risks and security threats and proposes measures and actions for their prevention, early detection, and management.. Following the adoption of the decision of 20 November 2020 declaring a pandemic crisis in the country (until 30 June 2021), the main headquarters for crisis management was active. Two members of civil society organisations, elected through a public call, participate in the work of this body. A centralised information system was set up to inform the public about COVID-19. The Ministry of Health issues daily updates to the public through regular press conferences or press statements. A centralised web site was set up: www.koronavirus.gov.mk The government also set up two mobile applications and two national call centres to keep the public informed about the pandemic. The government holds its session through the e-government information system.</p> <p>2) Substantial implementation: Government engaged in a dialogue with business organisations, social partners and civil society when designing measures to respond to the COVID-19 crisis. Additional efforts should be made to extend the number of participants and topics in public consultation and reduce the number of laws adopted in shortened procedure.</p> <p>3) Partial implementation: The national e-services portal www.uslugi.gov.mk provides electronic services to the public. In August 2020 a project aimed to develop new e-services and digitalising state registers began with drafting a list of 135 new services for citizens and businesses. In November 2020 certified electronic signature was introduced.</p>
<p>PG 5</p> <p>With a view to mitigate the economic consequences of COVID-19 pandemic and to stimulate economic recovery, establish an effective and transparent mechanism to support the businesses</p>	<p>There was partial implementation of PG 5</p> <p>1) Substantial implementation. In 2020, the government developed and started implementing four sets of measures to improve the resilience of private companies focusing on SMEs and targeting self-employed. The fifth set of measures was announced in early 2021. The government has provided initial public information about money spent and the</p>

<p>affected by the crisis, in particular micro, small and medium-sized enterprises and self-employed.</p> <p>Extend social protection coverage and provide incentives for businesses and employees in the informal economy sector to register and to facilitate their transfer to the formal economy.</p> <p>Create a register of para-fiscal charges to streamline their use and further decrease the administrative and regulatory burden of companies.</p>	<p>effectiveness of measures In addition, the IMF’s preliminary assessment concluded that the timely policy actions taken by the government have an essential role in mitigating the economic and social impact of the pandemic.</p> <p>2) Partial implementation. Social protection activities focused on countering the impact of COVID-19.. The government implemented the guaranteed minimum assistance (GMA) scheme. The new Law on Social Protection contained ‘activation’ measures to encourage recipients of the GMA to get jobs. However those activations measures were only partially implemented. The impact of changes in social protection on the formalisation of jobs is not assessed.</p> <p>3) Partial implementation. The Ministry of Economy published on its website a list of 377 para-fiscal charges for businesses, by competent authority, which were mapped based on the catalogue of public services. Steps to reduce and abolish these charges have yet to take place. The government asked IPA funds to carry out a project in this area.</p>
<p>PG 6</p> <p>Continue taking measures to preserve employment including by ensuring short-time work schemes and flexible working arrangements.</p> <p>Increase the capacity of and cooperation between the Employment Agency and Centres for Social Work to provide integrated services and measures for inclusion in the labour market including training upskilling and reskilling.</p> <p>Ensure adequate and sustainable funding to strengthen the health care sector with an aim to improve access to quality public health care for all citizens.</p>	<p>There was substantial implementation of PG 6</p> <p>1) Substantial implementation. According to labour market figures, the economy showed some resilience due to the measures taken to offset the consequences of the crisis including by subsidizing wages and/or social contributions. Additional income support was provided to people in vulnerable situations and low-income people. The business organisations are involved in the design of the measures.</p> <p>2) Partial implementation. Cooperation between the Employment Service Agency and the Centres for Social Work has improved, but this cooperation should be further strengthened and implemented in a systematic way. EU financial support to the Employment Service Agency supports measures to encourage unemployed people to find work. However, the mentoring and psychosocial support services of these measures have not yet been set up. Services to provide training to the unemployed are currently being implemented.</p> <p>3) Substantial implementation. The health sector was prioritised by the government in 2020. This is reflected in health expenditure. Health expenditure was 5.0% of GDP in 2019, but is estimated to have increased to 8.5% of GDP in 2020. It is planned to account for 5.8% of GDP in 2021, and set to increase to 8.0% of GDP by 2060. The 2021-2025 public investment plan focuses on capital investments, including in health. The plan also focuses on increasing wages in the health sector to stem the decline in numbers of specialised health workers. According to the World Bank, social and health support was well targeted during the pandemic. In the future, North Macedonia should give higher priority to healthcare by appropriate allocation of staff and money to the preventive policies and primary healthcare. This can be achieved by introducing hospital procedures that require shorter stays in hospitals, and by diminishing/ending unnecessary referrals and hospitalisations.</p>

6. ASSESSMENT OF THE OTHER AREA/SECTOR AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2020-2022 ERP

Business environment

Structural weaknesses in the business environment continue to be an obstacle for domestic companies even though North Macedonia is ranked 17 out of 190 economies in the latest World Bank *Doing Business 2020* report. Informality and the quality of education of the work force are among the top concerns reported by businesses (BEEPS VI, 2019). The absence of civil servants from their posts, because of the pandemic has made the public administration less responsive to businesses. There is a need to make the regulatory environment more predictable, tackle widespread informality, streamline para-fiscal charges and improve the efficiency of the workplace-inspection system. An effective and independent judicial system is a prerequisite for creating an environment that is investment- and business-friendly. Effective measures to further strengthen the rule of law, ensure adequate and timely contract enforcement and decrease corruption could benefit the business environment and overall competitiveness. There is also a need to further promote the skills needed to develop innovation and entrepreneurship, support women's entrepreneurship, simplify business survival and bankruptcy procedures. It is also necessary to monitor the cost-effectiveness of business-support schemes and ensure the coordination of different programmes. . Further digitalisation in public administration in particular streamlining company registration and the provisions of licenses and permits by consolidating the services under one-stop-shop could help to ease doing business. The Public consultation about complex policies and laws relevant for business operation were reduced due to the pandemic. These consultations will need to be restored and intensified.

