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ECONOMIC REFORM PROGRAMME

OF

**NORTH MACEDONIA
(2019-2021)**

COMMISSION ASSESSMENT

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1. EXECUTIVE SUMMARY

Economic growth resumed in North Macedonia in 2018 and the outlook is now positive.

Driven by strong exports and robust consumer spending, real gross domestic product (GDP) increased by 2.7% in 2018. However, investment continued to decrease. Thanks to an improved domestic environment, as the political crisis has receded and the positive outlook for negotiations to join the EU becomes firmer, the Economic Reform Programme (ERP) expects growth to increase sharply from 3.2% in 2019 to 5.0% in 2021, driven mainly by domestic demand. However, this optimistic scenario carries significant risks. In particular, as the external environment might deteriorate more than expected, and import growth might increase more than expected due to rising domestic demand, the growth contribution from the external balance could be lower. The projected strong pick-up in investment might be compromised by a low implementation of planned public infrastructure works, and by a low impact of the increased financial support for private investments.

A number of policy reforms support fiscal consolidation, but this may not be enough to stabilise debt in the long-term.

The ERP expects the general government primary deficit to decrease from 1.7% of GDP in 2019 to 0.7% in 2021. However, the intended consolidation measures have many implementation risks. Strengthening fiscal sustainability would require further efforts to mobilise revenue and make policy changes that generate savings, including to the pension system. Capital expenditure was heavily cut in 2018, but has been increased significantly in the fiscal outlook. However, it remains subject to serious risks of under-implementation. While there has been further progress on fiscal transparency, the increasing debt burden of public sector companies that operate outside the general government fiscal regime requires closer scrutiny.

The main related challenges include:

- **Stabilising public debt by lowering primary deficits while safeguarding growth-enhancing capital expenditure.** Fiscal consolidation requires stringently implementing adopted and planned measures on pensions, income taxes and streamlining social assistance. Additional measures that could speed up debt reduction include (i) improving revenue collection; (ii) reducing tax exemptions; (iii) putting in place a more transparent state aid framework; and (iv) further reforms to the pension system. However, fiscal adjustment must not come at the expense of investment in public infrastructure and education. Debt stabilisation needs to be anchored in a strengthened fiscal governance framework. This involves adopting the new organic budget law, which would provide for fiscal rules and a proper medium-term budget framework.
- **Improving the transparency of off-budget bodies tasked with major public sector infrastructure projects.** Public companies that would, according to international statistics standards belong to the general government sector are currently not included in the general government fiscal data. Since they implement substantial infrastructure projects financed by government-guaranteed loans, including them in the government's fiscal accounts would provide a more accurate picture of public finances.
- **Domestic companies are not sufficiently integrated into global value chains. This denies them lucrative opportunities and hampers their and the economy's productivity and competitiveness growth.** Further awareness should be raised on the underlying causes of inefficient inclusion of domestic companies in global value chains. Notably, the need to: (i) improve the overall business climate, making rules more transparent and user-friendly; (ii) improve entrepreneurial skills and financial literacy in SMEs; and (iii) develop a more competitive services sector.

- **The size of the informal sector continues to be a challenge for the business environment as it creates unfair competition from unregistered companies.** It limits the opportunities of formal businesses to expand and invest in further development, innovation and productivity. Undeclared revenues and work also harm public revenue collection and reduce the opportunities associated with formal employment, including job security and safety at work. Due to its complex character, reducing this sector will require a fine balance of formal enforcement and other carefully designed measures to remove the underlying incentives for informality.
- **A reform of all levels of the education system is crucial to boost the labour market.** This should include primary school to higher education, vocational educational training (VET), lifelong learning and validation of non-formal and informal learning (VNFIL). This should particularly benefit young people, women and less represented ethnic groups who experience high unemployment and inactivity rates especially in underdeveloped regions. Long-term unemployment affects low qualified people in particular. A large proportion of workers with low qualifications are affected by informal and precarious employment and they are more likely to move countries to find work. Reforms are underway to address the difficult transition from school to work and skills mismatches.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2018 has been partially implemented. The government adopted a number of reforms which are expected to underpin fiscal consolidation, in particular regarding pensions, social assistance, and the introduction of progressive taxation. The government also cleared a substantial amount of unpaid liabilities. It continued to improve fiscal transparency by further enhancing fiscal reporting, such as on budget users' arrears. However, essential measures to improve budget planning and fiscal discipline, such as a proper medium-term budget framework and fiscal rules, are still outstanding, and debt has not been sustainably stabilised.

The government adopted the strategy and the action plan for the formalisation of the informal economy. Steps were taken to clarify the inspectorates mandates by expanding the role of Inspection Council. However, further efforts should be made to strengthen the civil courts' institutional capacity. In response to the difficult context of the labour market, the government decided a reform of the education system. The adoption of the 2018-2025 Education strategy and action plan is based on clear identification of the main challenges and the definition of the priority areas to be addressed within the period. It covers the six pillars of the education system and will require considerable resources and efforts with strong coordination to be effective.

The ERP sets out reform plans that are broadly in line with the priorities identified by the Commission. The macro-fiscal framework targets a significant reduction in the primary balance based on durable revenue and expenditure measures. This would support the stabilisation of general government debt. Not all of the planned structural reform measures adequately address more fundamental policy reforms that would alter market conditions and address the underlying causes of obstacles to productivity and growth. Instead, some of the ERP's measures focus on disbursing subsidies to the private sector. Furthermore, the suggested measures lack quantifiable goals and an impact assessment, which could ensure their proper follow up. The introduction of the Youth Guarantee will now cover the whole country with a particular emphasis on underdeveloped regions, with some 40,000 young people covered during the next three years. The reform of the Social Protection system shall be adopted soon.

2. ECONOMIC OUTLOOK AND RISKS

The economy recovered in 2018 on the back of strong exports. After nearly stagnating in 2017, GDP growth is estimated to have risen to 2.7% in 2018, driven mainly by the external balance and supported by robust household spending. Investment contracted, however. Net exports' positive contribution to growth was due to both, stronger exports and lower imports – the latter partly because of the stalled implementation of import-intensive government infrastructure works.

The ERP expects growth to accelerate significantly between 2019 and 2021 averaging 4.1%. GDP growth is projected to increase to 3.2% in 2019 (which is 0.3 percentage points (pps) than projected in last year's ERP), to 4% in 2020, and to 5% in 2021. The ERP expects the negative output gap to close in 2020 and to turn strongly positive in 2021, as the rate of GDP growth would exceed the potential growth estimate of around 3%. The main growth driver would be an investment rebound, which would average 5.5% between 2019 and 2021, due to public works being stepped-up. In addition, private investment would benefit from increased government financial support and from an improved business climate as the country progresses on its Euro-Atlantic path. Growth drivers would shift markedly in 2019 from the external balance to domestic demand, although net exports would retain their positive contribution to growth thanks to a continued strong increase in exports.

The programme presents two alternative macroeconomic scenarios based on what it views as the main risks to growth. The first scenario presumes lower-than-expected growth in the main trade partner economies. This would lead to lower exports, but also weaker investment. In this scenario, output growth is projected to be lower by an average of 0.8 pps in each of the three programme years. The second scenario assumes delays in investment in infrastructure and equipment. This would also translate into weaker import growth. As a result, annual output growth would be some 0.6 percentage points lower than in the baseline scenario. The ERP does not estimate the impact of the realisation of both external and domestic risks.

The ERP's baseline assumptions for an investment- and exports-driven rebound of GDP growth seem overly optimistic. Given last year's steep decline in investment, promising early indicators of investment activity, and the political stabilisation, the government's expectation of an increase in gross capital formation in 2019 of 4.2% seems realistic. However, the subsequent acceleration of investment growth may prove unrealisable. The Resuming public capital spending carries many implementation risks. State aid to private companies, made available under the government's Plan for Economic Growth, had a slow take-up in 2018, and it is uncertain to what extent the financial support measures will attain their goals. External demand might be weaker than expected, and there might be a stronger than projected investment-related pick up in imports, translating into a smaller contribution from the external balance. On the supply side, there are also a number of caveats on the role of foreign direct investment (FDI) as a key pillar of export-driven growth. Some foreign-owned companies seem to have reached the limits of their production capacity, and mention that the shortage of qualified workers limits further extension. Domestic firms could benefit from the presence of FDI to enhance their export potential and slowly increase their integration into global value chains, but there are few linkages between foreign and local companies in the country.

Consumer prices are expected to remain stable. Inflation is expected to increase from 1.5% in 2018 to 2% in 2019 and to remain at that level for the remainder of the forecast horizon. These projections seem plausible. Being a small open economy, international price developments determine the country's price level. The programme assumes that oil prices will stabilise after 2019, and that the main increase in consumer prices will be from commodities

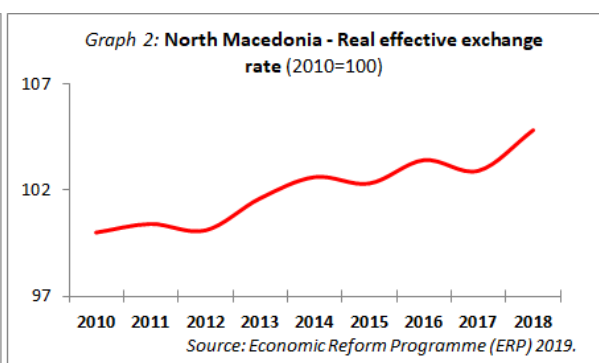
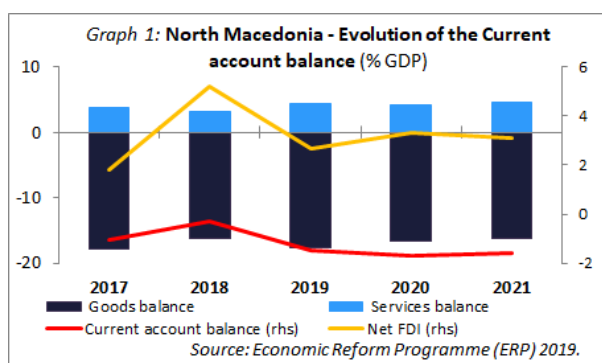
and food prices. The programme also expects rising pressures from increasing domestic demand, which is plausible considering the expectations that output growth in 2020 and 2021 will be above potential.

Table 1:
North Macedonia - Comparison of macroeconomic developments and forecasts

	2017		2018		2019		2020		2021	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	0.0	0.2	2.1	2.8	2.8	3.2	3.1	4.0	n.a.	5.0
<i>Contributions:</i>										
- Final domestic demand	0.6	0.3	1.3	0.6	3.3	3.0	4.0	3.6	n.a.	4.1
- Change in inventories	-0.4	n.a.	0.1	n.a.	0.0	n.a.	0.0	n.a.	n.a.	n.a.
- External balance of goods and services	-0.2	-0.1	0.7	2.2	-0.5	0.2	-0.9	0.4	n.a.	0.9
Employment (% change)	2.4	2.4	2.2	2.0	2.2	2.1	2.1	2.2	n.a.	2.6
Unemployment rate (%)	22.4	22.4	21.3	21.2	20.6	20.1	20.1	19.1	n.a.	18.1
GDP deflator (% change)	3.5	3.4	1.5	3.7	2.4	2.4	2.1	2.4	n.a.	2.4
CPI inflation (%)	1.3	1.4	1.6	1.5	2.0	2.0	2.1	2.0	n.a.	2.0
Current account balance (% of GDP)	-1.3	-1.0	-0.7	-0.5	-0.9	-1.5	-1.5	-1.7	n.a.	-1.6
General government balance (% of GDP)	-2.8	-2.8	-2.8	-2.2	-2.6	-3.0	-2.3	-2.3	n.a.	-2.0
Government gross debt (% of GDP)	39.3	39.5	42.2	41.0	44.5	43.3	45.7	43.2	n.a.	41.4

Sources: Economic Reform Programme (ERP) 2019, Commission Autumn 2018 forecast (COM).

