Report Number: ICRR0022581

1. Operation Information

Operation ID P171851	**Operation Name** Public Finance and Competitiveness DPO	
Country North Macedonia	**Practice Area (Lead)** Macroeconomics, Trade and Investment	

Non-Programmatic DPF

L/C/TF Number(s) IBRD-90100	**Closing Date (Original)** 31-May-2020	**Total Financing (USD)** 139,019,390.63
Bank Approval Date 19-Sep-2019	**Closing Date (Actual)** 31-May-2020	

	IBRD/IDA (USD)	Co-financing (USD)
Original Commitment	139,250,000.00	0.00
Revised Commitment	139,250,000.00	0.00
Actual	139,019,390.63	0.00

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2. Program Objectives and Pillars/Policy Areas

a. Objectives

According to the Program Document (page 15), the program development objective of the North Macedonia Public Finance and Competitiveness Development Policy Loan (DPO) was "to support reforms to strengthen public finances, improve market competition, and reduce the regulatory burden in North Macedonia."

For purposes of this ICR review, the program objective is parsed into:

Objective 1: To mobilize additional revenues
Objective 2: To make spending programs more efficient and bolster public financial management
Objective 3: To improve market competition and reduce the regulatory burden [on businesses]

b. Pillars/Policy Areas

The Program had three pillars and eight prior actions.

Pillar 1 - Mobilizing Additional Revenues supported enactment of:

- PA1 - Personal Income Tax Law to introduce the progressive income tax rate of 18 percent, remove exemptions on capital income taxation and increase the capital income tax rate to 15 percent, and reduce the allowed tax deductions while increasing the personal tax allowance to protect the low-income households; and,
- PA2 - Law on Excises to introduce excise taxes on coal, gas, and electricity.

Pillar 2 - Making Spending Programs More Efficient and Bolstering Public Financial Management supported enactment of:

- PA3 - Amendments to the Law on Pension and Disability Insurance, the Law on Compulsory Capitally Funded Pension Insurance, and the Law on Compulsory Social Insurance Contributions to introduce the price indexation of benefits, harmonize the accrual rates, and introduce a higher pension contribution rate to improve the fiscal and social sustainability of the multi-pillar pension system;
- PA4 - Law on Social Protection and Amendments to the Law on Child Protection to consolidate social assistance benefits, expand the coverage of the bottom quintile and protect the energy- poor, while maintaining targeting through the introduction of a Guaranteed Minimum Assistance program; and
- PA5 - Law on Reporting and Monitoring the Liabilities to identify and monitor arrears of the general government and launch the quarterly publication of reported arrears from September 2018 onward.

Pillar 3 - Improving Market Competition and Reducing the Regulatory Burden on Businesses supported enactment of:

- PA6 - Energy Law to deregulate electricity generation, open the electricity supply market for all customers, and introduce competitive-based support mechanisms for renewable energy generation;
- PA7 - Public Procurement Law to strengthen transparency and increase private-sector competition in public procurement; and
- PA8 - Inspection Supervision Law to introduce risk-based inspections, a provision for inspectors to issue warnings, and a grace period for businesses to correct first-time infractions.

c. Comments on Program Cost, Financing and Dates

<u>Program Cost and Financing</u>: The DPO was financed by a development policy loan from IBRD with EUR 125 million (US$139.25 million). EUR 125 million (US$139.019 million) was fully disbursed. The difference in the U.S. dollar amounts was due to changes in the EUR/US$ rate between the appraisal and disbursement dates.

Dates: The DPO was approved on September 19, 2019, became effective on October 21, 2019, and closed as scheduled on May 31, 2020.

3. Relevance of Design

a. Relevance of Objectives

Relevance to Country Development Constraints. This DPO aimed to address constraints to economic growth and development arising out of adverse fiscal and public financial management events and private sector development issues that had festered throughout 2009-17 and that tested the government as it prepared to negotiate its accession to the European Union (EU) in 2018-19.

- Fiscal fragility stemmed from: low personal income tax revenues and regressive personal income taxes; low excise tax revenues; unsustainable government spending on pensions; inadequate and poorly targeted social assistance spending; and the accumulation of public sector arrears.
- Private enterprise lacked dynamism, affected by: the poor operational performance of critical service sectors, especially electricity generation and supply; the lack of a competitive process in the procurement by the government of goods and services; and the poor environment to doing business, marked by indiscriminate government inspections of businesses.
- It was an opportune time to undertake economic reforms, as the international political environment had turned favorable to the country: (a) after North Macedonia settled its name dispute with Greece, the EU Council started the screening process for accession negotiations in 2018 (North Macedonia had been an EU candidate country since 2005); (b) the accession negotiations would start in 2019, and as a candidate for EU membership, North Macedonia would need to adhere to a range of EU economic directives; (c) the policy reforms supported by this operation would help North Macedonia align its laws and regulations to these directives – Directive 2014/14, requiring that public contracts for the provision of works, supplies, and services be awarded to the most economically advantageous tender identified on the basis of the best price-quality ratio; Directive 2014/15, introducing new standard forms for publishing public procurement notices by entities in the water, energy, transport and postal sectors to obtain works, supplies, and services; and the Third Package of Energy Market Regulation covering, among others, the introduction of open and fair retail energy markets and the unbundling of energy supply and generation from the operation of transmission networks; and (d) the North Atlantic Treaty Organization had agreed to sign an accession protocol with North Macedonia also in 2019, providing a durable security setting to economic policymaking by the government.

Relevance to Government Priorities. The development objectives of the operation were aligned with the government's medium-term priorities of reinforcing macroeconomic stability, social equity, and competitiveness.

