PROJECT PERFORMANCE ASSESSMENT REPORT

FORMER YUGOSLAV REPUBLIC OF MACEDONIA
Public Expenditure Policy-Based Guarantee

Report No. 106281
JUNE 28, 2016
PROJECT PERFORMANCE ASSESSMENT REPORT

THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

PUBLIC EXPENDITURE POLICY-BASED GUARANTEE
(P133791, G-2170-MK)

June 28, 2016

IEG Human Development and Economic Management Department
Independent Evaluation Group
Currency Equivalents (annual averages)

*Currency Unit = FYR Macedonian Denar (MDen)*

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**Abbreviations and Acronyms**

- CBMIS: Cash Benefits Management Information System
- DPO: development policy operation
- FDI: foreign direct investment
- GDP: gross domestic product
- IBRD: International Bank for Reconstruction and Development
- ICR: Implementation Completion and Results Report
- IEG: Independent Evaluation Group
- ILO: International Labour Organization
- IMF: International Monetary Fund
- IT: information technology
- OPCS: Operations Policy and Country Services
- PEPEG: public expenditure policy-based guarantee
- PFM: public financial management
- PPAR: Project Performance Assessment Report
- VAT: value added tax

**Fiscal Year**

Government: January 1 – December 31
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This report was prepared by Aghassi Mkrtchyan, who assessed the project in October 2015. The report was peer reviewed by Shahrokh Fardoust and panel reviewed by Chad Leechor. Yezena Yimer provided administrative support.
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Principal Ratings

THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA, LOAN:
(P133791, G-2170-MK)

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* The Implementation Completion and Results Report (ICR) is a self-evaluation by the responsible World Bank department. The ICR Review is an intermediate IEG product that seeks to independently verify the findings of the ICR.

Key Staff Responsible

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<th>Division Chief/ Sector Director</th>
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<td>Appraisal</td>
<td>Evgenij Najdov</td>
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IEG Mission: Improving World Bank Group development results through excellence in evaluation.

About this Report

The Independent Evaluation Group (IEG) assesses the programs and activities of the World Bank for two purposes: first, to ensure the integrity of the Bank’s self-evaluation process and to verify that the Bank’s work is producing the expected results, and second, to help develop improved directions, policies, and procedures through the dissemination of lessons drawn from experience. As part of this work, IEG annually assesses 20-25 percent of the Bank’s lending operations through fieldwork. In selecting operations for assessment, preference is given to those that are innovative, large, or complex; those that are relevant to upcoming studies or country evaluations; those for which Executive Directors or Bank management have requested assessments; and those that are likely to generate important lessons.

To prepare a Project Performance Assessment Report (PPAR), IEG staff examines project files and other documents, visit the borrowing country to discuss the operation with the government, and other in-country stakeholders, and interview Bank staff and other donor agency staff both at headquarters and in local offices as appropriate.

Each PPAR is subject to internal IEG peer review, Panel review, and management approval. Once cleared internally, the PPAR is commented on by the responsible Bank department. The PPAR is also sent to the borrower for review. IEG incorporates both Bank and borrower comments as appropriate, and the borrowers’ comments are attached to the document that is sent to the Bank’s Board of Executive Directors. After an assessment report has been sent to the Board, it is disclosed to the public.

About the IEG Rating System for Public Sector Evaluations

IEG’s use of multiple evaluation methods offers both rigor and a necessary level of flexibility to adapt to lending instrument, project design, or sectoral approach. IEG evaluators all apply the same basic method to arrive at their project ratings. Following is the definition and rating scale used for each evaluation criterion (additional information is available on the IEG website: http://worldbank.org/ieg).