The country's external position has improved and appears to be sustainable. The current account deficit narrowed in 2018 to 0.3% of projected GDP, which is lower than the previous year's projection, thanks to the improved trade balance. According to the programme, the current account deficit will widen again in 2019 to 1.5% of GDP, and will remain at about that level for another two years. The projected deterioration is less severe than previously anticipated. It is expected to be driven by a slightly widening deficit in the primary income, reflecting an expected increase in foreign investors' capital income, and lower secondary income from remittances. Still, the expected extent of current account deterioration seems large, and not in line with the projections for its components. The merchandise trade deficit is expected to remain largely stable at 16-17% of GDP. Risks to this projection arise from potentially overestimated export and underestimated import growth, the latter also resulting from the ERP's expectation of a decline in the oil price and thus the energy trade deficit, which makes up about one third of the current account shortfall. In all three years, the current account deficit is projected to be more than covered by FDI inflows. However, recent and projected further raises in minimum wages, which are now at about half the average wage, pose a risk to external competitiveness against the background of stagnant labour productivity, in spite of government support to labour-intensive industries. Following a sizeable increase in 2018, gross external debt is expected to rise further in 2019 and to decline thereafter, to 77.1% of GDP in 2021. The decline would result from lower public sector external debt, even though borrowings by public enterprises are expected to rise further also in 2020 and 2021. Compared to 2017, external debt would still be higher by 3.8 pp in 2021.



The banking sector improved its resilience and lending picked up further. The financial sector is dominated by banks, even though their share in total financial sector assets has dropped somewhat in recent years. The banking sector concentration remains high and unchanged compared to previous years, with some 58% of assets held by the three biggest banks. Liquidity is abundant, in spite of accelerated growth in lending to the non-financial sector in 2018 (7.6%, up from 5.9% in 2017). Liquid assets account for about one third of total assets and cover more than half of short-term liabilities. The capital adequacy ratio rose further in the first half of 2018, to well over twice the regulatory minimum of 8%. Banks' profitability jumped markedly, compared to the previous year. The quality of banks' assets improved in 2018: the share of non-performing loans (NPL) in total loans to the non-financial sector (including the impact of mandatory write-offs) decreased by 1.1 pp year-on-year, to 5.2% at the end of the year. The decrease is mainly due to the collection of non-performing claims in the corporate sector. Risks to banks' solvency are contained by the high provisions covering NPLs. Lending growth is still largely driven by household loans, but credit to non-financial enterprises picked up significantly in 2018. The share of deposits in euros is still high, which complicates the central bank's efforts to incentivise lending in national currency.

Table 2:
North Macedonia - Financial sector indicators

	2014	2015	2016	2017	2018
Total assets of the banking system (EUR million)	6511	6878	7233	7513	8187
Foreign ownership of banking system (%)	76.2	74.8	75.0	74.4	72.9
Credit growth	10.0	9.6	6.5	5.4	7.3
Deposit growth	10.5	6.4	6.1	5.0	12.1
Loan-to-deposit ratio	88.1	90.6	87.0	87.7	86.2
Financial soundness indicators					
- non-performing loans	10.8	10.3	6.3*	6.1*	5.0
- net capital to risk-weighted assets	15.7	15.5	15.2	15.7	16.5
- liquid assets to total assets	29.8	28.2	28.9	27.1	26.7
- return on equity	7.4	10.4	13.6	13.5	16.0
- forex loans to total loans (%)	49.4	46.5	44.9	42.5	41.4

* including the impact of write-offs.

Sources: National Central Bank, Macrobond.

3. PUBLIC FINANCE

The budget deficit narrowed in 2018 on the back of a severe decline in capital spending.

The general government deficit improved, decreasing from 2.8% of GDP in 2017 to 1.8% in 2018. This was mainly the result of the government's re-evaluation of ongoing construction projects and of implementation delays, which lowered capital spending by 1.4% of GDP compared to 2017. Fiscal performance was supported by higher tax revenue (+9.3%) and social contributions (+6.9%). Overall revenue collection improved by 4.9% year-on-year, but remained below budget. Current spending increased by 6.4%, as the government stepped up social transfers and subsidies. A supplementary budget, adopted in November, was used to reallocate funds budgeted for capital expenditure to municipalities to allow them to pay off a sizable part of their arrears, amounting to 0.5% of GDP.

The 2019 budget assumes a larger deficit with increasing revenues and much higher capital expenditure. The 2019 deficit target (3% of projected GDP) is 0.5 pps higher than projected a year earlier, mainly on account of the expected clearance of arrears by municipalities, amounting to some 0.4% of GDP. It assumes an increase in total government revenue by 11.8% over the 2018 outcome. A number of reforms enacted in 2018 are expected to increase revenues. Firstly, the introduction of progressive income taxation is projected to add some MKD 1.4 billion, or 0.2% of GDP. Secondly, an 0.4 pps increase in the pensions contribution rate, and an 0.1 pps increase in the health insurance contribution rate are expected to raise some MKD 2 billion (equivalent to 0.3% of GDP, including savings from the introduction of CPI-only pensions indexation). On the expenditure side, on-budget capital investment is set to increase significantly, by 1.7 pps as a share of GDP. The programme's projections also incorporate a 5% rise in public sector wages as of September 2019; the fiscal impact from the social assistance reform (some 0.3% of GDP in 2019), including the introduction of a means-tested guaranteed minimum income and the phasing out of some non-targeted allowances; and stepped up financial support to private investments under the "Plan for Economic Growth".

Table 3:

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

	2017	2018	2019	2020	2021	Change: 2018-21
Revenues	31.0	31.2	32.2	31.4	30.4	-0.8
- Taxes and social security contributions	26.8	27.2	27.7	27.3	26.6	-0.6
- Other (residual)	4.2	4.0	4.5	4.2	3.8	-0.2
Expenditure	33.9	33.4	35.2	33.7	32.4	-1.0
- Primary expenditure	32.5	32.3	33.8	32.4	31.2	-1.1
<i>of which:</i>						
Gross fixed capital formation	4.2	3.2	4.9	4.6	4.6	1.4
Consumption	10.3	10.3	10.5	10.1	9.5	-0.8
Transfers & subsidies	18.1	18.7	18.4	17.8	17.1	-1.6
Other (residual)	0.0	0.0	0.0	0.0	0.0	0.0
- Interest payments	1.4	1.2	1.3	1.3	1.3	0.1
Budget balance	-2.8	-2.2	-3.0	-2.3	-2.0	0.2
- Cyclically adjusted	-2.0	-2.1	-2.2	-2.6	-3.3	-1.2
Primary balance	-1.5	-1.0	-1.7	-1.0	-0.7	0.3
- Cyclically adjusted	-0.6	-0.9	-0.9	-1.3	-2.0	-1.1
Gross debt level	39.5	41.0	43.3	43.2	41.4	0.4

Sources: Economic Reform Programme (ERP) 2019.

Public stimulus remains an important growth driver. The government’s medium-term priorities are focused on reducing income inequality and the informal economy, and supporting investments. The programme’s revenue and expenditure are consistent with the revised Fiscal Strategy. Between 2018 and 2021, the ERP expects the general government revenue as share of GDP to drop by 0.8 pps, due to a lower tax revenue ratio. The revenue ratio is, however, already very low by comparison. In the same period, the programme expects transfers and subsidies to drop by 1.7 pps as a share of GDP. The social assistance reform is projected to lead to budget savings as of 2020, through the streamlining and targeting of transfers, and through the elimination of child allowance for the third child. The government estimates the combined expected benefit from the pensions reform (higher contributions and CPI-only indexation) to be around 0.35% of GDP per year. The primary balance would drop from 1.4% of GDP in 2017 to 0.7% in 2021. As the ERP expects the output gap to close in 2020, the cyclically adjusted primary balance would become strongly expansionary in the programme’s last two years.

Box: The 2019 budget

The 2019 general government budget was enacted by the parliament on 21 December 2018. It targets a general government deficit of 3% of projected GDP, which is 0.8 pps higher than the projected 2018 deficit. The revenue ratio would increase by 1pp, and the expenditure ratio by 1.8 pps. The main policy measures with a fiscal impact derive from the introduction of progressive income taxation, and from pensions and social assistance reform.

Main measures in the 2019 budget*			
Revenue measures	Expenditure measures		
<ul style="list-style-type: none"> • Introduction of progressive Income taxation (+0.2% of GDP) • Rise in pensions and health insurance contributions (+0.3% of GDP) (including impact of change in pensions indexation) 	<ul style="list-style-type: none"> • Reform of social assistance, including introduction of minimum guaranteed income (+0.3% of GDP) 		
Total revenue effect	(+0.5% of GDP)	Total expenditure effect	(+0.3% of GDP)

* Estimated impact on general government revenue and expenditure.
Source: ERP 2019

Borrowing by public enterprises and upcoming debt repayments challenge the projected debt trajectory. The programme expects general government debt to increase in 2019 to 43.4%, remain largely stable in 2020, and then decrease to 41.4% in 2021. Due to a rise in the guaranteed debt of public enterprises, in particular the Public Enterprise for State Roads (PESR) which is tasked with the implementation of major road infrastructure projects, from 8.3% in 2017 to 11.8% in 2021, total public debt would climb to 54.5% in 2020, and drop only slightly thereafter. The government’s annual gross financing needs are estimated at around 14% of GDP on average between 2018 and 2021, rising to about 17% in 2021 as the third Eurobond (500 million) matures. However, when public companies - in particular the PESR - are included, overall refinancing needs of the public sector are likely to be substantially higher. The government plans to meet these needs in 2020 and 2021 from domestic and foreign sources, complemented by a new World Bank loan in 2019, as well as by drawing down its central bank deposits. Given the recently lengthened maturities of domestic issues, the government has enhanced its potential for domestic refinancing of the maturing external debt. Still, the composition of debt exposes the government to marked interest rate risk, given the high share of short term domestic currency debt. In addition, the

continually high share of foreign currency-denominated public debt (over three quarters of the total) creates vulnerabilities in case of exchange rate depreciation.

Box: Debt dynamics

The general government debt ratio is expected to rise further in 2019, stay at about that level in 2020, and decline in 2021 to below its 2019 level. The primary balance would contribute the bulk of the debt rise in 2019, but would drive debt levels to a declining degree from then onwards. The share of interest expenditure in the debt dynamics would remain stable for the programme's duration. The contribution of stock-flow adjustments would vary each year, reflecting in large part the expected build-up and drawdown of government deposits at the central bank, in relation with anticipated borrowing and debt repayments.