- The *Economic Reform Program 2019-21* aimed to strengthen revenues, improve public financial management, increase market competition, make the environment for doing business more attractive, and strengthen the labor market and social protection.
- The *Government Fiscal Strategy 2019-22* aimed to contain fiscal risks and proposed gradual fiscal consolidation. According to the strategy, public debt would moderate starting in 2021 – the primary deficit would decline to 0.8 percent in 2021, which would lead to a decline in public and publicly-

guaranteed (PPG) debt to 50.8 percent of GDP after its peak in 2020, when highway construction ended. The debt limit would be kept at 60 percent of GDP for PPG debt and a maximum of 13 percent of GDP for guaranteed debt. Revenues would be boosted by: progressive personal income taxation; higher social contributions for pension and health insurance (by 0.4 in percentage points in 2019 and 0.1 percentage points in 2020); stricter control of both wage expenses and employment; reform of social benefits to improve their efficiency; and pension reform, to contain the growth of spending.

Relevance to Bank Group Strategy. The program objectives were consistent with the Bank Group's strategy in North Macedonia.

- The *Country Partnership Strategy for the Former Yugoslav Republic of Macedonia for the Period of FY2015 - FY2018* (CPS) committed Bank Group support for the country's development priorities ("two pillars") – Growth and Competitiveness, and Skills and Inclusion. The first program objective was aligned with the outcome envisioned under the first CPS pillar to have "improved fiscal and public financial management." The second program objective was aligned with two other outcomes under the first CPS pillar to have "more clean energy available" and to attain "better conditions for private investment."
- The *Country Partnership Framework for the Republic of North Macedonia 2019-2023* (CPF) supported the country's development priorities ("three focus areas") – Export-Led Growth (improving the environment for a competitive private sector), Inclusive Growth (expanding skills and opportunities for the most vulnerable), and Sustainable Growth (enhancing sustainability and enhancing resilience to shocks). The first program pillar was consistent with the objective under the third CPF focus area to "strengthen fiscal and public finance management," specifically with the targets to "reduce general government deficit and arrears" and to "reduce the pension deficit." The second program pillar was consistent with the objective under the third CPF focus area to "accelerate the transition to a more sustainable energy mix" and the objective under the first CPF focus area to "improve connectivity and access to markets."

b. Relevance of Prior Actions

Rationale

Pillar 1 - Mobilizing Additional Revenues

- **PA1:** <u>Enactment of the Personal Income Tax Law to introduce a progressive rate of 18 percent, remove the exemption on capital income taxation and increase the rate to 15 percent, and reduce the allowed tax deductions, while increasing the personal tax allowance to protect the low-income households</u>. This prior action aimed to address the low contribution to government revenues of the personal income tax, which was regressive: (a) personal income taxes were only 2.4 percent of GDP, compared to 9 percent of GDP in the EU; (b) the personal income tax was regressive – the tax rate remained as low as 10 percent and deductions and exemptions were allowed for capital, property, and other types of income to the benefit of the rich; and (c) the capital income tax was particularly regressive – capital accounted for more than 30 percent of the income of the rich and only 2.5 percent of the income of the poor, but exemptions rendered the effective tax rate less than 10 percent. This prior action would contribute to the objective to mobilize additional revenues: (a) the new marginal personal income tax rate would rise to 18 percent for labor incomes above Macedonian denar (MKD) 90,000 (US$1,710) a month, equivalent to 26 percent of GDP per capita; (b) a higher personal income tax rate of 15 percent flat would apply to capital income; (c) tax allowances would be cut by at least 30 percent for rental income, capital gains, royalties, and authorship rights; (d) tax exemptions would be eliminated for interest earnings, insurance income, and capital gains from securities; and (e) the tax allowance would rise from MKD 7,500 (US$143) to MKD 8,000 (US$152) per month to protect low-income households. The personal income tax reform measures comprising this prior action would have an estimated fiscal impact of +0.25 percent of GDP, according to the Program Document (page 16). The relevance of PA1 is rated highly satisfactory.

- **PA2:** Enactment of the Law on Excises that introduces excise on coal, gas, and electricity. This prior action aimed to address the low contribution of excise taxes to government revenues: (a) excise taxes were only 3.7 percent of GDP, lower than in peer countries Montenegro (5.3 percent of GDP) and Croatia (4.2 percent of GDP); (b) excise taxes on diesel fuel accounted for a low one-third of total excise taxes; and (c) the excise tax rates were not harmonized with the EU rates. This prior action would contribute to the objective to mobilize additional revenues: (a) the excise tax on diesel fuel would rise by 25 percent or MKD 3.00 (US$0.057) per liter beginning in 2018 – the fiscal impact was estimated at +0.3 percent of GDP; (b) a new excise tax on coal, gas, and electricity would be introduced, taking the share of fossil fuel consumption subject to excise taxation from 58 percent in 2017 to 93 percent by 2019; (c) although the law would retain the current excise tax rate on coke and fuel, it would expand the products subject to excise taxation to include e-cigarettes and heat-not-burn tobacco (tobacco products that produced aerosols containing nicotine and other chemicals). The relevance of PA2 is rated highly satisfactory.

Pillar 2 - Making Spending Programs More Efficient and Bolstering Public Financial Management

- **PA3:** Enactment of the amendments to the Law on Pension and Disability Insurance, the amendments to the Law on Compulsory Capitally Funded Pension Insurance, and the amendments to the Law on Compulsory Social Insurance Contributions to introduce price indexation of benefits, harmonize the accrual rates, and introduce a higher pension contribution rate to improve fiscal and social sustainability of the multi-pillar pension system. This prior action aimed to address the fiscal unsustainability of pension spending: (a) the contribution rate of, and pension revenues from, the three-pillar system (pay-as-you-go [PAYG], fully-funded mandatory individual accounts, and voluntary private-open pension fund) were low; (b) accrual rates were high and disproportionately lower for fully-funded than for PAYG participants; (c) indexation was overly generous; (d) as a result, government budget transfers to the pension system reached almost half of the pension spending (10.6 percent of GDP in 2017), half of which covered the residual PAYG deficit (2.3 percent of GDP). By restoring the fiscal sustainability of the pension system, this prior action would contribute to the objective to bolster public financial management: (a) pension insurance contribution rates would be raised by 0.4 percentage points annually in 2019 and 2020, increasing overall contributions; (b) accrual rates would become more harmonized between participants in the old system, whose accruals would be lowered, and participants in the multi-pillar system, whose accruals would be raised; (c) second-pillar participants born before 1967 would return to the PAYG system, avoiding the risk of pension cuts; (d) contribution arrears would be paid; (e) pensions would be consumer-price-indexed; and (f) in case real GDP grew above 4 percent, pensions would, in supplement, be real GDP wage-indexed. The pension system reform measures comprising this prior action would have an estimated fiscal impact of +0.35 percent of GDP, including +0.15 percent of GDP due to the increase in the pension contribution rate, according to the Program Document (page 16). The relevance of PA3 is rated satisfactory.