Measure 9: “E-marketplace for low-value procurement”

This measure is rolled over from last year. It aims to develop an online market-place for low-value procurement and to professionalise civil servants working with public procurement. This measure follows on from the new public procurement law, which has been in force since April 2019. The law aims to harmonise the legal framework for public procurement with the 2014 EU Procurement Directives. It is expected that the measure will help to increase transparency and predictability on the market by publishing public procurement plans electronically and well in advance. The number of bidders per tender is also expected to rise, in particular bids by SMEs. However, the potential effects of these developments have not been sufficiently elaborated upon nor quantified. The risk identified for implementing the measure is perceived as high, but no mitigating measures have been suggested. The financial sustainability of the measure is not described. No budget is provided for 2022 and 2023.

Measure 10: “Streamline the use of para-fiscal charges”

This is a newly introduced and a very relevant measure, related to the policy guidance 5 of the May 2020 Economic and Financial Dialogue between the EU and the Western Balkans and Turkey. North Macedonia decided to use a phased approach in elimination of para-fiscal charges. The measure envisages the assessment of 377 para-fiscal charges that were identified in 2020, conducting further elimination, remodelling or streamlining, or proposing their optimisation and digitalisation. The methodology for further rationalisation of para-fiscal charges for SME's is not elaborated and will be established after the 377 charges are screened and optimised. The reason for such a reversed order is not elaborated though it could be linked to swift reduction of some para-fiscal charges. North Macedonia's chambers of commerce have indicated that businesses do not necessarily object to para-fiscal charges but would like to know what they are used for. Measure 10 could therefore also seek to clarify the

rationale for these charges. The government could further elaborate on the impact these para-fiscal charges have on competitiveness.

Measure 11: “Support start-ups and SMEs in selected less-developed regions of the country to grow, produce added value and create a local living economy”

This is a newly introduced measure. It is very relevant and is linked to the key challenge of competitiveness in domestic companies and the integration of domestic companies into global value chains. The measure does not tackle regulatory issues related to the business environment. Instead the measure is related to the implementation of a project that is funded by the IPA and implemented by an external partner. This means that the implementation of the action is not under the control of the government. To encourage businesses, the measure should have included regulatory changes benefitting purpose-oriented start-ups and SMEs, focusing on green-economy and women entrepreneurship. The part of the impact assessment for this measure that deals with competitiveness is rather generic and should consider adding quantitative information.

Measure 14: “Broadening the scope of digital services provided on National E-service Portal”

This measure is also rolled over from the previous year and has been implemented for several years. It is relevant for reducing costs and time spent in dealing with the administration. It is therefore important for improving the overall business environment and the ease of doing business. Although e-services for individuals have progressed, e-services for businesses have not yet been sufficiently developed. There are currently 127 services provided by administrative bodies that are accessible online in the portal. However many business-related services offered by individual institutions (such as the central register, the tax authority, the agency dealing with land and property) are not yet linked to the portal. Of the 127 e-services only 50 provide for fully electronic interactions, while more than 80 services merely redirect to the web-site of the respective institutions, where the level of digitalisation of the service depends on the IT development of the institution. The measure elaborates well on its purpose, timeline, impacts, and on potential risks affecting its implementation. These risks stem from the inefficient coordination and communication between state institutions, lack of IT human resources and lack of commitment at operational level. Those risks could significantly challenge the measure’s implementation and should be clearly monitored and counteracted by mitigating actions. The indicators used to measure implementation of measure 14 are those set in the IPA monitoring scheme. A large-scale, EU-funded project to upgrade the e-services portal with 135 new services for companies and businesses started in August 2020.

Research, development and innovation (R&D&I)

North Macedonia’s average innovation performance remains below 50% of the EU average. The European Innovation Scoreboard 2020 also assesses the country as a ‘modest innovator’. Investment in research and innovation remains low at 0.36% of GDP. Private sector participation is negligible but slightly improving at 0.1% of GDP. There is a need for closer cooperation between academia and the private sector. The country performs poorly in public-private co-publications, private co-funding of public R&D expenditures, design applications, and sales of new-to-market and new-to-firm product innovations. The government’s support for R&D&I in 2020 was provided mainly through State-aid schemes implemented by the Fund for Innovation and Technology Development. In particular, increased support was given to research and innovation activities in initiatives linked to the response to COVID-19. The impact of this financial support on private-sector R&D remains to be evaluated. It is also important to ensure that the funding provided is distributed in a more transparent manner and

accompanied by proper monitoring and an evaluation of the results. The country's annual participation in the Horizon 2020 framework programme is increasing. However, North Macedonia's performance in the programme remains below its potential and the overall success rate of 11.4% is below the average success rate of 15.8%. In 2012, the government adopted an integrated research and innovation strategy covering the whole innovation value chain from basic research to business innovation. However, this strategy now needs to be updated. The smart-specialisation strategy, which is expected to replace an existing competitiveness strategy, is still being developed.

Measure 13: “Enhancing cooperation between the academy and the industry”

This measure is rolled over from last year. It includes two sub-measures: (i) further development of the science technology park (STP) and (ii) grants to increase cooperation between academia and industry. The STP is planned to be a complex organisation offering professional business support and innovation services to increase both innovation, and networking possibilities at national level. The facility was formally established within the State university in Skopje, and some funding was secured for its initial operation. However, the government has not yet explained what specific fields of operation and specialisation the STP will have. A balanced public-private structure for ownership and management, with initial public funding, is a preferred model for operating a life-science park. However, measure 13 does not mention whether potential private investors have been found. This measure could benefit from activities going beyond the establishment of the STP, for example encouraging industry to provide advice to universities on areas of research that would be beneficial for certain sectors of the economy. Increased possibilities for private-sector funding of research and innovation would also be beneficial.. Overall, there are no detailed plans on activities under this measure.. The government has also not quantified the measure's expected impact on competitiveness, while the measure's impact on employment and gender has been insufficiently considered. Some activities on this measure should have already begun in 2020. However, due to the pandemic, State resources were diverted to COVID-19 assistance measures to private companies and the public. There is therefore a degree of uncertainty whether the State budget will have funds to finance this measure in 2021. The government has also not quantified the measure's expected impact on competitiveness, while the measure's impact on employment and gender has been insufficiently considered. Some activities on this measure should have already begun in 2020. However, due to the pandemic, State resources were diverted to COVID-19 assistance measures to private companies and the public. There is therefore a degree of uncertainty whether the State budget will have funds to finance this measure in 2021.