Table 4: North Macedonia					
Composition of changes in the debt ratio (% of GDP)					
	2017	2018	2019	2020	2021
Gross debt ratio [1]	39.5	41.0	43.3	43.2	41.4
Change in the ratio	-0.3	1.5	2.3	-0.1	-1.8
<i>Contributions [2]:</i>					
1. Primary balance	1.5	1.0	1.7	1.0	0.7
2. "Snowball" effect	0.0	-1.3	-0.9	-1.4	-1.8
<i>Of which:</i>					
Interest expenditure	1.4	1.2	1.3	1.3	1.3
Growth effect	-0.1	-1.1	-1.3	-1.7	-2.1
Inflation effect	-1.3	-1.4	-1.0	-1.0	-1.0
3. Stock-flow adjustment	-1.8	1.8	1.6	0.3	-0.8

[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) 2019, ECFIN calculations.*

Budget projections face sizeable risks calling for more ambitious fiscal consolidation.

There are numerous uncertainties about the programme's expected budget execution and fiscal targets, mainly on the downside. Revenue may remain below budget if GDP growth forecasts prove too optimistic. Assuming the planned scale-up in investment spending happens, attaining the targeted reduction in the primary balance until 2021 would require the government to strictly adhere to the new pensions indexation formula and refrain from ad hoc pension increases. The expected budget savings from the social assistance reform in 2020 and 2021 depend on the swift adoption and entry into force of the new law, which will generate savings, including by reforming the rules on parental allowance. The expected budgetary developments may also be affected by the untransparent administration of the new state aid regime, which may lead to higher than budgeted expenditure for subsidies. However, the momentum of the expected robust economic growth could be used for more ambitious fiscal consolidation to stabilise public debt levels. This would entail targeting a primary balance, particularly through additional revenue-increasing measures, such as more efficient tax collection involving an improvement in the Public Revenue Office's capacity, and more inspections. To this end, the swift adoption of relevant measures (Tax System Strategy; Inspections Law) is necessary.

Box: Sensitivity analysis

The programme includes a sensitivity analysis of the fiscal deficit with regard to three parameters. In case economic growth is lower than expected in the baseline scenario, by 1pp annually on average, the budget deficit would increase by an average of 0.5 pps per year. Lower capital expenditure (75% realisation) would imply a reduction in GDP growth by 0.6 pps per year, and an increase in the deficit by 0.3 pps; reduced tax collection by 5% per year would

increase the deficit by 0.9 pps. The programme also assesses the potential impact on public debt developments from higher interest rates and depreciation of the local currency against the baseline scenario.

The government has further increased the transparency of public finances, but it needs to improve information on public enterprises and on state aid. After publishing the amount of budget users' unpaid liabilities, the government has made significant progress in clearing its arrears, and has speeded up outstanding VAT reimbursements. The amount of publicly available fiscal documentation has increased further, and a law that will enable the government to further increase the available public data is due to be passed by parliament. However, the expected sizeable increase in public enterprises' guaranteed debt, which could result in potential liabilities for the government, calls for increased transparency on the financing of these operations, in particular including extra-budgetary units in fiscal documentation where required by international statistical standards. The transparency of the new state aid regime also needs to be improved, in particular by creating a central state aid registry. Furthermore, improvements to the fiscal framework are still pending. This concerns in particular the adoption of the new organic budget law, which sets out fiscal rules. In order for these to fully deliver the intended benefits, a proper medium-term budget framework, more realistic macroeconomic forecasts, and better control of expenditure commitments need to be put in place.

4. STRUCTURAL CHALLENGES AND REFORM PRIORITIES

This chapter provides the Commission's independent analysis of North Macedonia's economy and identifies the main structural challenges. Each of these challenges influences the overall competitiveness in its own way. However, as the challenges are very often mutually reinforcing, it will be essential to address them in the medium-term to boost competitiveness and inclusive growth. The three most important challenges identified are: (i) addressing youth unemployment, (ii) integration of domestic companies in global value chains and (iii) formalisation of the economy. The informal economy distorts competition, decreases the quality of the business environment, decreases public revenue and leaves some workers without social protection or with limited rights. By failing to integrate with global value chains, domestic firms are missing lucrative opportunities and the ability to increase their productivity, learn from best practices and in such a way positively influence the country's trade balance, growth and competitiveness.

4.1. Key challenges

Key challenge #1: Addressing youth unemployment

Labour market remains characterised by overall low activity and employment and high unemployment. Both youth unemployment and long-term unemployment are a prominent issue in underdeveloped regions, especially affecting low qualified and less represented ethnic groups. Young people are exposed to poor and lengthy transitions from school to work largely due to a weak education system starting from early childcare and primary school. Ensuring a high quality education for all and improving the educational infrastructure and curricula as well as the competences of the teaching staff is essential. Low awareness of the population of the need to acquire qualifications by participating in the lifelong learning process remains an issue. The contribution of employers in training programmes is critical in addressing employment gaps and high level of unemployment.

Key Challenge #2: Integration of domestic companies in global value chains

Strong integration in global value chains (GVC) would provide North Macedonia with the opportunity to raise economic growth, employment and wages, in particular for skilled workers. These networks trade parts and tasks produced in multiple locations that often cross borders multiple times before they are assembled as final products. GVCs operate in a predictable sequence, with each stage of production depending on the previous one creating a stable relationship. Integrating into GVCs can therefore benefit the domestic economy more than standard trade transactions because they are more likely to persist. This in turn provides an opportunity for domestic companies and the economy as a whole to absorb technology, skills (including managerial and entrepreneurial competences) and production standards.

Attracting foreign direct investment (FDI) has been central to the government's economic policy for many years, partly as a way to integrate in GVCs. North Macedonia is among the most open economies to FDI and scores better than the OECD average on regulatory restrictiveness to investments¹ (OECD, 2016). However, the policy of attracting FDI has mainly involved establishing special economic zones (SEZ) offering incentive packages for foreign companies. As of 2016, the government had granted EUR 225 million in the form of investment incentives to 25 foreign investors employing a total of 20 000 workers (World Bank, 2018). In spite of the financial cost, the policies of attracting FDI have not been effective in creating backward linkages between domestic firms and these foreign investors. North Macedonia's FDI has failed to produce spill-over effects for the rest of the economy. Domestic purchases by international investors accounted for just 1% of total exports in 2017 arguing that some foreign investment related policies have resulted in enclave industries having only a few ties with domestic firms.

Productivity and competitiveness of domestic firms would benefit from enhancing linkages with foreign firms. In addition to forgoing positive effects on competitiveness, missing the exposure to GVCs through foreign companies deprives the domestic firms of opportunities to strengthen their management capabilities and adopt international quality standards. This would help create a positive feedback loop and lead to further integration in the global economy and result in better access to finance.

The underlying causes of the weak links of domestic companies with foreign producers are complex and there is generally insufficient awareness by policy makers of the obstacles and the motivation of foreign firms to invest in the country. Part of the problem is that the current incentive schemes do not attract the types of foreign producers that could easily integrate with domestic firms. However, more importantly, managers and staff of exporting companies think the issue lies with local suppliers often unable to match the sophistication, technical and safety requirement of imported intermediary products or services. Therefore, this inability of domestic firms to integrate in GVCs is closely linked to overall weaknesses in the business environment.

Businesses cite the lack of entrepreneurial skills and financial literacy in SMEs as their number one concern as it prevents them from innovating, accessing finance, expanding and ultimately making themselves more attractive partners to foreign firms. Even though there is high liquidity in the banking system, banks require high collateral for lending, partly due to the unpredictability and uneven application of the insolvency regime and enforcement of collateral. In financing their working capital and fixed assets, companies rely heavily on

¹ According to the OECD FDI Regulatory Restrictiveness Index (2016), North Macedonia scores 0.022 compared to an OECD average of 0.067 (0=open, 1=closed).

internal funds and retained earnings. Exporting firms highlight that even in cases when support was offered to domestic firms to adjust processes to comply with EU standards, local firms showed little interest (World Bank, 2018). This could indicate different business cultures between the domestic companies and those leading the global value chains, insufficiently skilled labour force as well as weak capacity or motivation to attract and retain talent including adequate management.

Further increasing the efficiency and transparency of inspections and reducing the time and costs of commercial disputes would address the challenges that restrict the competitiveness of domestic companies. Increasing transparency of para-fiscal charges on central and local level would facilitate doing business. Inefficient inspections in North Macedonia reduce companies' productivity. For example, an additional tax inspection reduces productivity by 5.5% for the median firm (World Bank, 2018). The central government has 28 inspectorates with overlapping mandates, subject to as many as 200 laws and employing over 900 inspectors. The Inspection Council, which reports to the central government, supervises inspectorates, but has no power to correct problems. The new Law on inspection supervision has been enacted by the government and aims to address the weaknesses in inspection processes. It is a step in the right direction in streamlining the inspections procedures and improving the business environment and it therefore has a potential to help boost the competitiveness of domestic businesses. The law enables the Inspection Council to resolve issues with inspectorates in a way that is consistent with international practices. The law also envisages warnings for minor infractions and grace periods for corrective actions.

Developing the services sector is also vital to address the weak integration of domestic companies in global value chains. Services, such as logistics, transportation and information and communication technologies (ICT) are currently fairly unsophisticated, which forces foreign companies to use alternatives outside the country. Furthermore, the restrictions on regulated professions seem to hinder competition in the services sector. Diversifying into service tasks within GVCs could give the country the necessary to upgrade to more sophisticated products and services while diversifying production and thereby increase export diversification and further increase productivity (learning by exporting).

Rather than tackling these underlying business environment issues, the government's flagship policy to improve domestic firms' competitiveness is to provide various forms of state aid to businesses. Based on the Law on financial support of investments, adopted in January 2018, the support is provided to companies that have procured and installed products from suppliers registered in the country where the final product is intended for export, among other beneficiaries. However, the effectiveness of this policy remains under-investigated and unclear. Further effort should be made to monitor the cost effectiveness of these schemes and ensure coordination of different programmes.

North Macedonia is encouraged to implement all the aspects of the Regional Economic Area Multi-Annual Action Plan (REA MAP). The REA MAP is based on EU standards and will facilitate country's integration in regional and European value chains and will also help increase the attractiveness of the economy for FDIs in tradable sectors. Further connectivity with neighbouring countries in transport and energy will further strengthen the access to, and integration in, the regional market. The creation of a regional digital space and of more integrated labour markets with neighbouring economies will offer new possibilities for the country's youth, which is also important in light of the high youth unemployment.

Key challenge #3: Formalisation of the economy

The considerable size of the informal economy in output and employment distorts private sector competition. The informal sector remains extensive both in its share of GDP and in the number of people employed. Different indicators point to between 20% and 40% of

GDP, while informal employment represents 18.1% of total employment or around 130 000 individuals (Labour Force Survey, 2016). The country's informal sector takes various forms of which the most prominent are unregistered labour, undeclared wages and other irregularities in the enforcement of the Labour Relations Act. Hidden salaries are the most acute problem with income being partially or completely undeclared by almost 44% of employees. Other form of informal economy is the practice of not issuing tax receipts or invoices or reporting lower turnover.