- **PA4**: Enactment of the Law on Social Protection and the amendments to the Law on Child Protection to consolidate social assistance benefits, expand the coverage of the bottom quintile and protect the energy poor, while maintaining good targeting accuracy through the introduction of a Guaranteed Minimum Assistance program. This prior action aimed to address low levels of social assistance spending for an economy with a comparatively high level of poverty: (a) social assistance spending was a low 1.2 percent of GDP, compared to average social assistance spending of 2.2 percent of GDP in the Europe and Central Asia region, and covered only one-third of the poorest-quintile in the income distribution, the lowest coverage in the same region; (b) benefits were low; (c) while incentives for work were non-existent – parental allowances dis-incentivized job search, while least-resort benefits were not available in the transition to the labor market; (d) spending was fragmented across various programs, with questionable rates of cost-effectiveness; and (e) new initiatives, notably the Parental Allowance Program, skewed spending to non-means-tested approaches, with the result that while spending amounted to 0.5 percent of GDP, the allowance program benefitted only 23 percent of the poorest quintile. By upgrading the social assistance system and converting all benefits to means testing, this prior action would contribute to the objective to make social spending more efficient and bolster public financial management: (a) a new Guaranteed Minimum Assistance Program would consolidate all existing social assistance benefits, with the level of support set against a threshold of MKD 7,200 (US$136.80) a month, or 28 percent of median income – the new program would benefit 50 percent more households than before; (b) the Child Allowance Program would be redesigned and a new Education Allowance Program would be introduced, with the level of support set against a threshold of MKD 15,000 (US$285) – the new program would provide both primary and secondary education benefits; (c) a new Social Safety for the Elderly Program would replace the Permanent Financial Assistance Program, with the support set at 40 percent of the regular pension – the new program shifts spending on all elderly without pensions to a means-tested social protection program targeting the bottom 40 percent of the population; (d) overall, social assistance coverage of the bottom quintile would rise from 30 percent in 2016 to 50 percent in 2019. The social benefit reform measures comprising this prior action would have an estimated net fiscal impact of +0.15 percent of GDP, according to the Program Document (page 16), broken down into: the means-testing of the parental allowance, +0.23 percent of GDP; the increase in the child allowance, -0.01 percent of GDP, and the guaranteed minimum benefit and pro-poor energy programs, -0.07 percent of GDP. The relevance of PA4 is rated satisfactory.
- **PA5**: Enactment of the Law on Reporting and Monitoring the Liabilities to effectively identify and monitor arrears of the general government and the launch of the quarterly publication of reported arrears from September 2018. This prior action aimed to address systematic deficiencies with public financial management, specifically with financial reporting, that allowed the accumulation of arrears – central and local government arrears topped 3.5 percent of GDP in 2017, notwithstanding previous efforts dating back to 2012 to clear the arrears. By upgrading the financial monitoring and reporting system, this prior action would contribute to the objective to bolster public financial management: (a) all public entities would start reporting their monthly liabilities and arrears, allowing the government to identify and monitor all arrears; and (b) while better reporting alone would not reduce arrears, the new monitoring and reporting system would work in conjunction with other reforms (albeit not included in this operation) – the broadening of the definition of the budget to cover all funding sources under the new Organic Budget Law; the expansion of the Single Treasury Account under a new proposed law; and the planned adoption of a fiscal rule, creation of a fiscal council, and inclusion of fiscal risks in the fiscal strategy under *PFM Reform Program 2018–20*. The relevance of PA5 is rated satisfactory.

Pillar 3 - Improving Market Competition and Reducing the Regulatory Burden on Businesses

- **PA6**: Enactment of the Energy Law to deregulate electricity generation, open the electricity supply market for all customers, and introduce competitive-based support mechanism for renewable energy generation. This prior action aimed to address the heavy regulation, excessive subsidization, and lack of market competition in the electricity generation market: (a) only half the electricity market was liberalized, benefitting mostly large industrial and commercial consumers; (b) small businesses and households were not able to procure electricity from other than the state-owned EVN Macedonia, with the electricity tariffs set by the Energy Regulatory Commission; (c) commercial consumers subsidized households, which paid half the commercial price of MKD 8.63 (US$0.16) per kilowatt-hour; and (d) the market restrictions were contrary to North Macedonia's obligations under the EU Energy Community Treaty, which aimed to open internal electricity and gas markets to competition. By liberalizing the electricity generation and supply market, this prior action would contribute to the objective to improve competition and reduce the regulatory burden: (a) all electricity and gas consumers would be allowed to freely select their suppliers; (b) the sale by EVN Macedonia of electricity to the universal service supplier would be scaled down from 80 percent in 2019 to 30 percent by 2025; and (c) auction-based premiums would be introduced for renewable energy generation using transparent tender procedures to encourage private investment in renewable energy. The relevance of PA6 is rated satisfactory.
- **PA7**: Enactment of the Public Procurement Law to strengthen transparency and increase private-sector competition in public procurement. This prior action aimed to address the lack of competition and transparency in public procurement: (a) public procurement was cornered by few companies offering a single bid for a large number of tenders – some 25 percent of tenders in 2018 had only one bid, according to the U.S. Agency for International Development; and (b) participation in public procurement was costly and burdensome for small companies because procedures were opaque and charges and fees were exorbitant. By reducing the burden on all firms to participate in public procurement and easing restrictions for small firms, this prior action would contribute to the objective to improve competition and reduce the regulatory burden: (a) the principle of “proportionality”, which states that procedures followed for awarding a contract must be proportionate to the value of the contract, would be adopted when setting eligibility criteria for contractors, implying that smaller-value contracts which would be the domain of small firms would require comparatively less stringent qualification hurdles than large-value contracts which would be the domain of large firms; (b) e-auctions would become optional, in particular in contracting for professional services that are awarded principally on the basis of price – bidders misused the system by resorting to price-dumping only to have the contracts subsequently amended to raise contract prices; (c) "quality" would be added to "lowest price" as a criterion for contract awards; and (d) new pro-competitive procedures would be introduced – an e-marketplace and e-catalog for small-value procurement; the annual publication of procurement plans; notification of signed contracts; upgrades to the e-procurement system; creation of an e-appeal system; and an *ex-ante* control role for the Public Procurement Bureau. The relevance of PA7 is rated satisfactory.
- **PA8**: Enactment of the Inspection Supervision Law to introduce risk-based inspections, a provision for inspectors to issue warnings, and a grace period for businesses to correct first-time infractions. This prior action aimed to rectify dysfunctions in the country's system of business inspections: (a) indiscriminate inspection practices discouraged the entry of new firms and the growth of incumbent firms, as evidenced by studies conducted separately on North Macedonia by the U.S. Agency for International Development and the European Commission; (b) inspectors had considerable discretion about which sanctions to impose, with the range of fines for infractions varying widely from EUR 200 to EUR 5,000; (c) non-compliance judgments often resulted in disproportionate fines and charges, with the