Digital economy

The digitalisation of the economy has proven to be particularly relevant in the context of the COVID-19 pandemic. The country's Association for e-Commerce reported that the value of online transactions made between the public and domestic online traders in the second quarter of 2020 increased by 177% compared to the same period in the previous year. Further digitalisation is still hampered by the relatively high cost of digital services and by the low level of digital skills in the population. The share of the population with internet access (mobile and fixed) in 2019 reached 83.65%. The National Broadband Competency Office was set up according to the European model of gathering experts in the field tasked with an advisory role to national and regional authorities on broadband investments in the country. The national operational broadband plan aims to provide the measures to: (i) improve national broadband connectivity; (ii) assess future public investments in broadband areas where there is no commercial interest in providing broadband; and (iii) develop 5 G technology. In 2019, the country adopted legislation to facilitate the use of electronic identification at national level

and foster the use of e-signatures. E-signature is currently limited to a few institutions that provide services to businesses, even though the equipment and software for e-signature has been widely installed. However, the legal framework in electronic communications still needs to be aligned with the EU *acquis*. The 2018-2022 national cybersecurity strategy addresses the country's challenges in cyberspace and fosters the development of a safe, secure, reliable and resilient digital environment. However, further efforts are needed to address shortcomings such as: (i) fragmented cybersecurity protection among institutions; (ii) inadequate cooperation with the private sector; and (iii) the need to improve the legal framework. Digital literacy is one of the education strategy's priorities, while a specific strategy is being drawn up to address digital skills. The government has organised campaigns to inform the public on how to use e-services. An analysis across all of the country's public institutions demonstrated shortages of qualified ICT staff. This analysis recommended the development of policies to retain existing ICT staff and attract new staff with the necessary ICT skills.

Economic integration performance

Before the negative impact of the COVID-19 crisis, the economy had a high and growing degree of trade openness. The total value of trade in goods and services amounted to 132% of GDP in 2019. In 2019, exports and imports grew by 10.3% and 9.6% respectively. Import coverage by exports stood at 76.9% in 2020, with the merchandise-trade deficit amounting to 17.4% of GDP. Before the detrimental effect of COVID-19 on trade, the trade deficit had been falling for several years, leading to a narrowing in the current account deficit and easing the pressure on the exchange rate. The EU remains the country's main trading partner. Before the disruption caused by the COVID-19 crisis, total bilateral trade with the EU increased by a further 8.9% between 2018 and 2019. In 2019, total bilateral trade with the EU exceeded EUR 10.5 billion or 70.2% of total trade. In 2019, the country's second largest partner was the group made up of the CEFTA parties (10.1% of total bilateral trade in 2019). By country, Germany, the United Kingdom, Serbia, Greece and Italy were North Macedonia's biggest trading partners in 2019. 95.6% of products from North Macedonia can access the EU market without customs duties. The export product mix had been improving in years before the COVID-19 pandemic. The share of iron, steel, and clothing in total exports remained stable (17.4% in 2019, the same percentage as in 2018, although this has dropped from 33.3% in 2013). However, there was a further increase in the exports of chemicals, machinery and transport equipment (this category accounted for 57.2% of exports in 2019 compared with 32.8% in 2013). The key import products are platinum and platinum alloys; petroleum oils; other metals and alloys; and flat-rolled iron products. Exporting companies, notably SMEs, still face key obstacles to trade. These impediments are due to non-tariff barriers, including technical standards and administrative obstacles. The insufficient quality of logistics is an impediment to further increases in exports. In 2018 the World Bank's logistics performance indicator ranked North Macedonia 81st out of 160 countries (World Bank, 2018). The Economic and Investment Plan and deepening the regional integration of the common regional market both have the potential to further increase trade and enable competitiveness and growth.

Measure 15: "Trade facilitation"

This measure is continued from the previous year. It is relevant as it refers to the implementation of CEFTA Additional Protocol 5 on trade facilitation. This additional protocol includes a number of activities to simplify and speed up procedures conducted by different agencies present at the border, in particular by improving the electronic exchange of information. To this end, the countries of the CEFTA region are expected to continue using the functionalities of the SEED+ system. The possible inclusion of Moldova in the system, administered by CEFTA, will enable all CEFTA parties to be integrated and participate in the

exchange of pre-arrival information on shipments. Activities to extend the concept of authorised economic operators are continuing. These activities are also expected to reduce the time spent on customs clearance and speed up the movement of goods across borders. The ERP provides a good quantitative assessment of the expected impact of measure 15 on competitiveness.

Measure 16: “Facilitating North Macedonia-Serbia cross-border crossing”

This measure is related to Measure 15, but it focuses specifically on setting up a joint rail station on the border between North Macedonia and Serbia at the Tabanovce/Presevo crossing. At present, checks by the relevant agencies (police, customs, veterinary agencies and phytosanitary agencies) are carried out twice by the relevant services of the two countries. The construction of the new joint facility will house the services of both countries in a single, energy-efficient building. This will enable faster checks and joint conduct of the necessary procedures, thus speeding up the flow of passengers and goods. It will also provide an opportunity to carry out checks while the train is moving. The proposed timeline of 2021-2023 for the proposed activities seems realistic. Nevertheless, the entire process is clearly delayed, as the agreement to set up a joint border crossing between the two countries was signed in 2015. The description of the measure indicates that it would increase the competitive advantage of rail compared to road transport, although the description does not quantify this increased competitive advantage. Savings created by the measure are expressed only in time saved per train. The measure’s possible adverse effects on other means of transport (notably road) are not considered. In addition, the possible benefits on the environment from the reduced carbon footprint of rail transport compared to other means of transport is not considered. The description includes a risk analysis and presents appropriate mitigating actions.