The persistently high informal sector has several underlying causes. The high unemployment rate (19.6% in Q4 2018) with an extremely high long-term unemployment rate (77.9% of unemployed in 2017) reduces the ability of potential workers to enforce their rights and forces them to accept informal jobs or partly-declared salaries. These undeclared workers are most likely to engage in industries and services where cash transactions are common. The high share of cash in the money supply, due to the factors such as insufficient financial literacy and a historical propensity towards cash transactions, complicates the tracking of transactions and is a cause of informality. In addition, the high tax wedge for low-income groups transitioning from social assistance to formal employment could contribute to the size of the informal sector. Informality is also caused by underlying socio-cultural factors and shortcomings of the welfare system. Ensuring adequate and timely contract enforcement and increasing the transparency of legal changes will increase public and businesses' trust in state institutions. This will then lead to an increased perception of the link between taxes paid and benefits received which will reduce the acceptance of the informal economy and reduce its proliferation. Further increasing the consistency in law enforcement, clarifying the mandates of various inspections, notably on labour law and occupational safety, will also help reduce informality. Further increasing educational attainment and quality could also help decrease informality since individuals with a lower level of education are more prone to undeclared work (80% of employees with university degrees have a written contract versus 56.8% of those with primary education).

The complex character of informality renders its formalisation challenging. Enhancing the skills, expertise and powers of tax officials, improving judicial efficiency and ensuring greater independence of inspectors are some key objectives in the fight against the informal economy. However, using negative incentives such as punitive measures and better enforcement could further reduce disposable income and increase labour costs, which could reduce consumer spending, exports and consequently GDP. This could lead to even lower employment and create a vicious circle, so it should be approached carefully and combined with other measures. An additional problem in formalisation is the high level of tolerance for informality among the general population with 21.1% willing to participate in undeclared work in order to get a higher wage (CRPM, 2016). In general, perceived fairness of official rules and norms have significant effect on encouraging voluntary compliance and thus improve tax morale. Therefore, reducing the informal economy in North Macedonia will require finely balancing formal enforcement with other measures designed to remove underlying incentives for informality, such as adjusting the legislation to simplify the establishment and activities of 'self-employed', crafts people, sole proprietors and micro enterprises.

The informal sector has many negative consequences for the overall competitiveness of the economy and growth. It creates unfair competition for formal businesses that limits their opportunities for expansion and further investments in their development, innovation and productivity. It also reduces the opportunities associated with formal employment, including job security and safety at work. According to the latest Business Environment and Enterprise Performance (BEEPS) survey (2016), the practices of competitors in the informal sector are seen as the main obstacle for businesses in the country. 56% of companies cite competing

against companies in the informal sector as a main challenge, exceeding the average for Southeast Europe by 7 pp.

The first medium-term strategy for the formalisation of the informal economy (2018–2022) and its related action plan were adopted in 2018. The action plan includes measures relating to the regulatory and business environment, and on raising the public and businesses' awareness of the importance of formalising informal activities combined with deterrent measures. 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 there is a need to remove the underlying causes of informality such as weaknesses in the labour market and business environment. However, in order to address these underlying causes and ensure that the wide set of measures and actions is undertaken, the strategy's measures need to be further integrated in other sectors' policies and action plans.

4.2. Labour market, education and social policies

Labour market development

The labour market is improving slightly, however, considerable gaps remain compared to the EU average. In 2018, the highest employment rate (51.7%) and the lowest unemployment rate (21%) for people aged 15-64 was recorded since 2007. However, the activity rate has remained nearly unchanged over the past decade, hovering around 65.4% (15-64). Nevertheless, this continued positive trend has large gaps. Youth unemployment, long-term unemployment, female unemployment and regional disparities are among the challenges facing North Macedonia. Long-term unemployment (LTU) in 2017 stood at 17.4% and more than half of long-term unemployed have been seeking employment for four or more consecutive years.

Young women, the low skilled, young people living in rural areas and less represented ethnic groups are particularly exposed to unemployment or informal employment. The youth unemployment rate remains a serious problem. It peaked at close to 60% in 2007 but decreased over the years to reach 45.4 in 2018. The employment gap between best performing region (Southeast) and the weakest one (Northeast) remains significant at 25%. The high inactivity rate among women is closely related to educational attainment, which may signal some barriers to employment for women with lower levels of education. 30% of women in the labour force have a university level education compared to 17% of men, however, 12% of men are unemployed compared to 31% of women. Despite some increase in women's employment in the past years, the gender employment gap for people aged 20-64 is 21.9 pps (2017), almost double the EU-28 average. Considering low education levels, men have more than 2 times higher employment rate than women, even if employed women are on average better educated than employed men. The unemployment rate of Roma stagnates around 50% despite labour market improvements and several – largely ineffective – support schemes and policies.

Low quality employment affects the labour market dynamic and youth employment in particular. Approximately half of young workers aged 15-24 are in low quality employment. Particularly worrying is the high share of young people (estimated at 35%) in informal employment. A quarter of young people in 2017 (24.6% in Q32018) are not in employment, education or training (NEETs). Young people under 30 represent more than one third of all unemployed (37.9% in 2017). Knowledge-based service sectors have grown fast, but their share in employment remains rather low (around 10% in 2017). The issue of young people's emigration from the country is well known but its significance is not yet sufficiently considered by policy makers. Due to their inability to find a regular job elsewhere, in 2017, 13% of all workers were self-employed (EU-28 average: 10%). The share of unregistered

employment in total employment is estimated 18.1%, but decreased over the years (by 10 pps since 2008).

Tackling high youth unemployment is a national priority. A one-year pilot phase of the Youth Guarantee scheme targeting people aged 15-29 was successfully introduced in 2018 in three municipalities. In 2019, the Youth Guarantee will be extended to the whole country with a particular emphasis on the most underdeveloped regions (Northeast, Polog, Southwest and Prespa) where urgent measures are needed. The Youth Guarantee includes activities to reach out to non-registered NEETs in their direct environment and to connect them to individual services such as counseling, mediation and training. Some 10,000 young people (aged 15-29) are expected to benefit from the Youth Guarantee in the underdeveloped regions which represents one quarter of all beneficiaries in the country. However, the efficient implementation will require a significant effort by the Ministry of Labour and Social Policy, the Employment Service Agency as well the National Youth Council, responsible for the fieldwork activities.

There is encouraging progress in social dialogue. Regular meetings of the Economic and Social Council (ESC) contributed to a significant increase in the number of recommendations and opinions to the government. Social partners are involved in the drafting of the new law on labour relations which will include provisions on freedom of association, collective bargaining and strike. The law will further regulate branch collective agreements and facilitate setting up a trade union. The development of Local Economic and Social Councils is expected to be reinforced in 2019. There are plans to increase the number of compulsory consultations of the ESC, but a clear timeframe and the use of output indicators to measure the policy impact is recommended.

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 on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion to benefit 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 aligning of their labour markets and welfare systems with the EU's.

North Macedonia faces challenges for a number of indicators of the Social Scoreboard² supporting the European Pillar of Social Rights. This is particularly the case for equal opportunities and access to the labour market. The employment rate, despite increasing in recent years, is well behind the EU-28 average. The main reasons for such a low performance in activity and employment are the gender gap and youth unemployment. The problem is even more pronounced for less represented ethnic groups. The labour force faces strong regional disparities. Informal and precarious work affects a large proportion of workers and one in three young people has only a temporary work contract.

NORTH MACEDONIA		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU average, improving
	Gender employment gap	Worse than EU average, deteriorating
	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, no change
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, deteriorating

The labour force faces strong regional disparities. Informal and precarious work affects a large proportion of workers and one in three young people has only a temporary work contract.

The Youth Guarantee has been successfully introduced to tackle youth unemployment, which mainly affects the country's poorest region. It is the main tool for facilitating the school-to-work transition and access to work, particularly for NEETs. It involves strengthening of the Employment Service Agency so that it offers career counselling, orientation and motivation trainings, job search assistance and employment mediation.

The reform of the social protection system aims to increase coverage. However, this crucial reform is still under consultation. It aims to cover more of the population in its effort to tackle poverty, which include introducing a guaranteed minimum assistance (GMA) and integrating other associated rights that were previously not accessible. It provides for a set of new laws such as the law for social security of older people or the child protection law. The success of the social protection reforms strongly depends on modernising the institutions that implement them.

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 (LFS) 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.

² 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. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around EU-28 average) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2014-2017 are used.

Social protection system

The current social protection system excludes those at risk of poverty or social exclusion. In 2017, 22.2% of the population was at risk of poverty compared to 21.5% in 2015. This increase in poverty is evident among those aged over 65. In addition, almost 40.63% of the country's population living in a household with dependent children was at risk of poverty or social exclusion. This risk affects 71% of households with one single adult with dependent children, significantly higher than the average of 48% for EU-28. Social transfers have almost no impact on alleviating poverty. Social financial assistance is currently only granted under certain conditions, which keeps the most vulnerable people outside the protection system. The coverage is therefore relatively limited and not always adequate.

The social protection system reform aims to tackle the poverty by covering a larger proportion of the population. A set of new laws regulating social protection (notably, the law on social protection, law on social security of elderly and amendments to the law on child protection) have been recently put forward for a public debate and will be ready for adoption in the coming months. However, their implementation will require an additional budget. Therefore, a new personal income tax law will introduce progressive taxation. The draft legislation foresees the introduction of a guaranteed minimum assistance (GMA) and integrates other associated rights that were previously not accessible. In particular, the new legislations aims to strengthen the link between financial rights and social services and intends to place more emphasis on activation offers to push people out of the informal economy. The requirement for applicants to be registered as unemployed will be abolished, so that the new system is also accessible to other vulnerable groups such as seasonal and temporary workers. The draft law for social security of older people aims to provide a minimum income to people above 65 that do not receive a pension or other assistance due to insufficient contribution (15 years minimum required) and is expected to cover around 4,000 people. The new child protection law will redefine the child allowance, introduce an education allowance and transform the existing parental allowance for the third child into a one-off benefit for the first, second and third child.

Cooperation between institutions should be strengthened and increasing their capacity is key for effective implementation. The success of the social protection reforms depends strongly on modernising the institutions that implement them. This particularly involves adapting the management and information system and ensuring its interconnectedness and improving coordination between social work centres, employment agencies and adult education centres. Increases in staff, training and professionalisation are pre-requisites for providing tailored services for the most vulnerable.

Education and skills

The education system does not addresses inequalities in employment. For those with a university-level education, the activity rate is above 85% while the rate falls to 34.1% for those with primary and lower secondary education. Regarding gender, the activity rate for women with university-level education is slightly above that for men (86.4% vs 83.9%) but the rate falls to 54.2% for women with 4 years of secondary education compared to 76.4% for men. Moreover, the activity rate of women with incomplete primary and lower secondary education is three times lower than that of men (13.5% vs 40.2%). The 2015 PISA test results were far below the OECD average. They show that a large proportion of young people do not have the basic skills to enter the labour market, in addition to other reasons such as low mobility, and unattractive wages and working conditions. The latest tracer study on VET and higher education graduates shows that young people are rarely well matched to the jobs they hold early in their career.