law providing little guidance about issuing warnings prior to imposing fines, such that numerous sanctions were levied for minimal infractions; and (d) the Inspection Council had a weak mandate, which precluded intervention in the action of various inspection authorities. By reforming the business inspection system, this prior action would contribute to the objective to improve competition and reduce the regulatory burden: (a) a risk-based business inspection system would be adopted; (b) checklists would be used to ensure predictability, uniformity, and transparency; (c) inspectors would be required to issue warnings, except when infractions were flagrant; (d) grace periods would be allowed for corrective actions; and (e) the Council of Inspection Authorities would have the power to resolve issues with inspectorates under implementing rules that would define the operating procedures for the new risk-based business inspection system. The relevance of PA8 is rated satisfactory.

Rating

Satisfactory

4. Relevance of Results Indicators

Rationale

The program defined eight results indicators.

RI (number and description)	Associated Prior Actions	Baseline / Target	Status
Pillar 1 - Mobilizing Additional Revenues			
RI1. Personal income tax revenues	PA1	Baseline: 2.5 percent of GDP (2017) Target: 2.7 percent of GDP (2019)	2.72 percent of GDP (2019) 2.8 percent of GDP (2020)
RI2. Share of fossil fuel consumption subject to excise taxation increased.	PA2	Baseline: 57.5 percent (2017) Target: above 92.9 percent (2019)	98.3 percent (2019)
Pillar 2 - Making Spending Programs More Efficient and Bolstering Public Financial Management			
RI3. Overall PAYG pension deficit	PA3	Baseline: 4.8 percent of GDP (2017) Target: 4.45 percent of GDP (2019)	4.53 percent of GDP (2019) 4.72 percent of GDP (2020, estimate)
RI4. Social assistance coverage of the bottom quintile, total households and female-led households	PA4	Baseline: 33 percent and 22.6 percent (2016) Target: 50 percent and 40 percent (2019)	58.1 and 61.6 (2019, simulation)
RI5. General government arrears	PA5	Baseline: 3.5 percent of GDP (2017)	2.42 percent of GDP (2019)

		Target: Below 2.7 percent of GDP (2019)	2.65 percent of GDP (2020, estimate)
Pillar 3 - Improving Market Competition and Reducing the Regulatory Burden on Businesses			
RI6. Percentage of electricity consumers able to choose an electricity supplier on the open market	PA6	Baseline: 50 percent (2017) Target: 100 percent (2019)	100 percent (2019) 100 percent (2020)
RI7. Average number of bidders per competitive procurement procedure	PA7	Baseline: 3.41 (2017) Target: Above 3.41 (2019)	3.34 (2019) 3.63 (2020)
RI8. Risk-based inspection introduced in inspectorates relevant for businesses.	PA8	Baseline: 0 inspectorates Target: 3 inspectorates (June 2020)	0 (2020) 4 (January 2021)

Pillar 1 - Mobilizing Additional Revenues

- **RI1:** Personal income tax revenues, in percent of GDP only partly measured the result of the enactment of the Personal Income Tax Law, which aimed to increase direct tax revenues. While this indicator would measure progress toward revenue mobilization, it could not measure progress toward progressivity, which was a key part of reforms to the personal income tax system – introduction of a progressive rate of 18 percent, removal of the exemption on capital income taxation and increase in the rate to 15 percent, reduction by at least 30 percent in the allowed tax deductions for rental income and capital gains, elimination of tax exemptions for interest earnings, insurance income, and capital gains from securities, increase in the tax allowance for low-income households. A separate indicator should have been introduced to measure progressivity, considering that the regressiveness of the personal income tax system was thoroughly emphasized at appraisal and closing – "the PIT was not progressive", "deductions and exemptions that could be applied to capital, property, and other specific types of income made the system even regressive", "because of the exemptions, the effective tax rate on capital income was actually less than 10 percent", and "this contributed to rising income inequality, which is among the highest in the region." Because of the omission, this results indicator is rated moderately unsatisfactory.
- **RI2:** The share of fossil fuel consumption subject to excise taxation was fully adequate to capture the result of the enactment of the Law on Excises, which aimed to increase indirect tax revenues, and to measure progress toward the objective of mobilizing additional tax revenues. An increase in the share of fossil fuel consumption that was subject to excise taxation would reflect the introduction of excise taxes on coal, gas, and electricity. This results indicator is rated satisfactory.

Based on the foregoing results, the relevance of the results indicators for Pillar 1 is rated as moderately satisfactory.