Measure 17: “Strengthening the internal market in the Republic of North Macedonia”

This is a new measure in the ERP. It is relevant for the planned country reforms in the area of internal market and further inclusion of the country in the European single market as indicated by the Economic and Investment plan. The measure is expected to improve the country’s position by harmonising its legislation with that of the EU in the area of free movement of goods, free movement of services, and market surveillance. This measure is implemented with the support of the IPA-funded project to strengthen market surveillance in 2021-2023. It marks a significant start of reforms in this area after a long period of inactivity. The measure’s expected impact on competitiveness and environment, which is only described in general terms rather than with a clear focus on quantitative targets, could be improved further.

Energy

The economy is characterised by high energy intensity, inefficiencies in the ageing energy production system, persistent high dependency on coal, and inefficient energy consumption. These four characteristics of the economy all exacerbate air pollution. Domestic energy production is dominated by fossil fuels. According to the latest available data, 39.43% of gross energy consumption in 2019 was covered by domestic production, while 60.57% was imported. On energy consumption, oil accounted for the largest share at 51.41%, followed by electricity (27.58%), biomass (10.08%) and coal (5.98%). For final electricity consumption, 72.19% was covered by domestic production, while 27.81% was imported. Domestic electricity production in 2019 relied heavily on lignite (41.95%), followed by hydropower (16.86%), gas (10.81%), wind (1.48%), biogas (0.78%) and solar (0.33%). On infrastructure investment, the country continues to construct several sections of gas pipeline. The 2018-2040 national energy strategy was adopted and it properly reflects the main challenges in the energy sector. However, the national energy strategy should now be harmonised with the

national climate strategy by taking into account the commitments under the Paris Agreement on Climate Change. The government should also adopt a programme to implement the energy-development strategy. North Macedonia should benefit from further regional integration in energy and further liberalisation of the energy market. The country's electricity market is now open, and the regulation of wholesale and retail prices has ended. The overall percentage of electricity consumption provided on the open market in 2019 was 49.13%. The country has adopted the new balancing rules. In line with the Economic Investment Plan, the Commission will support the development of renewable energy sources and less-polluting energy sources that will secure energy supply in line with the commitments of the green agenda for the Western Balkans.

Measure 1: “Increasing the competitiveness of the electricity market”

This measure is rolled over from the previous year. It aims to set up a more liquid and better-organised electricity market to allow more competition in energy supply for the benefit of customers. The measure will also stimulate cross-border regional-market integration and connectivity. The measure can also be seen as part of the EU's decarbonisation policies, the Green Deal, and the Economic and Investment Plan. The measure could potentially have a significant impact on the economy, as lower energy prices might make the country more competitive. However, the potential impact – either on vulnerable households or on any economic sectors – has not been quantified. The environmental impact assessment of the measure should be strengthened. Significant potential risks related to the implementation of the measure are sufficiently elaborated upon and should be clearly monitored. Other goals should also be considered, such as the need to revitalise the old, electricity-producing infrastructure.

Measure 2: “Promotion of renewable energy sources”

This measure is rolled over from last year, when it was presented together with a measure to improve energy efficiency. It will help diversify energy generation, and improve the security of energy supply. This is expected to benefit the economy by lowering electricity costs and creating green jobs. The measure includes both regulatory aspects (including the adoption of the law on biofuels) and activities to build power-generation capacity. The introduction of the ‘prosumer’ concept has not been adequately developed and lacks quantification. Following the comments received from the Energy Community Secretariat on the draft national energy and climate plans, the government should reconsider its schemes to support the deployment of renewables. In particular, it should reconsider its schemes for small hydropower facilities, and ensure that the incentives it provides do not favour specific renewable energy resources that either do not require support or have disproportionate environmental impact. The description of the measure does not discuss or quantify any impacts on competitiveness, social outcomes, employment, or poverty reduction.

Measure 3: “Improvement of energy efficiency”

This measure is also rolled over from last year. However, unlike last year it is now presented separately from the measure on promoting renewable energy sources. A refurbished and improved building stock will help pave the way for a decarbonised and clean energy system. This is because the buildings sector is one of the largest energy consumers, and is responsible for a significant share of greenhouse-gas emissions and air pollution. Renovation of both public and private buildings is an essential measure in this context, and has been singled out in the European Green Deal as a key initiative to drive energy efficiency in the sector. The description of the measure does not capitalise on the importance of the measure. The environmental impact, which could be particularly relevant for this measure, was not

sufficiently presented and lacks quantification. Impact assessments on economic and social outcomes were also not sufficiently elaborated.

Transport

The transport market remains concentrated on road transport, with limited investment in other means of transportation and with no consistent, intelligent system to manage and control transport traffic. Road maintenance is handled by state companies that are not fully efficient, operating with old equipment. In 2020, the transport sector's contribution to gross value added was 3.5%, which is lower than the EU average level of around 5%. The country's integrated road transport system is deemed to reduce travel time by 17% and road fatalities by 16.6%, benefiting trade flows and the economy (ERP, 2021). The World Economic Forum's *2019 Global Competitiveness Report* ranks the country 84th out of 138 economies for transport infrastructure. Although better than some other peers, North Macedonia still struggles with relatively low-quality transport infrastructure, as well as weak trade and transport logistics. These problems present barriers for foreign companies wanting to invest in the country. They also cause difficulties for domestic companies. The flagship policy of the Economic and Investment Plan will be to further develop the Trans-European Transport Railway Corridor VIII, directly linking North Macedonia, Albania and Bulgaria. This corridor will give the country's companies an alternative export option via Albanian and Bulgarian ports. North Macedonia would also benefit from the opening up of the rail-transport market – at least for domestic and regional firms. The fatality rate in traffic accidents is high at 32% above the EU average. This is why the government is finalising the process to create a lead road-safety agency to ensure a coordinated and comprehensive approach to road safety.