The new 2018-2025 education strategy should be the main tool to overcome the problems that have accumulated in all areas of education. However, it lacks coordination and there are insufficient resources to implement it efficiently. The new education strategy and action plan (adopted early 2018) cover all fields and levels of education and aims to develop an inclusive and integrated education system by focusing on outcomes instead of on knowledge acquisition in order to make the learning more relevant to global labour market needs. The strategy and action plan seek to address a number of challenges, but they lack specific goals and do not suggest a clear system to monitor implementation, which is divided between different agencies that all lack financial resources. To achieve the strategy's objectives and cover the costs of the action plan, additional contributions from the State budget and from other sources will be necessary. In 2017, education spending amounted to 12.4% of the state budget, compared to 12.1% in 2016.

The enrolment of children in pre-school education remains very low overall and especially among marginalised communities. Moreover, the governance and management of pre-school is under the responsibility of different bodies. For primary level, learning accomplishment is critically low as demonstrated by results of the 2015 PISA Survey. For general secondary education, the curricula still contain some outdated lessons. Vocational Education and Training remains insufficiently attractive. The number of vocational subjects in the curricula is the lowest in Europe (about 52% compared to 70% in the EU-28). In addition, the hours spent in practical training are exceptionally low. The programmes are not flexible enough to adapt to swift technological development. The Law on the National Qualification Framework (NQF) was adopted in 2013 but it was only applied as of the end of 2015. The reform of the NQF and the validation of non-formal and informal learning and learning outcomes-based education are ongoing. In 2018, the National Board for Qualification Framework adopted 36 qualifications together with a decision for their allocation at different education levels and the first training sessions for the Sectoral Qualification Councils took place. The country is a full member of the European Qualifications Framework (EQF) and successfully presented the NQF to the EQF in 2016. Since 2014, the country participates in Erasmus+ as a "Programme Country", on the same footing as Member States. The country has access to actions in the field of higher education, youth, sport, vocational education and training (VET) as well as school and adult education projects for cooperation and mobility. North Macedonia can also cooperate with partners outside Europe under international projects. Participation in the lifelong learning system is very low (2.2%) compared to the average for the EU-28 (10.9%).

4.3. Competitiveness and sectoral issues

Business environment

Weaknesses in the business environment and the large informal sector continue to be main structural bottlenecks to competitiveness and growth. They affect the productivity and innovation potential of domestic firms preventing them from focussing on integration in global value chains, which is a key challenge for the economy. Since 2004, North Macedonia improved its World Bank 'Doing Business' (2019) ranking by an impressive 70 places and ranked 10th out of 190 countries in 2019. However, while specific indicators making up the overall ranking improved, businesses remain concerned about particular elements of the business environment. Frequent policy changes and red tape are among the top five concerns reported by businesses (BEEPS V, 2016). There is a need to make the regulatory environment more predictable and user-friendly, tackle widespread informality, streamline para-fiscal charges and improve the efficiency of the inspection system.

The effective application of the rule of law is key for improving the business environment. Effective and independent judicial systems are a prerequisite for creating an

environment that is investment- and business-friendly as they instil confidence throughout the entire business cycle. Effective measures to further strengthen the rule of law, ensure adequate and timely contract enforcement and increase the transparency of legal changes could positively affect the business environment in North Macedonia and consequently lead to an increase in productivity and competitiveness. Moreover, further decreasing corruption would make the country a more attractive place for doing business.

Research, development and innovation

The country is evaluated to be a ‘modest innovator’ and spends less than half a percent of GDP on research and development (R&D). The European Innovation Scoreboard 2018 assesses the country as a 'modest innovator'. The country's average innovation performance remains below 50% of the EU average, despite slow improvements. This is linked to a very low total rate of R&D expenditure, which amounted to 0.44% of GDP in 2016 (compared to the EU-28 average of 2.1% of GDP in 2018) consisting mainly of public expenditure with minimal private sector input. Public funding for research, development and innovation has accelerated in 2018 through the use of a wider range of support instruments by the Fund for Innovation and Technology Development. However, the impact remains unquantified and unclear and it should be urgently monitored. The country's annual participation in the Horizon 2020 framework programme is increasing, but the overall success rate in 2018 (10.3%) is below the program's overall success rate of 14.9%.

There is a lack of innovation infrastructure and cooperation and coordination among academia, the private sector and the government. An integrated research and innovation strategy covering the whole innovation value chain from basic research to business innovation was adopted in 2012, but needs to be updated. There is no detailed assessment of the innovation system or what needs to be done in order to improve the overall governance of innovation at policy and institutional level. Other policy documents in the area, such as strategies on research, higher education and smart specialisation, are also not yet in place.

Digital economy

The digitalisation of the economy is progressing, but is hampered by the low level of digital skills and high costs of digital services. The proportion of households with internet access increased by 21 pp between 2012 and Q1 of 2018, rising to 79.3% in 2018. Mobile broadband penetration is also expanding and reached 73% in 2018. However, fixed broadband penetration remains limited and negatively impacts competitiveness. According to the OECD Competitiveness Outlook (2018) with regards to digitisation the country scores 2.3 out of 5. In 2018, the government finished mapping the national broadband of existing electronic communication networks, which will enable it to develop its broadband strategy. In 2018 the country adopted the 2018-2022 cybersecurity strategy which provides a coherent and strategic approach to cybersecurity with five main goals: (i) cyber-resilience; (ii) cybersecurity culture; (iii) cybercrime; (iv) cyber-defence and (v) exchange of information and cooperation. It is complemented by a detailed action plan. Both documents demonstrate national authorities' commitment to comprehensively tackling this issue.

The population's insufficient digital literacy is a significant obstacle to further digitalisation of the economy. Digital literacy is one of the education strategy's priorities. However, a specific strategy addressing digital skills is still missing. The use of electronic signatures is limited to a few institutions that provide services to businesses. The interoperable system is only used by a few institutions, despite the equipment and software having been installed. E-government is at an early stage of preparation. E-commerce, on the other hand, increased by 62% in 2018. However, some key barriers to e-commerce still have to be removed, including customs duties and VAT on imports for small value items.

Investment activity

The low investment level and capital stock significantly slow down efforts to increase productivity and the overall competitiveness of the economy. In 2009-2017 investment contributed 1.8 pp to GDP growth and in the same period the investment-to-GDP ratio averaged 29%. In 2018, investment in the country will contribute only 0.4 pp to GDP growth, which is significantly lower than for regional peers³. In the first three quarters of 2018, gross fixed capital formation was estimated at 27.4%. In 2017, the country experienced a slump in investment spending impacted by a decline in confidence, following the prolonged political crisis. Investment spending did not fully recover in 2018 and remains insufficient in view of the shortcomings in the country's infrastructure and production potential.

Traditionally, most investments in the country have been private. The share of public investment in total investment increased in 2009-2017 compared to 2001-2008 (from an average of 22%, to an average of 26%), but this was mainly due to the increase in investment in roads and civilian construction projects. Such projects financed on- and off-budget increased from 28% of total public investment in 2002-2008 to 43% in 2009-2017. Since these areas traditionally have a lower rate of return and a lower multiplication effect on the economy, the overall rate of return on investment in the economy fell to 9.7% in the period 2008-2017 compared to 13% in 2000-2008. The large informal economy and challenges in the labour market, including insufficient managerial skills, negatively affect private investment behaviour. While the political crisis caused a slump in investment in 2017, the investment spending in the economy remains insufficient overall due to the persistent challenges in the business environment, which is often causing projects to be delayed due to cumbersome procurement procedures and poor performance of contractors.

Trade performance

Exporting companies, notably SMEs, still face key constraints to trade. These impediments are linked to non-tariff barriers, including technical standards and administrative obstacles. Barriers also include relatively high logistical and customs costs and a lack of managerial, financial and technical skills. The economy posts a high and growing degree of trade openness. The total value of trade in goods and services amounted to 124% of GDP in 2017. In 2018, both exports and imports grew by 17% and 12.4% respectively. Import coverage by export stood at 76.4% in 2018 with trade deficit amounting to EUR 1.8 billion or 16.9% of GDP. A decline in trade deficit was observed over the last years leading to decline in the current account deficit and easing the pressure on the exchange rate.

The EU is the country's main trading partner (70.6% in 2017) followed by the CEFTA parties (10.5% in 2017). Germany, Greece, the United Kingdom, Serbia and Bulgaria are the biggest trading partners. 95.6% of products of North Macedonia can access the EU market without customs duties. The export product mix has been improving in recent years. The share of iron, steel, and clothing in total exports has fallen further (to 17.4% in 2018 compared to 33.3% in 2013), to the benefit of chemicals and machinery and transport equipment (55% compared to 32.8%). The key import products are platinum and platinum alloys, petroleum oils, other metals and alloys and flat-rolled iron products. Given the different exporting product specialisation among Western Balkan countries, there are significant potential opportunities for increasing trade integration in the form of regional value chains that could link up with global value chains, especially in sectors such as food and car manufacturing (World Bank, 2018). A serious impediment to further increases in exports

³ Investments' contribution to GDP growth in 2018: Montenegro 2.7 pps, Kosovo 2.1 pps, Albania 1.5 pps, Serbia 1.7 pps and Bosnia and Herzegovina 0.8 pps.

is the quality of logistics. In 2018 the World Bank's logistics performance indicator ranked North Macedonia 81st out of 160 countries (World Bank, 2018). The country scored especially low on customs and quality of logistics. It also had the highest average customs clearance days in Western Balkans, for 83% of firms it took over five days to complete the process (BEEPS V, 2016).

Energy

The economy is characterised by high energy intensity, inefficiencies in the ageing energy production system, persistent high dependency on coal, and an inefficient energy consumption. The regional connectivity in energy is still inadequate and the implementation of the Energy Community commitments, notably on the Sustainability Charter, remains poor. The new law on energy that came into force in January 2019 liberalised the electricity market for micro and small companies and households. However, corresponding by-laws are missing and insufficient effort was made to educate relevant partners about their obligation on the liberalised electricity market. The country is also finalising the process of adoption of new balancing rules.

Energy consumption is dependent on imports and domestic production is dominated by fossil fuels. 41% of the final energy consumption in 2017 was covered by domestic production, while 59% was imported. For energy consumption, oil was the highest at 50.4%, followed by electricity (27.5%), biomass (11%) and coal (6.1%). In terms of final electricity consumption, 74% was covered by domestic production while 26% was imported. Domestic electricity production relied heavily on lignite (62%) followed by hydro production (19.8%) and gas (14.8%). Electricity supply reliability is uneven in the country and the IMF's analysis points to North Macedonia having one of the highest proportions of revenue loss due to the power cuts (7.5%) in the region, second only to Kosovo⁴ (BEEPS V, 2016). The country is making some progress in regional connectivity, notably in developing an electricity transmissions inter-connector with Albania and starting the preparatory work for gas interconnections with Greece. Those projects, once realised, will accelerate the integration of North Macedonia into pan European networks, contribute to increased diversity and security of supply and will help increase the competitiveness of the energy market over time. Regarding investment in infrastructure, the country is continuing to construct several internal gas pipeline sections. Related to energy efficiency, the amended national renewable energy action plan is now in line with the binding target of a 23.9% share of renewables in the energy mix by 2020 (currently at around 20%) and energy efficiency savings of 9% by 2018 relative to 2009 in both public and private buildings.