Pillar 2 - Making Spending Programs More Efficient and Bolstering Public Financial Management

- **RI3:** Overall PAYG pension deficit, in percent of GDP was mostly adequate to capture the result of amendments to the Law on Pension and Disability Insurance, the Law on Compulsory Capitally Funded Pension Insurance, and the Law on Compulsory Social Insurance Contributions (PA1) and to measure progress toward the objective of bolstering public financial management by improving the fiscal sustainability of the multi-pillar pension system and hence reducing budgetary financing of the PAYG pension deficit. This indicator would reflect the result of increasing contribution rates, harmonizing accrual rates, eliminating overly-generous benefit indexation rules, and reducing pension contribution arrears. However, a separate indicator assessing pension adequacy would be needed to reflect the result of indexing pension benefits to inflation. This results indicator is rated moderately satisfactory.
- **RI4:** Social assistance coverage of the bottom quintile, all households and female-led households, in percentage was mostly adequate to measure the impact of the enactment of the Law on Social Protection and amendments to the Law on Child Protection. An increase in the coverage of the bottom quintile of all households would reflect the results of efforts to consolidate social benefits programs, to resort to means-testing, and to emphasize the poor. The focus on the lowest quintile was well aligned to better target the poor. Moreover, the inclusion of female-led households as a results indicator was consistent with gender objectives in Bank operations. This results indicator is rated moderately satisfactory.
- **RI5:** General government arrears, in percent of GDP only partly measured the result of the enactment of the Law on Reporting and Monitoring Liabilities, which aimed to improve fiscal transparency and accountability and control the accumulation of arrears, and progress toward the objective of bolstering public financial management. The underlying argument was that better monitoring, reporting, and measurement of government arrears would lead to better control of government arrears. However, because there are many drivers of the volume of arrears, attributing a reduction in arrears to better monitoring and reporting alone raises results attribution issues. This results indicator is rated moderately unsatisfactory.

Based on the foregoing results, the relevance of the results indicators for Pillar 2 is rated as moderately satisfactory.

Pillar 3 - Improving Market Competition and Reducing the Regulatory Burden on Businesses

- **RI6:** The percentage of electricity consumers able to choose an electricity supplier in the open market was fully adequate to measure the result of the enactment of the Energy Law, which aimed to deregulate the generation and supply of electricity, and progress toward the objective of improving market competition. Retail consumers did not have a choice of an electricity supplier prior to the liberalization measure (PA6) and were wedded to the incumbent national or universal supplier. The results indicator would reflect the extent to which the Energy Law enabled customers to switch from the universal to other suppliers, including new entrants, in the open market. While customer choice does not fully capture the degree to which market competition has been achieved, it suffices to measure the result of the first step of a long market liberalization process, the end-stage of which could later be evidenced by market concentration measures like the Herfindahl-Hirschman Index, which quantifies the market shares of firms competing in a market and provides a measure of the degree of market concentration and competition. This results indicator is rated satisfactory.

- **RI7:** The average number of bidders per competitive procurement procedure only partly measured the result of the enactment of the Public Procurement Law, and progress toward the objective of improving market competition. While this indicator is considered one of several credible indicators of competition in procurement (the others include the proportion of open tenders, proportion of single tenders, proportion of value awarded in single-bid contracts, number of unique suppliers by item, and number of unique suppliers by entity), the use of an average number fails to convey information whether greater competition was achieved for large-value government contracts, which are the subject of complaints and controversy. This results indicator is rated moderately unsatisfactory.
- **RI8:** The number of risk-based inspections introduced in inspectorates relevant for businesses was fully adequate to capture the result of the enactment of the Inspection Supervision Law, which aimed to reduce the costs of business inspections to firms by introducing a risk-based inspection system, and to measure progress toward the objective of reducing the regulatory burden on businesses. . An increase in the number of risk-based inspections in the inspectorates that were relevant to businesses would reflect progress made with risk-based inspections. This results indicator is rated satisfactory.

Based on the foregoing results, the relevance of the results indicators for Pillar 3 is rated as moderately satisfactory.

Rating

Moderately Satisfactory

5. Achievement of Objectives (Efficacy)

OBJECTIVE 1

Objective

To mobilize additional revenues.

Rationale

- Personal income tax revenues increased from 2.5 percent of GDP in 2017 to 2.72 percent of GDP in 2019, exceeding the target of 2.7 percent of GDP. More recent data from the government indicate that personal income tax revenues rose further to 2.8 percent of GDP in 2020. However, vital parts of the fiscal reform supported by this operation, including the introduction of a progressive tax rate and removal of exemptions on capital income taxation, have been postponed to 2023, three years after the closing of this operation. Meanwhile, the government recently disclosed that it was working with the International Monetary Fund and the EU on an "optimal direct taxation model" that could be discussed with the public by mid-2022. But, because of the reversal of key parts of the personal income tax reform (postponement beyond the closing date) and because of the absence of an indicator to capture the objective of progressivity, efficacy is rated modest despite exceeding the target.
- The share of fossil fuel consumption subject to excise taxation increased from 57.5 percent to 98.3 percent, exceeding the target of 92.9 percent. The government issued Decree-Law on the Application of the Law on Excises During the State of Emergency in April 2021 to ensure the continued application of the new method to calculate excise duties on fuels during the COVID-19

pandemic. Progress was also made with the excise tax on tobacco, albeit not part of this program, by broadening the tax base for tobacco taxation.

With the achievement of the first of the RI targets rated modest, and the second, high, the efficacy of this pillar is rated moderately satisfactory. A higher rating would have required a maintenance of the income tax reform schedule and evidence of a reduction in the regressiveness of revenue collection.

Rating

Moderately Satisfactory

OBJECTIVE 2

Objective

To make spending programs more efficient and bolster public financial management.