Measure 4: “Implementation of an Intelligent Transport System (ITS) along Corridor X”

This measure is rolled over from the previous year. The ITS should be put in place along Road Corridor X, which is a strategic objective of the 2018-2030 national transport strategy. The ITS-related measures along Corridor X are currently being carried out without a specific ITS strategy, although there are now plans to draw up an ITS strategy. The measure will help to improve the safety of road transport and ease traffic flow along Corridor X. It is unclear how the measures will influence travel time along the corridor, given that the main bottlenecks are at border crossings and toll stations, the numbers of which have significantly increased in recent years. The measure states that its expected economic impact is a reduction in the time it takes to travel to border crossings, but the description of the measure should further elaborate how ITS will directly influence this indicator. The measure's full potential impact on competitiveness and growth cannot be fully determined, given the description's insufficient analysis and its lack of any estimate for savings (in cost and time). Apart from improving the measurement of greenhouse-gas emissions along the corridor, the possible environmental impact of rolling out the ITS and having an ITS strategy in place has not been analysed.

Agriculture

The agricultural sector is characterised by highly fragmented agricultural holdings that are mostly privately owned (80%). It is also characterised by insufficient use of modern technologies. In 2019, agriculture's share of GDP dropped by 0.5 pps., and it now accounts for nearly 8% of GDP. Employment in agriculture also declined in 2019 to 13.9% of total employment (slightly higher than the EU average of about 10%). According to the latest farm-structure survey (2016), an average agricultural holding in North Macedonia uses 1.8 ha of agricultural area and breeds 2.1 LSUs (livestock units). The average farmer cultivated 1.5 ha of land, which is less than 10% of the size of the average farm in the EU-28 (16.1 ha). The

size of property holdings and their highly fragmented nature significantly curbs productivity, as it prevents economies of scale and hampers investments in modernisation. Exports of agri-food and fishery products account for 9.72% of total exports (EUR 624.5 million versus EUR 6.42 billion in 2019). Imports of agri-food products in 2019 accounted for 9.89% of total imports (EUR 837.15 million versus EUR 8.46 billion). Although the trade deficit in the agri-food industry decreased by 13.8% in 2019 compared with 2018, the sector is still considered to have weak competitiveness. Agricultural subsidies per hectare (estimated at between EUR 340 and EUR 380) are above the EU average (estimated at below EUR 300 for the EU-27). Subsidies remain linked to production, and are implemented via a very complex administration scheme. There needs to be a stronger link between agricultural policies and other sectoral policies such as those on trade, education and SMEs. Several actions could be taken to increase productivity through innovation and the application of modern technologies. These actions include: (i) investing in the skills and know-how of agricultural workers; (ii) strengthening the agriculture advisory services; and (iii) connecting agriculture with research, education, and tourism.

Measure 5: “Improving the irrigation system”

The measure is rolled over from the previous year. It continues to target capital investments in: (i) the construction of multipurpose dams; and (ii) the expansion of regional hydro systems. This measure gives very little attention to investments in small-scale irrigation systems. In addition, the ERP does not address actions addressing the regulatory framework so as to improve the role of water users in managing small-scale irrigation schemes. The measure also does not consider progress in adopting appropriate pricing methodologies, even though this is crucial for the sustainability of investments in irrigation. The description of the measure also fails to include information on: (i) the budget of the public water-management company for maintaining the irrigation systems; and (ii) the revenues collected from irrigation users. There is also a lack of information on the private investments made by farmers to make irrigation technologies more environmentally friendly and reduce water use (e.g. drip-by-drip, water wells, and boreholes). The description of the measure also does not mention synergies with other structural measures such as agricultural cooperatives. The quantitative information in the description referred to the construction of nine irrigation systems but these are not mentioned in the narrative part of the description. The impact assessment is generic and does not include sufficient quantitative information.

Measure 6: “Consolidation and defragmentation of agricultural land”

This measure, rolled over from last year, is still relevant as it aims to reduce the excessive fragmentation of agricultural land by consolidating small parcels in larger units suitable for modern and efficient agriculture. Abandoned and state-owned land should be considered under the measure (it is not considered under the measure at present) and if needed incorporated in the regulatory framework. The ERP contains quite specific information on: (i) the land-consolidation areas which are undergoing land consolidation; and (ii) the planned phases of land consolidation. Actions to incentivise voluntary land consolidation by groups of farmers are still missing from the measure, even though voluntary land consolidation is considered crucial for the sustainability and expansion of land consolidation. The description of the measure contains budgeted estimates of capital investments involved in the process. Risks are well identified in the measure, but no mitigation measures are mentioned. The role of the municipalities has proven crucial to consolidate land. However, land-consolidation processes remain deeply centralised, and some degree of decentralisation should be considered to complement the mandate of municipalities planning the rural and urban spaces in their territories.

Measure 7: “Agricultural cooperatives”

The measure to support associations of farmers in agricultural cooperatives remains relevant, as it addresses a key challenge faced by the agricultural sector due to the small size and fragmentation of farms. This measure is rolled over from previous years but there has still been only limited progress in its implementation despite the support provided through national and IPA funds. The measure now takes into consideration the Commission recommendation to link the measure to the alignment process with EU law on producer groups and common market organisations. The government has now set up constructive cooperation between the activities under this measure and the activities supporting the Common Market Organisation in North Macedonia. Although progress was made in preparing the relevant legal framework, there has been a serious delay in adopting both the Law on Agriculture and Rural Development and the relevant secondary legislation. The reform is consistent with other related measures in the ERP, but expectations are low that young farmers – and young female farmers in particular – will become involved in the coming years. This is mainly due to the lack of motivation among farmers to be part of a cooperative. There should be a more active national campaign to increase farmers’ interest in agricultural cooperatives. The expected impact of this measure on competitiveness, employment and gender needs to be considered more, and the impact of the measure could be further quantified.