Transport

The transport market is heavily concentrated on road transport, which contributes to very high transport-related green-house gas emissions amounting to 15% of country's total emissions. In 2017, the transport sector's contribution to gross value added was 3.5%, which is lower than the EU average level of around 5%. The optimisation of the country's transport system and network therefore has great potential to increase productivity and growth. On the quality of transport infrastructure, the World Economic Forum's 2018 Global Competitiveness Report ranks the country 89th out of 138 economies for transport infrastructure⁵. The transport infrastructure's relatively low quality combined with weak trade and transport logistics present barriers for foreign firms wanting to invest in the country and for including domestic firms in global value chains. Rather than focusing on further

⁴ Compared to Serbia, Bulgaria, Albania, Bosnia and Herzegovina, Montenegro and Romania.

⁵ Serbia is ranked 42nd, Montenegro 100th, Albania 109th, Bosnia and Herzegovina 104th.

expanding its road networks, the government should focus on implementing the connectivity reforms related to rail transport and would also benefit from opening of the rail transport market at least for domestic and regional undertakings. Improving the connectivity of transport infrastructures will accelerate the integration of North Macedonia into pan-European networks and will help further develop economic corridors over the region.

The road maintenance budget is insufficient and road maintenance is handled by insufficiently efficient state companies operating with old equipment. Ageing infrastructure and improper maintenance lead to more road traffic accidents and consequently to substantial financial costs. In addition, the fatality rate in traffic accidents is 78 people in million inhabitants, which is significantly higher than the EU average of 52. To address this issue the government is considering forming a lead road safety agency to ensure a coordinated and comprehensive approach to road safety.

Agriculture

The relatively large agricultural sector consists of highly fragmented private and state-owned land parcels with low productivity and poor irrigation infrastructure. Overall, the agricultural sector accounted for 10.9% of GDP in 2017 and 15.8% of employment in 2018, but these shares are considerably higher in some regions. Despite access to fertile land, water resources and a favourable climate and despite the country's proximity to export markets, the average farmer produces less than a third of that of the average farmer in the EU-28. In 2018, more than 80% of agricultural land was privately owned with only around 20% state-owned. Extensive private ownership contributes to the small farm size and land fragmentation. This significantly curbs productivity as it prevents farmers from benefiting from economies of scale and hampers investments in modernisation. According to the latest farm structure survey (2016), individual farmers cultivated on average 1.5 ha of land, which is 10 times less than the average farm in EU-28 (16.1 ha).

Agriculture's potential to boost income and diversify exports is undermined by several structural challenges. These include low access to credit, low R&D spending, deficient infrastructure and extension services, lack of a market orientation, outdated labour-intensive farming technologies, and the low quality of human capital. There is a need to further support and recognise the importance of economic cooperation between farmers. Smallholder farmers need to better engage with value chains in order to improve their incomes, while reducing market risks. A focus on sustainable agri-business will also be essential to improve standards and productivity, to build and reinforce competitive value chains, and to increase access to markets and regional integration. Agricultural education and training, agricultural extension, and participatory research need to be improved as they are key factors in increasing the number of skilled agricultural workers and increasing competitiveness through innovation and applied technologies. Agricultural subsidies per hectare (estimated at between EUR 340 and EUR 380) are above the EU average (estimated at below EUR 300 for EU-27). Although subsidies are linked to production, they involve a very complex administration scheme and there are indications that they may slow down the structural transformation of the sector.

Industry

The main obstacles to competitiveness in industry include low investment and innovation, limited export diversification, underdeveloped enterprise clusters and a significant skills gap. The industry sector contributed 25% of gross value added of the economy in 2018 and 31% of jobs. Manufacturing generates 19% of country's employment (EU average 20%) with the textile and apparel industry being the largest employer. The country has shifted towards medium value added production and exports in recent years, supported by sizable state aid. Between 2011 and 2016 producing spare parts for the motor

vehicle industry created more than 11 000 jobs; more than any other sector. Nevertheless, traditional products such as iron, steel and textiles still make up a large share of exports.

There are significant variations between different industries in terms of technology adoption, management capabilities, product quality and mark-ups, which also result in diverse levels of productivity across industries. Human capital inadequacies also hinder productivity: the average manufacturing and services worker is on average four times less productive than their counterpart in Europe and Central Asia (World Bank, 2018). Linkages between domestic industry and international production chains remain weak. The new 2018-2027 industrial strategy, adopted by the government in November 2018, integrates the measures for creating industry based on green, innovative, circular and smart growth. The 38 planned measures cover five strategic measures that reflect companies' needs. They aim to reinforce the manufacturing foundation, raise productivity, facilitate innovation and technology transfer, catalyse green industry and green manufacturing and stimulate manufacturing exports. However, the suggested measures need to be implemented quickly and the underlying causes of low innovativeness and weak global value chain integration need to be addressed.

Services

The services sector accounts for over half of employment and over 60% of GDP. The sector grew by 1.7% in 2017, but it faces several structural problems. The further development and growth of services sector companies is hampered by weak entrepreneurial skills and a significant skills gap in employees, particularly soft skills, which are especially important in services. Export of the country's services continues to grow and it increased by 1.5% in 2018. However, services still represent only 25% of the value of the country's export basket, which is partially explained by the low share of high growth firms in the sector. In the last 3 years only 5.5% of medium sized service firms experienced average annual growth in employment of more than 10%⁶. Tourism and transport continue to constitute the largest chunk of the county's export in services (40%) followed by services provided to manufacturing companies (25%). The latter have significant growth potential because their development is closely related to the inflow of export-oriented FDI. Telecommunications and computer and other information services, along with other business services, represent close to 25% of service exports and could also be expanded. There is potential for regional cooperation with Western Balkan neighbours when it comes to the export of services, especially for tourism packages, which in many cases are complementary rather than competing.

⁶ The number is lower than in aspirational peers such as Croatia (9.2%), Poland (10%) and Estonia (9.7%).

ANNEX A: IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2018

Overall: Partial implementation (44.0%)⁷	
2018 policy guidance	Summary assessment
<p>PG 1:</p> <p>Develop a proper medium-term fiscal consolidation strategy.</p> <p>Stabilise the public debt ratio by pursuing a sufficiently tight fiscal stance while protecting capital spending.</p>	<p>There was limited implementation of PG1:</p> <p>1) Partial implementation. The government implemented reforms (pensions reforms, rise in health contribution rates, income tax reform, social assistance reform), the net fiscal impact of which is calculated by the IMF to amount to 0.2% of GDP in 2019. However, while sustainable, these measures – in spite of the over-optimistic GDP growth assumptions of the government – may not be sufficient to bring about the envisaged reduction in the general government primary balance in 2020 and 2021. The government expects the social assistance reforms alone to raise the primary balance by some 0.3 pps in 2019, before offsetting effects would set in by 2020 or 2021. Yet, the relevant social assistance law enabling the implementation of these reforms has not been adopted.</p> <p>2) No implementation. The lower than projected budget deficit in 2018 (1.8% of GDP compared to the target of 2.8%) and the expected contained rise in general government debt came about as capital spending was very low (51% execution rate).</p>
<p>PG 2:</p> <p>Streamline and better target social spending and agricultural subsidies.</p> <p>Reduce public sector payment arrears and develop an arrears prevention strategy.</p>	<p>There was partial implementation of PG 2:</p> <p>1) Partial implementation. The government has adopted the new Law on Social Protection and Parliament is expected to pass it in the first quarter of 2019. It is reflected in the 2019 budget and aims to improve the targeting of social assistance benefits, e.g. by consolidating the partially overlapping child and social protection benefits with means-tested minimum guaranteed income, and a social pension for the elderly. Third-child parental allowance would be abolished in turn. Measures to reform the system of agricultural subsidies were very limited and consisted mainly of an evaluation of direct payments with recommendations for alignment with the CAP.</p> <p>2) Substantial implementation. The share of VAT refunds within the legal deadline of 30 days has increased, and government and other public sector units have cleared substantial amounts of unpaid liabilities. The municipalities have been transferred funds through the 2018 supplementary budget to clear about half of their arrears in the first half of 2019. All public entities are now required to publish their overdue obligations on a quarterly basis. The government imposed a fiscal rule on municipalities to restrict the scope for over-optimistic revenue planning,</p>

⁷ 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>Take the necessary organisational steps in view of improving tax collection.</p> <p>Adopt the organic budget law with a set of fiscal rules and establish an independent fiscal council to assist in their enforcement.</p>	<p>which, although it is rather generous, might contain the future accumulation of arrears at local level.</p> <p>3) Partial implementation. Preparatory steps have been taken but the adoption of essential reforms to strengthen revenue administration and enhance monitoring to improve efficiency of VAT and corporate tax collection are still pending. The government adopted a law on the prevention of money laundering and financing of terrorism, which limits allowed cash payment. The law on profit tax has been amended with the aim of better regulating transfer pricing and enhancing corporate tax collection.</p> <p>4) No implementation. The ERP expects that the new organic budget law will be adopted in 2019.</p>
<p>PG 3:</p> <p>Conduct monetary policy consistent with the exchange rate peg, using available scope within this framework in line with safeguarding price stability.</p> <p>Adopt and implement a comprehensive NPL resolution strategy, addressing all underlying obstacles also outside the remit of the central bank, with the involvement of all relevant stakeholders.</p> <p>Adopt and implement a comprehensive strategy for fostering the use of the local currency, with the participation of all relevant stakeholders.</p>	<p>There was substantial implementation of PG3:</p> <p>1) Full implementation: The NBRNM has appropriately used its scope to pursue a more accommodative monetary policy in 2018 in an environment characterised by low inflation and considerable inflows of foreign capital</p> <p>2) Partial implementation: The authorities developed a comprehensive strategy for the improved management of non-performing loans in the Republic of North Macedonia in cooperation with relevant stakeholders. It was adopted in December 2018. Implementation started.</p> <p>3) Partial implementation: The authorities developed a comprehensive strategy on de-euroisation in the Republic of North Macedonia in cooperation with relevant stakeholders. It was adopted in December 2018. Implementation started.</p>
<p>PG 4:</p> <p>Prepare risk assessments focusing on sectors and branches most vulnerable to informalities</p> <p>and identify and apply appropriate corrective measures.</p>	<p>There was limited implementation of PG4:</p> <p>1) No implementation: building on the strategy, the 2018-2020 action plan for formalization of the informal economy, which sets 29 measures, was adopted in August 2018. The strategy does not include a risk assessment of particular sectors and branches of the economy, although it does include an analysis of the most common types of informality and their causes.</p> <p>2) Partial implementation: In June 2018, new regulation was passed to incrementally limit the size of cash transactions. The authorities are also strengthening customs border control to combat 'suitcase trade' by informal businesses. In September 2018, a coordinating body was set up to monitor the action plan implementation. The first implementation report is due in April 2019. The Law on trade of green markets, that would eliminate informality in this sector entered into force in January 2019, but was suspended shortly after.</p>
<p>PG 5:</p> <p>Clarify the mandate of each inspectorate to avoid overlap</p>	<p>There was partial implementation of PG5:</p> <p>1) Partial implementation: The draft new Law on inspection supervision was published on ENER in November 2018. It will specify the mandate of each inspectorate to avoid overlap and to establish and apply transparent and consistent policies. It has not yet been approved.</p>