**Outcome**: The extent to which the operation’s major relevant objectives were achieved, or are expected to be achieved, efficiently. The rating has three dimensions: relevance, efficacy, and efficiency. **Relevance** includes relevance of objectives and relevance of design. Relevance of objectives is the extent to which the project’s objectives are consistent with the country’s current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in Poverty Reduction Strategy Papers, Country Assistance Strategies, Sector Strategy Papers, and Operational Policies). Relevance of design is the extent to which the project’s design is consistent with the stated objectives. **Efficacy** is the extent to which the project’s objectives were achieved, or are expected to be achieved, taking into account their relative importance. **Efficiency** is the extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and benefits at least cost compared to alternatives. The efficiency dimension generally is not applied to adjustment operations. **Possible ratings for Outcome**: Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

**Risk to Development Outcome**: The risk, at the time of evaluation, that development outcomes (or expected outcomes) will not be maintained (or realized). **Possible ratings for Risk to Development Outcome**: High, Significant, Moderate, Negligible to Low, Not Evaluable.

**Bank Performance**: The extent to which services provided by the Bank ensured quality at entry of the operation and supported effective implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of supported activities after loan/credit closing, toward the achievement of development outcomes. The rating has two dimensions: quality at entry and quality of supervision. **Possible ratings for Bank Performance**: Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

**Borrower Performance**: The extent to which the borrower (including the government and implementing agency or agencies) ensured quality of preparation and implementation, and complied with covenants and agreements, toward the achievement of development outcomes. The rating has two dimensions: government performance and implementing agency(ies) performance. **Possible ratings for Borrower Performance**: Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.
Preface

This is the Project Performance Assessment Report (PPAR) on the Former Yugoslav Republic (FYR) of Macedonia Public Expenditures Policy-Based Guarantee implemented in 2012–2013. The Independent Evaluation Group (IEG) prepared the report. It is based on interviews, documents, and data collected in the course of a visit to FYR Macedonia in October 2015, during which government officials, external development partners, business groups, academics, nongovernmental organizations, civil society groups, and other stakeholders were consulted. The evaluation also draws on in-depth interviews with World Bank and International Monetary Fund staff, including current and former members of the FYR Macedonia country teams in Washington, D.C., and Skopje; and on published and internal documents from the two institutions. The cooperation and assistance of all stakeholders and government officials are gratefully acknowledged, as is the support of the World Bank office in Skopje.

Following standard IEG procedures, a copy of the draft PPAR was sent to the relevant government officials and agencies for their review and feedback, and comments received from the Government of the Former Yugoslav Republic of Macedonia have been included in Appendix D.
Summary

This Project Performance Assessment Report (PPAR) evaluates the public expenditure policy-based guarantee (PEPEG) provided to the Former Yugoslav Republic (FYR) of Macedonia in the amount of €155 million implemented in 2012–2013. The PEPEG supported a commercial loan in the amount of €250 million. This was the country’s second policy-based guarantee (PBG) in the aftermath of the global crisis. The objective of this PPAR is two-fold. First, it assesses various dimensions of performance based on both Independent Evaluation Group (IEG) and Operations Policy and Country Services (OPCS) Vice Presidency guidelines. It also builds on evidence emanating from the assessment of FYR Macedonia’s first PBG and draws broader lessons on the use of this instrument in the World Bank.

The PEPEG had three specific objectives:

(i) improving the efficiency of public expenditures by strengthening public financial management practices;
(ii) improving the efficiency of service provision in the health sector; and
(iii) Strengthening social protection and inclusion.

These objectives were substantially relevant to World Bank and government strategies and to country conditions at both the entry and the closing of this operation. The program design, however, has shortcomings, and its relevance is rated modest. In spite of the relevance and institutional depth of most of prior actions, the design suffered from a lack of operational focus on the program’s macroeconomic and fiscal risks as well as a relatively narrow scope of the public financial management (PFM) reform agenda at a time of heightened risks.

The achievement of these multiple objectives was mixed. Efficacy of the first objective—improving the efficiency of public expenditures by strengthening public financial management practices—is rated modest. The program helped to achieve clearance of the arrears identified in the program and introduce changes in treasury practices to prevent accumulation of future arrears. However, because of remaining gaps the information about arrears at the level of central government is not fully reliable, while arrears at the municipality level and in the health sector remain quite large. Additionally, the efficiency of capital expenditures has deteriorated and has become an area of concern. The replacement of the indexation mechanism for pensions by ad-hoc increases has reduced the predictability of PFM.