Measure 8: “Farm road (re)construction”

This measure is new. The description of the measure should have explained in more detail the specific impact of rural roads on overall agricultural development. The impacts of road construction in rural areas may be positive in increasing market-prices for farm produce, increasing the size of farms, and encouraging greater adoption of modern farming techniques. Given the lacking impact assessment, it is unclear whether this measure is to be considered as an economic reform for the agriculture sector or if it has social relevance to improve quality of life in rural areas. The description of the measure should elaborate further on the prioritisation of the measure’s locations. More clarity is needed on who is responsible for implementation, and further explanation is needed on how the relevant ministries will be involved at the different stages of the works.

Industry

The main obstacles to competitiveness in North Macedonia’s industry include: (i) low productivity and the slow growth rate of productivity; (ii) limited modernisation of production processes and obsolete technologies caused by insufficient public and private spending on research and innovation; (iii) insufficient development of clusters of businesses; and (iv) a significant skills gap. The industrial sector contributed 24.6% of the economy’s gross value added and 30% of jobs in 2019. In 2019, industry’s share of higher-value-added manufactured goods (machinery and equipment, chemical products) rose at the expense of basic goods (iron, steel and clothing). This was mainly due to the activities of foreign companies. Nevertheless, in 2019, domestic companies in these sectors contributed an increasing share to total exports. The level of cooperation between universities and the industrial sector remains very low. Low levels of skill among workers also hinder productivity: the average manufacturing and services worker is on average only 25% as productive as their counterpart elsewhere in Europe and central Asia (World Bank, 2018). Linkages between domestic industry and international production chains remain insufficient. However, like elsewhere in the world, the transition towards a greener economy brings significant potential in the local market for low-emission technologies and sustainable products. This offers great potential for new activities and jobs in North Macedonia. The Economic and Investment Plan has productive investments based on circular-economy principles. This plan could significantly foster sustainable

production and consumption in North Macedonia's industry. Given the importance of manufacturing to the composition of GDP and jobs, additional reform measures in this area should be considered.

Services

According to the latest available data, the services sector accounted for 54% of the country's total employment and 54.06% of its GDP in 2019. The further development of companies in the services sector is hampered by weak entrepreneurial skills and a significant skills gap among employees, particularly in soft skills. Despite the increase in exports of services, they represent only around 26% of the value of the country's export basket, indicating the low competitiveness of companies in this sector. Tourism and transport continue to account for the largest chunk of the country's services exports (40% of services exports) followed by services provided by manufacturing companies (25% of services exports). Services provided by manufacturing companies have significant potential for growth because their development is closely related to the inflow of export-oriented FDI. Close to 25% of service exports are made up of exports in: (i) telecommunications services; (ii) computer, and other information services; and (iii) other business services. There is room for these categories of service exports to grow further.

Education and skills

This sector and the relevant reform measure (Measure 18) are analysed above in Section 4 under key challenge #1.

Employment and the labour market

This sector is analysed above in Section 4 under key challenge #1.

Social dialogue

Social dialogue in the private sector between employers and trade unions remains weak. The commitment of trade unions and employers to strengthen collective agreements also remains weak. The absence of trade-union activities means that few businesses have collective agreements at the company or branch level. Most members of trade unions are in the public sector. The Economic and Social Council (ESC) is actively involved in drawing up relevant legislation before its adoption, but this is limited to legislation drawn up by the Ministry of Labour and Social Policy. The tripartite ESC of North Macedonia (which includes representatives of employers, trade unions and the government) needs to increase its visibility and impact. On funding, the ESC depends on the budget of the Ministry of Labour and Social Policy to finance its activities and secretariat. At the local level, despite some progress in raising awareness on the benefits of social dialogue, the use of the local economic and social councils as an effective tool for formulation and implementation of local employment policies is still very limited.

Social protection and inclusion

The at-risk-of-poverty-after-social-transfers rate stood at 21.9% in 2019 and the Gini coefficient (30.8%) fell compared to previous years. Social transfers, particularly pensions, are very important for keeping people out of poverty. The implementation of the Law for Social Protection, the amended Law for Child Protection, and the Law for Social Security for the Elderly have helped increase social-protection coverage among vulnerable people, especially among households with children. The newly introduced social rights (i.e. the educational allowance, the social pension, and the increased GMA) were expected to reduce

the at-risk-of-poverty rate in the country but the effects of these newly introduced rights are not yet clearly visible. In addition, the COVID-19 pandemic has further damaged overall employment prospects in the country, and this will undermine attempts to assess the effects of the reform of the social-protection system.

The process of decentralising social services is still in its initial stage. Although the Law on Social Protection strengthens the powers of the social services, municipalities still do not take sufficient responsibility to carry out their social functions by designing and adopting their own social-protection programmes. Municipalities should improve coordination between the public employment service and other services such as social-work centres, social-service providers, and the health sector. This is another prerequisite for the success of the social reforms package. The social impact of the COVID-19 pandemic has been made less severe by enabling access to GMA for people whose employment ended during the pandemic. This covered more than 3 500 households in 2020. Due to universal health coverage, very few people in North Macedonia report an unmet need for medical care (2.5% in 2019).

Measure 19: “Strengthening the system for social inclusion of the vulnerable categories of people”

Measure 19 provides better-targeted cash transfers and increases the effectiveness of these cash transfers. It also improves the connection between: (i) cash transfers; (ii) measures for ‘activation’ on the labour market; and (iii) the social services. This measure is considered crucial for tackling poverty in the country, and is rolled over from the previous year with some changes. The new Law on Social Protection was adopted in 2019 with accompanying bylaws providing the comprehensive legislative framework for social protection in North Macedonia. The bodies that are responsible for implementing, monitoring and enforcing the law should increase their staff numbers and the skill levels of their staff. A system for licensing social services is currently under development. This system will ensure that each provider meets the prescribed standards and requirements for the relevant social service. The measure contains a relevant information campaign, including fieldwork targeting potential beneficiaries, particularly the people in vulnerable situations (Roma and women with children). Increased cooperation between the public employment service and the centres for social work is indispensable for fostering the support and labour activation of employable GMA beneficiaries.