<p>and put in place and apply transparent and consistent procedures. Create a register of para-fiscal charges on central and local levels that clearly states the purpose of each charge and make it publically available.</p> <p>Strengthen the institutional capacity of civil courts to uphold contracts and handle commercial disputes within a reasonable time and at reasonable costs.</p>	<p>2) Limited implementation: Procedures will be put in place once the law is adopted.</p> <p>3) Partial implementation: The catalogue should be finalised by early 2019. In the meantime, the process of preparing a parafiscal charges registry began with the development of a ‘catalogue of services’. At first, the catalogue will cover about 340 services resulting from 52 laws (charges and administrative fees will be included for each service). The registry will feed into the catalogue.</p> <p>4) Partial implementation: The first draft of the Judicial Network Analysis was prepared in 2018 and submitted to the international experts for comments. It will help strengthen the civil courts’ institutional capacity. Amendments to the laws on public notary and enforcement agents were adopted in December 2018. The amendments to the law on enforcement agents aimed at, among others, to redefine procedures for the extrajudicial settlement of debts and introduce a simpler and more cost-effective process of initiating enforcement procedures. Discussions are under way on how to reduce the costs of tariffs for both public notaries and enforcement agents. However, regardless of the judiciary reforms, no specific measures have been taken to improve capacity and efficiency in handling commercial disputes.</p>
<p>PG 6</p> <p>Modernise the education system at all levels by further improving the infrastructure, curricula and teacher qualification</p> <p>Pursue the reform of the VET system to facilitate school- to-work transition.</p> <p>Facilitate women's access to the labour market</p>	<p>There was partial implementation of PG 6:</p> <p>1) Partial implementation: The education strategy and 2018-2025 action plan was adopted in January 2018. The ERP includes a list of activities that have been implemented at preschool, primary and secondary education levels. However, there is no information about tertiary education. Improving education activities in preschools, teacher training in particular, has not yet started. In primary schools, the new curricula and teacher training are still not developed. The road-map for building new infrastructure is still being prepared.</p> <p>2) Substantial implementation: There were some structural improvements following the completion of the institutional structure for implementing the national qualifications framework, which is aligned with the European Qualifications Framework. In October 2018, guidelines were adopted for VET qualifications standards and syllabi.</p> <p>Furthermore, by the end of 2018, 153 occupational and 52 qualification standards had been developed; 5 of them on the business community’s request. 100 module-based and competence-focused curricula were introduced for general and vocational education. In addition, 1250 new module-based curricula are being prepared (70 for general education and 1180 for VET). A learning management system was introduced to support teachers' training. By the end of 2018, 28 trainers had trained 2300 teachers, directors and professional associates across the country’s secondary vocational schools.</p> <p>3) Limited implementation: According to the latest data available (Q3 2018), the labour market activity rate of women is still very low and has barely increased in one year. The available preschool services, childcare centres, and some recently adopted administrative</p>

<p>and ensure sufficient capacity of the Employment Service Agency for implementing the Youth Guarantee.</p> <p>Adopt the law on social protection to better target those at risk of social exclusion</p> <p>Increase enrolment in pre-school education.</p>	<p>measures should help women enter the labour market.</p> <p>4) Partial implementation: The Rulebook on internal organization of the Agency EARM and on the systematisation of staff were amended to recruit and train new employees to extend the implementation of the Youth Guarantee to the whole country.</p> <p>5) Substantial implementation. A set of new laws regulating social protection (notably, the law on social protection, law on social security of elderly and amendments to the law on child protection) have been recently put forward for a public debate and will be ready for adoption in the coming months. However, their implementation will require an additional budget. Therefore, a new personal income tax law will introduce progressive taxation.</p> <p>6) No implementation. Figures are not provided, though the government states that a report was prepared.</p>
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ANNEX B1: ASSESSMENT OF THE STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP

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 organised electricity market to allow more competition in energy supply for the benefit of customers. It will also stimulate cross-border regional market integration and connectivity. The measure will have a significant impact on the economy, though a potential initial increase of the energy price might reduce its competitiveness in the short term. However, as highlighted in last year's assessment, the potential impact on prices in particular, and therefore on vulnerable households, and on other economic sectors, is not quantified. The June 2018 adoption of the energy law marks a turning point in the transposition of the third Energy Package. However, adopting the implementing legislation is a challenge due to the short deadlines and the number and scope of the regulations that have to be developed.

Measure 2: Promotion of renewable energy sources and improvement of energy efficiency

This measure is also rolled over from last year. It will help diversify energy generation and contribute to energy supply security, with expected positive effects for the economy. The measure includes both regulatory aspects (including adopting the energy efficiency law) and power generation capacity building. It sets out alternative methods to promote energy efficiency and renewable energy such as pollution taxes, selling products with energy-saving characteristics and a campaign to encourage the buying-off of inefficient products. However, the exact way that this will be put into practice and the expected impact have not been sufficiently developed. Furthermore, energy efficiency activities should focus more on the residential sector. As pointed out in last year's assessment, energy efficiency and renewable energy use can only be fully achieved by fully complying with the relevant EU *acquis*.

Measure 3: Facilitating Macedonia-Serbia cross-border crossing

This measure, which is rolled over from last year, addresses the bottleneck in the railway border crossing between North Macedonia and Serbia (Tabanovce). It aims to decrease the waiting time at the railway border crossing by establishing a 'one-stop-shop' for border service procedures. The measure focuses on the construction component while neglecting to tackle the procedural issues necessary to smooth the railway border crossing. Additional procedural and regulatory reforms would generate a wider impact as they could be applied to border crossing procedures at other borders. The measure could increase competitiveness, particularly by facilitating cross-border freight traffic, but the competitiveness analysis is poorly carried out. The measure relies on external funding for construction and does not properly budget for the necessary maintenance investments.

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

This is a new measure. It plans for the ITS to be put in place along road Corridor X, which is a strategic objective of the 2018-2030 national transport strategy. The measure will contribute to road transport safety and the traffic flow along Corridor X. However, its impact cannot be fully determined given the insufficient analysis of the expected impact on competitiveness that does not include any estimate of savings (cost or time). However, the realistic cost estimate and planned timeline makes the measure credible.

Measure 5: Improving the irrigation system

This measure helps tackle one of the agricultural sector's main constraints, complementing Measures 6 and 7. Also rolled over from last year, it aims to revitalise the existing irrigation infrastructure and expand its coverage. Last year's recommendation to address weaknesses in the regulatory framework for irrigation management, to review pricing methodologies and to consider involving water users in irrigation management was not heeded. The human factor in agriculture, particularly the need to extend the services to farmers so they may adapt and benefit from proposed reforms was also not considered. In addition, the proposed investments still focus on big dams and very little attention is given to irrigation networks (only in the scope of IPA funding for small-scale irrigation systems). Investments by the national water management company are not explained in the ERP or presented in the budget. The same goes for the national and IPA funding available for on-farm investments in irrigation, which should be considered as part of this measure and budgeted accordingly. In spite of the size of the construction works and the many impacts they might have, there is no description of synergies with other sectoral policies. 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 agricultural land fragmentation by consolidating parcels in targeted consolidation areas. The measure complements Measures 5 and 7 in tackling the agricultural sector's main constraints. However, this reform is slow and has only been partially implemented. The Commission's suggestion in last year's assessment to incorporate abandoned and state-owned land into an amended Law on land consolidation was not followed. The measure's proposed activities lack details on the selected consolidation sites and quantitative objectives or estimates. Moreover, no actions are planned to incentivise voluntary land consolidation initiatives by groups of farmers. Estimates of capital investments involved in the process are not budgeted. Impact assessments are very generic and do not include sufficient quantitative information.

Measure 7: Agricultural cooperatives

The measure to support associations of farmers in agricultural cooperatives remains relevant as it addresses a key challenge of the agricultural sector. It is rolled over from previous years due to limited progress in its implementation. The Commission's recommendation to link the measure to the EU *acquis* alignment process on producer groups and common market organisations was not considered. Even though the reform is consistent with other related measures in the ERP (consolidation of agricultural land and financial support of investment), no information is given on synergies with other cross-cutting reform measures (e.g. introduction of progressive income taxation, social policy, etc.). As is the case with the other measures in the agricultural sector, the expected impact on competitiveness, employment and gender is not sufficiently considered, and the impact of the measure is not quantified enough.

Measure 8: Financial support of investments

The measure on financial support for investments is also rolled over from last year. Together with measure 9 it is part of the government's plan for economic growth. The measure includes ex-post direct state aid for companies to reward them for their successful past performance. All companies that meet the required criteria are eligible to apply on a 'first come, first served' basis. The measure raises concerns on objectivity, transparency and equitability in the disbursement of the funds. As highlighted in last year's Commission assessment, the measure does not address the underlying structural constraints to the low investment levels in the economy. The measure does not consider whether the companies would be willing to use their own funds to employ, innovate and grow regardless of the subsidies. The potential impact of

the grants on individual companies or even on the country's competitiveness therefore remains unclear. There has been insufficient effort to set up SMART indicators and the key performance indicators are only input-based. The expected impact on employment and gender is not sufficiently developed.

Measure 9: Financial support for micro, small and medium enterprises

Like measure 8, measure 9 is rolled over and is part of the government's plan for economic growth. The measure includes direct state aid to SMEs and micro enterprises for various projects, including raising quality standards, making medium-term business plans and introducing new products or production processes. Similar to measure 8, this measure is not a structural reform tackling underlying causes for why companies do not themselves invest in such processes. In addition, the assessment of the impact on the country's competitiveness is still missing. Furthermore, it raises similar concerns as measure 8 in terms of objectivity, transparency and equitability in the disbursement of the funds. The key performance indicators presented are input-based and SMART indicators are not developed. The expected impact on the employment and gender measures is insufficiently addressed. There is a need to effectively monitor the outcome of the scheme and ensure coordination between different schemes of a similar type to avoid overlaps. There is also a need for a credible exit strategy.

Measure 10: Increasing competitiveness in the tourism and hospitality sector

The measure is rolled over from the previous year. The Commission's recommendation to embed the measure in a more strategic approach and to add further detail in the measure description, was not considered. The measure could have a significant impact on the sector. However, the scale of the impact is unclear as outputs are unquantified. This measure is also subject to multiple risks. At the same time, the measure seems to have been significantly scaled up compared to the previous year with funding from an EU project, even though this is not specified in the measure. Although it could potentially have a considerable impact on both employment and gender equality, this is not specified. Suggested indicators are input-based and a proper assessment of the impact on the competitiveness of the country is lacking.