Rationale

- The overall PAYG pension deficit was reduced from 4.8 percent of GDP in 2017 to 4.53 percent of GDP in 2019, meeting about three-quarters of the target reduction to 4.45 percent of GDP in 2019. However, a return to *ad hoc* indexation (based on the growth of minimum and average wages) partially reversed the reform at the end of 2019 and most of the gains were wiped out when the PAYG pension deficit widened to 4.72 percent of GDP in 2020.
- Social assistance coverage of the bottom quintile of all households rose from 33 percent in 2016 to 58.1 percent in 2019, exceeding the target of 50 percent. Social assistance coverage of the bottom quintile, female-led households, rose from 22.6 percent in 2016 to 61.6 percent in 2019, exceeding the target of 40 percent. The reform proved particularly timely as the country faced the COVID-19 crisis. Additional progress was made with the reform of the social service system with more cases placed under case management.
- General government arrears were reduced from 3.5 percent of GDP in 2017 to 2.42 percent in 2019, exceeding the targeted reduction to 2.7 percent of GDP. However, largely due to the impact of the COVID-19 crisis, general government arrears rose somewhat to 2.65 percent of GDP in 2020 preserving only part of the progress achieved. Additional actions have been initiated since as part of the broader PFM reform strategy, but the enactment of the new organic budget law and the introduction of the integrated financial management information system have been postponed to 2021 because of the economic downturn in 2020.

With the achievement of two of the three RI targets rated modest or higher, and the third, lower at negligible, the efficacy of this pillar is rated moderately satisfactory.

Rating

Moderately Satisfactory

OBJECTIVE 3

Objective
To improve market competition and reduce the regulatory burden on businesses.

Rationale
- The percentage of electricity consumers able to choose an electricity supplier on the open market rose from 50 percent in 2017 to 100 percent in 2019, meeting the target of 100 percent. All customers are also able to mutually arrange the terms and prices of their electricity purchases. Since the deregulation of the electricity sector, over 90 percent of industrial and commercial consumers have switched electricity providers and decreased their electricity costs by a reported 30 percent. Recent date supplied by the government indicate that the percentage of electricity consumed in the open market, which stood at 47.5 percent in 2018, increased to 49.1 percent in 2019 and 52.2 percent in 2020. The Energy and Water Services Regulatory Commission has also started to calculate and publish in its annual report the Herfindahl-Hirschman Index for various sectors of the energy market, although the 2020 data still indicate a highly concentrated retail electricity market and a moderately concentrated wholesale market. Meanwhile, the new auction-based premiums for generating renewable energy have attracted new investment from the private sector, and tenders have resulted in agreements with 32 investors for 56 megawatts of installed electricity capacity from renewables. The *Annual Implementation Report (November 2021)* of the Energy Community, the international organization established by the EU and its neighbors in 2005 to create an integrated pan-European energy market, declared that "Implementation in the electricity sector of North Macedonia is almost completed" and that "The retail market is open for competition. Small customers and households are entitled to universal service at regulated prices."
- The average number of bidders per competitive procurement procedure increased from 3.43 in 2017 to 3.63 in 2020, exceeding the target of 3.41, albeit with a one-year delay. However, there was no indication if the increase in the number of bidders was prominent for large value government contracts. Improved transparency, fairer competition principles, and lower costs may have increased the number of appeals by participant firms, but a least-cost selection method still dominates the award of public contracts, and the pace of reforms is slowed by weak capacity among the contracting authorities. The European Commission's *North Macedonia 2021 Report* observed that although the legal framework on public procurement was now "largely harmonized with the EU acquis", there was still "limited progress" made with the "implementation of the bylaws to the Law on Public Procurement" and that the "authorities should implement more effective anti-corruption measures into the procurement cycle." On large value contracts, the Center for Civil Communication's *Shadow Report on Public Procurements in North Macedonia* noted that of 80 large-scale tenders for which the Public Procurement Bureau conducted "administrative control" in 2019, 28 (35 percent) were issued either instructions for tender annulment or recommendations to repeat the bid-evaluation process. The results remained similar in 2020, when irregularities were found in a third of 128 procurement procedures for which the Bureau conducted "administrative control." Because of the one-year delay in meeting the target, the weakness of the indicator to measure progress with large-value contracts, and the foregoing findings, efficacy is rated modest.
- The number of risk-based inspections introduced in inspectorates relevant for businesses rose from zero in 2017 to four in 2021, exceeding the target of three, albeit after a one-year delay. Additional progress included: the finalization of plans for 14 inspectorates; the launch of risk-based inspections in four inspectorates; the creation of a complex set of bylaws, checklists, and methodologies for risk-based inspection; the training of 900 inspectors; and the decrease in the number of fines from 950 to

151. Nonetheless, because of the one-year delay in meeting the target, efficacy is rated substantial despite exceeding the target.

With the achievement of two of the three RI targets rated substantial or better, the efficacy of this pillar is rated satisfactory.

Rating

Satisfactory

Overall Achievement of Objectives (Efficacy)

Rationale

With the achievement of at least half the RI targets rated modest or better, the overall efficacy is rated moderately satisfactory.

<table>
<tr><th colspan="5">Relevance Ratings for RIs, and Efficacy Ratings</th></tr>
<tr><th>Results Indicator</th><th>Relevance Rating</th><th>Achievement Rating</th><th>Pillar Efficacy Rating</th><th>Overall Efficacy Rating</th></tr>
<tr><th colspan="4">Pillar 1 - Mobilizing Additional Revenues</th><td rowspan="13">Moderately Satisfactory</td></tr>
<tr><td>RI1</td><td>Moderately Unsatisfactory</td><td>Modest</td><td rowspan="2">Moderately Satisfactory</td></tr>
<tr><td>RI2</td><td>Satisfactory</td><td>High</td></tr>
<tr><th colspan="4">Pillar 2 - Making Spending Programs More Efficient and Bolstering Public Financial Management</th></tr>
<tr><td>RI3</td><td>Moderately Satisfactory</td><td>Negligible</td><td rowspan="3">Moderately Satisfactory</td></tr>
<tr><td>RI4</td><td>Moderately Satisfactory</td><td>High</td></tr>
<tr><td>RI5</td><td>Moderately Unsatisfactory</td><td>Modest</td></tr>
<tr><th colspan="4">Pillar 3 - Improving Market Competition and Reducing the Regulatory Burden</th></tr>
<tr><td>RI6</td><td>Satisfactory</td><td>High</td><td rowspan="3">Satisfactory</td></tr>
<tr><td>RI7</td><td>Moderately Unsatisfactory</td><td>Modest</td></tr>
<tr><td>RI8</td><td>Satisfactory</td><td>Substantial</td></tr>
</table>