Measure 20: “Strengthening the quality of primary healthcare”

The main goal of this measure is to improve the quality of primary healthcare (PHC) by: (i) reforming the PHC payment model to promote sickness prevention; (ii) drawing up standards; and (iii) reducing use of higher levels of healthcare. The measure contains plans to develop a platform to facilitate appointments and ensure the traceability of health data. On the availability of healthcare, North Macedonia has a well-dispersed network of primary healthcare at the municipal level. Despite 90.3% coverage by health insurance in 2016, data from the EU Statistics on Income and Living Conditions (EU-SILC) show that 20.5% of people in the country have difficulty using healthcare services. This figure is close to the official number of people at risk of poverty, suggesting that most of those who have difficulty in accessing healthcare may also be at risk of poverty. As indicated in the report by the European Social Policy Network on inequalities in access to healthcare in North Macedonia (Gerovska Mitev, 2018), the main weaknesses were in the accessibility and affordability of the healthcare system including: (i) a lack of integration of unregistered/undocumented people within health insurance and healthcare (mostly affecting Roma people); (ii) the difficulty of using healthcare experienced by specific households and income groups (such as households

with three or more dependent children, single persons with dependent children, and households with income below 60% of the median equalised income); and (iii) a high share of out-of-pocket payments (mostly private and informal) that increase the overall health expenditure of households.

ANNEX A: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2016	2017	2018	2019	EU-27 Average (2019 or most recent year)
Energy					
Energy imports dependency (%)	58.95%	56.45%	56.68%	N/A	60.62%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	N/A	291.58	265.46	288.99	112.92
Share of renewable energy sources (RES) in final energy consumption (%)	18.04%	19.63%	18.18%	16.81%	19.73%
Transport					
Railway Network Density (meters of line per km ² of land area)	26.85 ^w	26.85 ^w	26.85 ^w	26.85 ^w	49.0 ⁽²⁰¹⁸⁾
Motorization rate (Passenger cars per 1000 inhabitants)	190	194	200	205	519 ⁽²⁰¹⁸⁾
Agriculture					
Share of gross value added (Agriculture, Forestry and Fishing)	10.6%	9.1%	9.8%	9.3%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	16.2%	16.2%	15.7%	13.9%	4.3%
Utilised agricultural area (% of total land area)	49.8%	49.7% ^w	49.7% ^w	49.7% ^w	40.0% (2017, EU-28)
Industry					
Share of gross value added (except construction)	19.7%	20.5%	21.5%	20.7%	19.7%
Contribution to employment (% of total employment)	23.1%	23.3%	23.9%	24.1%	18.1%
Services					
Share of gross value added	61.7%	62.9%	62.5%	63.6%	73.0%
Contribution to employment (% of total employment)	53.1%	53.2%	52.9%	55.0%	70.8%

Business Environment					
Rank in WB Doing Business (Source: World Bank)	16	10	11	10	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	63	60	84	82	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	Up to 37.6%	N/A	N/A	N/A	N/A
Research, Development and Innovation					
R&D intensity of GDP (R&D expenditure as % of GDP)	0.44%	0.35%	0.36%	0.37%	2,2%
R&D expenditure – EUR per inhabitant	20.30€	17.20€	18.8€	19.9€	688.6€
Digital Economy					
Percentage of households who have internet access at home	75%	74%	79%	82%	86% ⁽²⁰¹⁸⁾
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	72%	75%	79%	81%	85% ⁽²⁰¹⁸⁾
Trade					
Export of goods and services (as % of GDP)	50.7%	55.1%	60.4%	62.3%	49.4%
Import of goods and services (as % of GDP)	65.5%	69.0%	72.8 %	76.5%	45.7%
Trade balance (as % of GDP)	-18.5 %	-18.1%	-16.8%	-18.2%	N/A

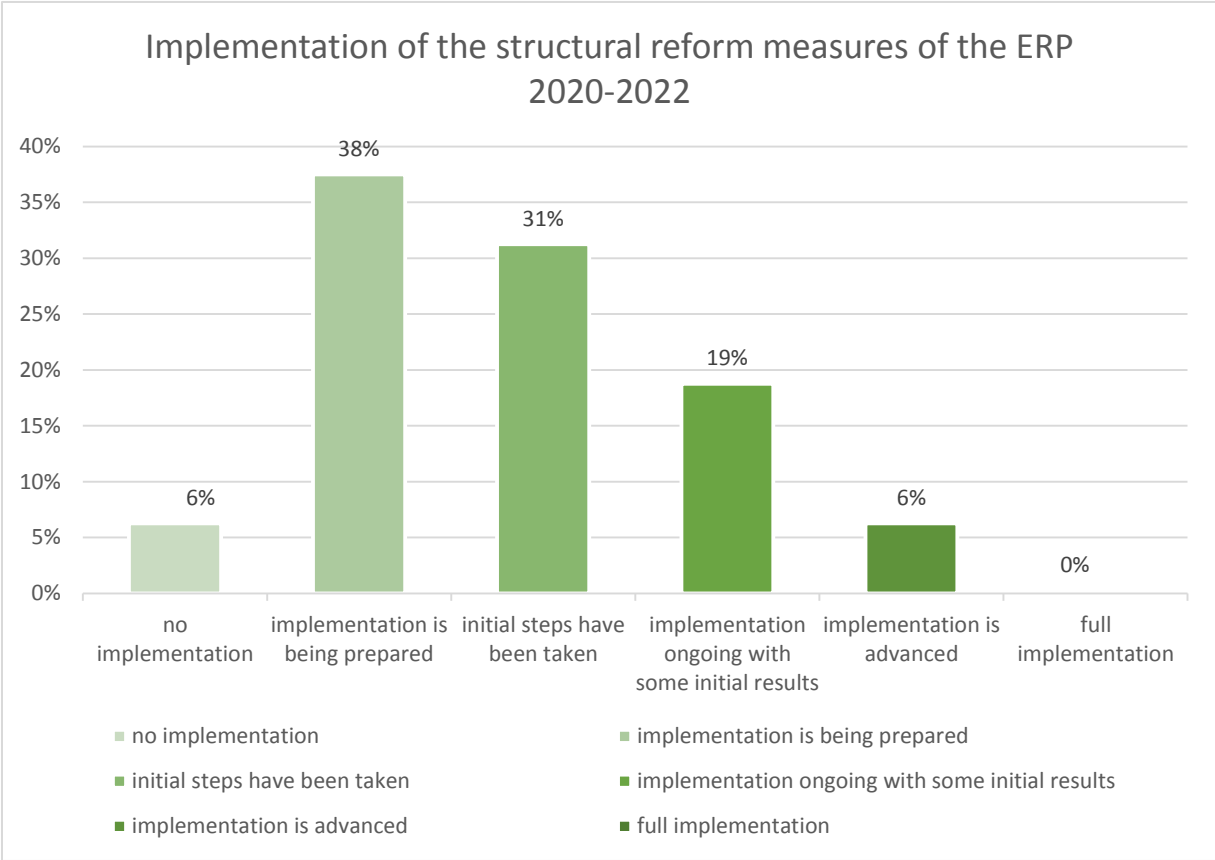
Education and Skills					
Early leavers from education and training (% of population aged 18-24)	9.9%	8.5%	7.1%	7.1%	10.2 %
Youth NEET (% of population aged 15-24)	24.3%	24.9%	24.1%	18.1%	10.1 %
Formal child care - children aged less than 3 years (% of total)	9.1%	10.3%	8.8%	13.0%	35.3 %
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	34%	32%	N/A	32%	56%
Employment					
Employment Rate (% of population aged 20-64)	53.3%	54.8%	56.1%	59.2%	73.1%
Unemployment rate (% of labour force aged 15-74)	23.7%	22.4%	20.8%	17.3%	6.7%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	21.2 pps.	21.9 pps.	21.4 pps.	21.3 pps.	11.7 pps.
Social Protection System					
% of population at risk of poverty or social exclusion	41.1%	41.6%	41.1%	39.9%	20.9%
Impact of social transfers (Other than pensions) on poverty reduction	14.79%	14.29%	14.79%	14.96%	32.380%
Self-reported unmet need for medical care (of people over 16)	2.9%	2.5%	2.3%	2.5%	1.7%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	6.63	6.38	6.16	5.56	4.99