Measure 11: Harmonisation of the public procurement legal framework with the *acquis*

The measure is also rolled over from last year. It aims to harmonise the public procurement legal framework. It is expected to increase transparency and predictability on the market following the request to publish public procurement plans electronically and in advance. The number of bidders per tender is expected to rise, in particular bids by SMEs. However, there is no quantification of the impact in terms of numbers of SMEs affected nor are budgetary savings quantified. The risks accompanying the measure are significant. A new software application should ensure increased transparency and fairness in the small-valued procurements, however a number of implementing acts need to be adopted in 2019 to make the law applicable. In addition, the software for small value procurements is to be developed in mid-2020. The full potential of the reform will depend on the human and technical resources at the disposal of the State Appeals Commission and Public Procurement Bureau.

Measure 12: Development of a National E-Services Portal

The measure is rolled over from the previous year. As highlighted in last year's assessment, the measure is relevant to reduce the cost and time for businesses to deal with the administration and is therefore important for improving the overall business environment and the ease of doing business. However, this measure has now been under implementation for several years and it is difficult to establish what progress has been achieved. Several risks to the effectiveness of this measure are highlighted, including inefficient coordination and communication between state institutions, lack of 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. Furthermore, the budgeted costs seem insufficient and only partial. The measure does not quantify the expected impact on competitiveness, which is only described in general terms rather than with a clear focus on quantitative targets.

Measure 13: Reducing the informal economy

The measure on reducing the informal economy is new and is prioritised based on the Commission's assessment of last year. As indicated in this year's analysis of key structural challenges, this measure is very relevant to increasing the competitiveness of the economy. The measure aims to implement the 2018-2022 strategy for the formalisation of the informal economy that was adopted in early 2018. The strategy identifies three salient motives for engaging in informal business activities, but these are not properly addressed by the measure's activities. Most of the included activities are based on more repressive stringent monitoring and inspection. In addition, the voucher mechanism for transforming informal workers into formal ones has already been in place for over 10 years and has not proven efficient in addressing informalities. The measure focuses on employment policies while ignoring other important aspects contributing to the informal economy, such as the overall business environment or taxation. The measure's expected impact on competitiveness is not sufficiently quantified and the impact on employment and gender not sufficiently considered. Finally, the gap between the adoption of the strategy (early 2018) and the first activities (planned to start as of April 2019) could signal a lack of commitment for reforms or insufficient institutional capacity.

Measure 14: Improving infrastructure and access to Finance for research, development and innovation

This measure, rolled over from last year, aims to provide funding for several stages of the innovation cycle to address some of the key RDI challenges. Although this measure is still highly relevant, it only partially addresses key constraints to RDI. Some of the measure's activities such as the Fund for Equity and Mezzanine Financing and Science and Technology Park are long-planned initiatives whose credibility is at stake given the long delays in implementation. In 2018, an improved record in disbursing grants was noted. More activities and funds will be added in 2019. However, the measure does not require the expected impact of the fund's investments to be quantified. Nor does it envisage adequate ex-post monitoring and evaluation. Overall, the expected impact of the competitiveness measure is unquantified and the impact on employment and gender is insufficiently considered.

Measure 15: Trade facilitation

The measure on trade facilitation, also from last year, aims to simplify inspections and clearance procedures. It has the potential to improve competitiveness by speeding up all trade that requires veterinary and phytosanitary certificates issued through the EU Trade Control and Expert System (TRACES). The measure is related to the Additional Protocol 5 of the CEFTA Agreement. The ERP provides a good quantitative assessment of the expected impact

on competitiveness. However, the budgeted costs should be clarified as they are quite small and it is unclear whether they cover all of the measure's required activities.

Measure 16: Further developing of the qualification system

The measure is rolled over from last year and relevant for improving educational outcomes. The adoption of the 2018-2025 education strategy and the related action plan clearly signals that education is a priority for the Government. However, strong leadership and coordination is necessary to carry out the action plan. Monitoring implementation and quickly addressing delays will be crucial.

Measure 17: Youth Guarantee

This measure is rolled over from the previous years and it aims to tackle youth unemployment. However, its implementation will pose a challenge for the involved institutions, namely the Ministry of Labour and Social Policy (coordinating institution), the Employment Agency (in charge of registration and counselling) and the National Youth Council (in charge of the fieldwork). Additional well-trained staff will be needed to implement the Youth Guarantee in the country's 30 employment centres for some 10 000 young people per year. The measure does identify the lack of physical and human capacities of the Employment Agency as a significant risk and suggests some mitigating actions. The impact of the measure on competitiveness could have been further elaborated. It is important to ensure that the focus of the measure is on the most vulnerable, particularly women and less represented ethnic groups living in underdeveloped regions, and on collecting of data. Networking and exchanges with European Public Employment Services will improve the way of working.

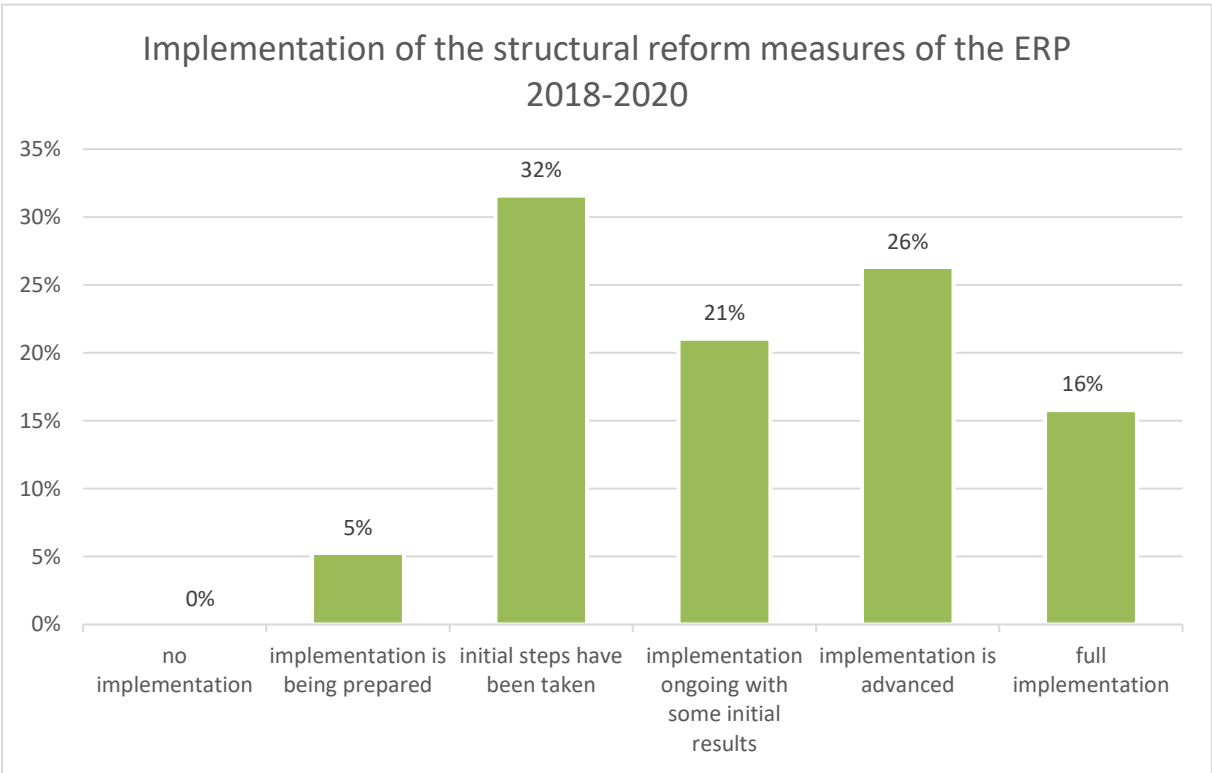
Measure 18: Enhancement of financial benefits in the field of social protection

This measure is considered crucial for tackling poverty in the country and is rolled over from the previous year. The law regulating the social protection, which is suggested by the measure, is urgent and should be adopted without further delay. Furthermore, additional attention should be put on adopting the bylaws and implementing regulation. The information campaign, including fieldwork targeting potential beneficiaries, particularly the most vulnerable (Roma, women with children), is relevant. However, the measure does not offer a sufficiently detailed outline on its implementation.

ANNEX B2: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2018-2020

Relatively good progress was made in implementing the measures in 2018 (average score: 3.4 out of 5). Activity reports provide a fairly accurate description of the level of implementation, though the scoring is overly optimistic for some activities. The scoring is imprecise for the measures related to agricultural and industrial development. For measures 9 and 10, the described implementation is not fully linked to the ERP 2018-2020 activities, which makes assessing the progress more challenging.

Implementation is stronger for some measures, such as measure 17 on active employment, measure 18 on the Youth Guarantee, measure 1 on harmonising the legal framework for public procurement with the *acquis* and measure 2 on improving internal financial control. In contrast, implementation is weaker for other measures, such as measure 8 on agricultural cooperatives, measure 6 on improving the irrigation systems and measure 11 on improving the competitiveness of domestic companies.



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The 2019-2021 ERP was submitted by the government of North Macedonia on 30 January 2019. It is in line with the revised medium-term fiscal strategy of December 2019 and the 2018 Budget Law. 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 seven ministries, several agencies and other offices were involved in this work. Upon completion, the government formally endorsed the ERP.

Stakeholder consultation

The draft ERP was posted on the Ministry of Finance's website between 23 November and 7 December 2018 to give stakeholders, including social partners, the opportunity to make comments and recommendations. Interested parties were also invited to send written contributions. The government held an additional public consultation in Skopje on 30 November 2018. The draft ERP was sent to the Economic and Social Council on 20 December 2018. The contributions to the consultation are included as an annex to the ERP.

Macroeconomic framework

The macroeconomic framework is coherent and consistent, but overly optimistic. The ERP presents two alternative scenarios compared to the baseline: (i) assuming lower growth in trade partner countries; and (ii) assuming lower investment, but it does not include a low-growth scenario combining both domestic and external risks. The external sector outlook is described in detail in the ERP and an analysis of external debt sustainability is provided in annex. 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 given potential current account or growth shocks.

Fiscal framework

The ERP is based on the latest budget projections following its revision and on the fiscal data available at the end of Q3 2018. Despite the revised economic growth assumptions, the ERP sticks to the fiscal targets of previous years. 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 aging.

Structural reforms

The structural reforms sections (4, 5 and 6) broadly follow the guidance note. Each measure has a description, which usually includes the annual timeline, a budget estimate, the expected impact on competitiveness and the expected impact on employment. However, the analyses of impacts on competitiveness, employment and gender are not sufficient as these factors are usually not quantified. Quantification is the most relevant criteria for properly prioritising the measures. The implementation risks - and how to mitigate them - are also briefly mentioned in the measure descriptions. The ERP includes 19 measures and largely respects the set page limit. Tables 9-11 in the annex are properly completed. Implementation reports of the 2018-2020 ERP's policy guidance and the structural reform measures (Table 11 in annex) is sufficient but sometimes lacks important details. The score of the reform implementation stage is also sometimes overestimated.

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