Overall Efficacy Rating

Moderately Satisfactory

6. Outcome

Rationale

The relevance of prior actions is rated satisfactory. The overall efficacy is rated moderately satisfactory. The outcome is rated moderately satisfactory.

a. Rating

Moderately Satisfactory

7. Risk to Development Outcome

Political Risk. According to the ICR, the political context in which the current coalition government operates remains difficult, which could affect the sustainability of the reforms supported by the DPO. Although it enacted the Personal Income Tax Law in 2018 (shifting to a progressive personal income tax rate) and exceeded the target for an increase in personal income tax revenue (of 2.7 percent of GDP), North Macedonia soon rolled back the personal income tax reforms in 2019 and deferred their implementation to 2023: all personal income would be taxed again at the flat rate of 10 percent beginning in January 2020; capital gains and interest on savings would once again be tax-exempt; and tax allowances would not be reversed. The government offered various reasons for the reversal, including that fiscal gains in the first semester of 2019 were lower than expected and that inequality narrowed only slightly.

The ad-hoc indexation to pensions could provide grounds for similar actions going forward. In addition, the Parliament is considering new provisions for early retirement. These measures could put at risk the fiscal and social sustainability of the pension system, and illustrate the high political risk to the sustainability of certain program outcomes.

Institutional Capacity Risk. Institutional capacity risk is substantial concerning the procurement reforms, according to the ICR. In particular, there are serious concerns about the ability of contracting authorities to carry out the new tender procedures, considering limitations both with staffing and with staff skills.

Macroeconomic Risk. Macroeconomic risks appear to be coming down. After an economic downturn of -4.5 percent in 2020, a rebound is underway with GDP growth projected at 4.6 percent in 2021. As the recovery takes hold, carefully balancing the withdrawal of fiscal support – which was boosted in 2020 to aid households and firms but which raised public debt to more than 62 percent of GDP – with structural and institutional reforms would be key to restoring public finance sustainability. The central bank would also need to find the right balance between supporting domestic demand and responding to rising inflationary pressures.

COVID-19 Risk. The COVID-19 pandemic inflicted significant human and economic costs on North Macedonia, and any escalation of the health crisis could pose risks to the sustainability of the fiscal and business reforms achieved under this operation. The public health response and supportive macroeconomic and financial policies have so far helped mitigate the impact of the pandemic on health outcomes and on the economy. Resolving the health crisis through an effective vaccination program would remain the priority.

8. Assessment of Bank Performance

a. Bank Performance – Design

Rationale

The performance of the Bank with design was moderately satisfactory. The three policy reform areas – tax revenue mobilization (personal income taxes, excise taxes), public financial management (pension spending, social assistance spending, and arrears reduction) and market competition (in electricity services, government procurement, and business inspections) were strategic choices arising from long-running constraints to development and were also opportune areas to help advance North Macedonia's accession to the EU. The eight prior actions – eleven pieces of key legislation – were well conceived and relevant to achieving the program objective to support reforms to strengthen public finances, improve market competition, and reduce the regulatory burden. However, some of the results indicators were weak choices to measure the degree of achievement of the program objectives. For this reason, the Bank's performance with design is rated moderately satisfactory despite the strength of the Bank's work on the analytical foundations, linkage with other operations, stakeholder consultation, and donor coordination as detailed below.

Analytical Foundations. The preparation of this operation was informed by analytic and technical assistance work by the Bank. The *Former Yugoslav Republic of Macedonia Systematic Country Diagnostic* (2018) analyzed challenges in the energy sector, competition in public procurement, and barriers to doing business. The *North Macedonia Public Finance Review* (2018) analyzed the sustainability of the pension system, the equity and effectiveness of social assistance, aspects of public financial management, and the progressivity of the personal income tax and tax exemptions. The *Technical Assistance on Pension System Reform* (2018) elaborated on the implementation aspects of pension reform. The *Technical Assistance on Social Assistance* (2018) helped with the design of reform measures related to social assistance. The *Technical Assistance on Public Procurement* (2012-14) explored e-procurement modalities.

Linkage with Other Bank Operations. This program was built on the Bank's long engagement in North Macedonia. Previous operations introduced fiscal, public financial management, and private sector development reform measures that progressively led to the reform program supported by this operation. The *FYR Macedonia Policy Based Guarantee* (P125837) aimed to strengthen public finances, improve the resilience of the financial sector, and promote the sustainability of social safety nets. The *FYR Macedonia Public Expenditure Policy Based Guarantee* (P133791) aimed to improve the efficiency of public expenditures and public financial management, strengthen pension and health systems, and improve social inclusion and the targeting of social assistance. The *First and Second Programmatic Competitiveness Development Policy Loan* (P126038 and P130847) aimed to strengthen competitiveness. The Bank took into account lessons learned from these operations in the following manner: (a) the personal income tax reform and the excise tax reform considered the likely impact of tax changes on poor households; (b) pension reform was matched by social protection measures, both following the *Project Performance Assessment Report for the FYR Macedonia Policy Based Guarantee* (2016) which found that the policy based guarantee (PBG) operation has not addressed policy issues related to public financial management comprehensively; and (c) this operation was renegotiated as a loan rather than a PBG.

Stakeholder Consultation. The Program Document indicated that consultations with stakeholders were conducted using the framework set by the *Rules of Procedure of the Government of the Republic of North Macedonia* for public consultations on all new laws. Arrangements included: the use of the website ENER to disclose draft laws for consultation; the preparation of regulatory impact assessments (RIA) of all laws proposed to be enacted by Parliament; the issuance of a minimum 15-day notice for consultations; and the engagement of all stakeholders in the RIA process. According to the ICR, laws supported by this program went through this consultation process. However, in the case of the personal income tax reforms, the consultation period was too short (two months) to have solidified stakeholder support for the reform measures.