w: data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as regards their quality and adherence to EU statistical methodology'

Source of data in Annex A: EUROSTAT, unless otherwise indicated.

ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM 2019-2021 ERP

While tackling immediate impact of COVID-19 pandemic has been a clear priority in 2020, some progress was made in implementing the measures from last year’s ERP (average score: 2.21 out of 5). Activity reports provide a mostly accurate description of the level of implementation. The scoring is slightly imprecise for the measures related to agricultural development and social sector. Implementation is stronger for some measures, such as measure 15 on Youth Guarantee and on measure 7 on increasing competitiveness in tourism sector. In contrast, implementation is weaker for other measures, such as measure 12 and 13 related to trade where the implementation is very limited. Implementation of the measure focused at reducing the informal economy has also been limited.



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government of North Macedonia submitted the 2021-2023 ERP on 29 January 2021. None of its components are missing.

Inter-ministerial coordination

The Ministry of Finance of North Macedonia coordinated the preparation of the ERP and an inter-ministerial working group comprised of several ministries, agencies and other offices were involved in this work. The submitted ERP contains the annex with the list of institutions and individuals involved in the ERP preparation. Upon completion, the government formally endorsed the ERP on 26 January. The coordination process worked well and the attendance to technical meetings was good. On 21 January, Minister of Finance, other relevant ministers and heads on institutions presented the reform measures included in the final version of the 2021- 2023 Economic Reform Programme to the EU Ambassador.

Stakeholder consultation

The draft of the 2021-2023 ERP's structural reforms was posted on the Ministry of Finance's website for 15 days before 21 January. Interested parties were also invited to send written contributions. On 15 January 2021, the draft 2021-2023 ERP was discussed in a session of the Economic and Social Council. Comments and suggestions received in writing are attached as an annex to the ERP.

Macroeconomic framework

The macroeconomic framework is coherent and consistent, while somewhat optimistic. The ERP presents two alternative scenarios compared to the baseline: (i) assuming lower growth in trade partner countries; and (ii) assuming lower investment. It does not include a low-growth scenario combining both domestic and external risks. The ERP's sensitivity analysis would have benefited from a more comprehensive impact assessment, including on employment, deficit and debt. The external sector outlook is described in detail and an analysis of external debt sustainability is provided in the annex. The latter could have been improved by providing more detail on parameters and on the results of the stress test.

Fiscal framework

The ERP is based on the latest budget projections following the latest budget revision and on the fiscal data available at the end of the third quarter of 2020. In line with the revised economic growth assumptions, the ERP has raised the deficit projections, compared to previous year's program. It includes: (i) information on the expected budgetary impact of new policy measures; (ii) an analysis of the budget balance's sensitivity to lower GDP, lower revenue, and higher expenditure growth; (iii) an analysis of public debt's sensitivity to changes in interest rates and exchange rates; and (iv) a short assessment of the long-term sustainability of public finances based on a number of assumptions, including population ageing. The external debt analysis refers to stress tests for shocks to the primary current account and to economic growth. These stress tests would have benefited from more detail on the impact of individual debt-creating flows and from alternative scenarios.

Structural reforms

The chapter on structural reforms follows the ERP guidance note. More efforts are needed to quantify the impact for each measure and turn the ERP into a more policy relevant document to guide economic reforms. The description of the implementation risks and mitigation measures has improved. The ERP includes 20 measures and exceeds the page limit. The government has not included any measure on the industry and services sectors though it is a very relevant component in terms of share of GDP and employment, however it has included

the analysis of these sectors. The measure on strengthening the quality of primary health care is also prioritised reflecting the emerging needs of COVID-19 pandemic. Tables 9-11 in the annex are properly completed. The implementation reports of the 2020-2022 ERP's policy guidance and Table 11 in annex are well prepared. The scores attributed mostly reflect the implementation level. Contributions received during the consultation process with external stakeholders were annexed to the document.

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