Donor Coordination. The Bank collaborated closely with other development partners in the design, as well as implementation, of this program. The principal partners included the International Monetary Fund (on fiscal reforms), the EU (on governance reforms), the European Commission (on public procurement reforms), the United States Agency for International Development (on doing business reforms), the European Bank for Reconstruction and Development, United Nations International Children's Emergency Fund, and the Energy Community Secretariat, based in Vienna (on energy reforms).

Rating

Moderately Satisfactory

b. Bank Performance – Implementation

Rationale

Monitoring. According to the ICR, the Bank closely monitored the implementation of the reforms supported by this operation. The Bank prepared monitoring notes for the Government - the notes were used by the government in its public communications program. The Bank also engaged directly with stakeholders to discuss the reforms during program implementation, including with representatives of the private sector, members of civil society, and with officers of the development partners that participated in the design of the various reform programs. The Bank also maintained its policy discussions with the government.

Adaptation. After the Bank disbursed the loan proceeds in October 2019, the government reversed two reform measures that had been advanced with the legal and regulatory measures supported by this program as prior actions. The government suspended the implementation of the progressive personal income tax rate of 18 percent and the new tax on capital income of 15 percent for three years; both had been parts of the Personal Income Tax Law passed in 2018 as PA4. The government introduced the wage indexation of pensions, in addition to the price indexation of pensions; the latter had been part of the Law on Pension and Disability Insurance which was passed in 2018 as PA3. According to the ICR, the Bank continued to engage the government in policy dialogue despite the policy reversals. In particular, the Bank: (a) developed a micro-simulation tool to evaluate the potential impact of the personal income tax reform package, using the 2019 data on tax returns and the 2019 Survey of Income and Living Conditions; (b) also simulated the effects of the pension benefits indexation reform package, compared to the status quo; and (c) discussed these analyses at length with the government. The dialogue has resulted in the commitment by the government to the principles of "fairness in taxation" as pronounced in the new *Tax System Reform Strategy 2021-2025*. Specifically, the government announced that: (a) it will lift its suspension of the reforms passed in the Personal Income Tax Law by 2023, following the evaluation of the partial reform results, the comparison of pre-2019, 2019, and 2021 personal income tax results, and consultations with all involved stakeholders; and (b) it has rejected measures earlier announced that would reverse pension reform, including early retirement, service period buyout, and introduction of the full wage indexation of benefits, following the Bank's policy dialogue with the Ministry of Labor and Social Assistance.

Rating

Moderately Satisfactory

c. Overall Bank Performance

Rationale

Bank performance in design is rated moderately satisfactory. Bank performance in implementation is rated moderately satisfactory. Overall Bank performance is rated moderately satisfactory.

Overall Bank Performance Rating

Moderately Satisfactory

9. Other Impacts

a. Social and Poverty

According to the ICR, several reform measures had positive social and poverty impacts.

- The excise tax reform protected energy-poor consumers.
- The pension reform protected the elderly.
- The social assistance reform targeted the poor more accurately.

b. Environmental

According to the ICR, several reform measures had positive environmental impacts.

- The Law on Excises, enacted in 2018 as PA2, would discourage demand for coal and gas as the prices of these fossil fuels rose with the new excise taxes.

- The Law on Social Protection, enacted in 2018 as PA4, provided social benefits to poor households vulnerable to weather disasters and other climate change risks.
- The Energy Law, enacted in 2018 as PA6, brought climate change co-benefits through new competitive schemes for renewable energy investments. The law, which harmonized the country's energy legislation with the Energy Community's Third Energy Package, promoted direct financing of energy-efficiency upgrades in homes. Focusing on renewables and energy efficiency helped reduce greenhouse gas emissions.
- The Public Procurement Law, enacted in 2016 as PA7, required that environmental and climate change impacts be disclosed as part of the technical specifications of public contracts for works and services.

c. Gender

The reforms expanded social benefit coverage to the bottom quintile of female-headed households, and are expected to have a gradual, future impact on female employment (ICR, p. 26).

d. Other

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10. Quality of ICR

Rationale

The ICR provides an informative context for this project across a broad range of fiscal and public financial management problems and private sector development issues faced by North Macedonia as it started negotiations for accession to the EU.

The assessment of the efficacy of the project was candid. While the program fulfilled all the prior actions and achieved practically all the outcome targets, the policy reversals by the government of key elements of pension reform and personal income tax reform put at serious risk the sustainability of the country's medium-term fiscal reform program.

The lessons are well-founded and potentially valuable to future operations that are complex and politically sensitive.

a. Rating

Substantial

11. Ratings

Ratings	ICR	IEG	Reason for Disagreement/Comments
Outcome	Moderately Satisfactory	Moderately Satisfactory	
Bank Performance	Moderately Satisfactory	Moderately Satisfactory	
Relevance of Results Indicators	---	Moderately Satisfactory	
Quality of ICR	---	Substantial	

12. Lessons

Two lessons are drawn from the ICR (pages 30-31), with some adaptation.

A programmatic series of DPOs may be a better instrument when reforms are complex, require intensive implementation efforts, and are politically sensitive. In this stand-alone operation, the Bank anticipated the risk of policy reversals in a politically volatile setting where pressure from interest groups was pronounced, stating in the Program Document (page 29) that "Public discontent against reforms might reduce public support for the government's agenda, which would reduce the government's ability to launch and sustain the needed fiscal and structural reforms. This could also lead to calls for snap elections." A programmatic approach would have better sustained the outcomes of this medium-term reform program over the political cycle.

Alignment of reforms in EU candidate countries with the EU accession process helps to fortify a candidate government's commitment to the reform program. In this operation, the Bank closely aligned the reform measures on excise taxation, public procurement, energy, and market competition with the requirements of North Macedonia's accession process with the EU. The approach served to secure greater political commitment to the reform measures in these policy areas since their implementation also served the purpose of the country's accession to the EU. In policy areas where there was no link to the accession process – the are no EU-wide rules on income taxation other than that a country's tax residents and nationals be treated equally – there was less discipline with the reform plan.

13. Project Performance Assessment Report (PPAR) Recommended?

No