There was substantial achievement of the second objective—improving the efficiency of service provision in the health sector. The program helped reduce the unit price of pharmaceutical and some medical equipment to a considerable extent. The implication of these changes for budgetary savings in 2013–2015, however, was less evident as an increase in the number and cost of prescriptions offset the positive impact of unit price reduction. An improvement in service provision to underserved areas came through the introduction of a new framework that helped to direct more resources to those areas.

Achievement of the third objective—strengthening social protection and inclusion—was also substantial. The government’s active labor market programs were strengthened by improving
the access of vulnerable groups to social services and generating fiscal savings. In the area of social protection, the program helped improve targeting to a considerable extent. Fiscal resources freed up because of improved targeting enhanced the levels of financial assistance to beneficiaries.

The overall outcome is rated moderately satisfactory. The objectives were substantially relevant, but the design was only modestly so. The risk to development outcomes is rated significant mainly due to the overall macroeconomic risks arising from pro-cyclical fiscal policy and weaknesses in the public financial management. Bank performance is rated moderately satisfactory that reflects strengths such as prioritization of clearance of arrears and Treasury reforms to alleviate a key constraint affecting the quality of PFM, and shortcomings in addressing macro and fiscal risks. Borrower performance is rated moderately satisfactory reflecting strengths such as clearance of arrears ahead of the schedule and important reforms to improve health and social expenditures, and weaknesses in transparency and predictability of PFM and the overall use of public resources including ad-hoc pension increases, large capital investments in non-productive areas, and large off-budget infrastructure investments.

Among the key lessons are:

- PBGs can potentially be a useful instrument for supporting countries facing large external financing needs.
- PBGs implemented in a context of challenging macro-fiscal situation and large financing needs need to incorporate a consistent macro-economic framework with necessary macro and fiscal actions for risk mitigation.
- Positive impact of important public expenditure measures (wage control, reforms in health procurement, and better targeting of social protection) can be eroded if the program lacks an overarching fiscal and debt framework. As FYR Macedonia’s case illustrates, fiscal savings achieved through these important measures can be dissipated by introducing non-priority spending such as ad-hoc pension increases or controversial capital expenditures.
- Comparing the aggregate interest rate of PBG-supported debt instruments with counterfactual market rates may not be enough for assessing the extent of reduction in the borrowing costs associated with the transaction. Estimating the change in sovereign risk perceptions, although a challenging task, may give more accurate assessment of the impact of the program.

Nick York
Director
Human Development and Economic Management
Independent Evaluation Group

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1 The outcome rating is assessed based on a six-point scale: Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, and Unsatisfactory (IEG and OPCS guideline).
1. Background and Context

1.1 In 2012, when the public expenditure policy-based guarantee (PEPEG) operation was prepared, external and regional context for the Former Yugoslav Republic (FYR) of Macedonia was challenging. The slow recovery from the global crisis in the Western Balkans region stalled at the end 2011 as the result of market turbulence associated with the sovereign debt crisis in Europe. The ensuing regional recession was particularly challenging for many emerging countries of Europe, including FYR Macedonia, because of hard external financing conditions. Against this background in 2011, FYR Macedonia and the World Bank converted the envisaged second operation in the series of development policy operations (DPOs) into a policy-based guarantee (PBG) to address larger than expected financing needs. With the help of the PBG, FYR Macedonia mobilized €130 million in the international loan market.\(^2\)

1.2 In 2012, many countries of the region saw a full-blown recession, including FYR Macedonia. Substantially narrowed fiscal space affected policy response. In the first half of 2012, FYR Macedonia introduced spending measures as the result of revenue underperformance. Financing requirements, however, remained sizeable because of greater economic contraction, relatively modest spending cuts, and problems in commitment controls that affected the overall fiscal stance. These translated into accumulation of arrears in budgetary payments and value added tax (VAT) refunds. Borrowing costs were high. While the government’s initial plan was to borrow €250 million through commercial loans, tough market conditions allowed borrowing €75 million only with a fixed interest rate of 6.5 percent and five-year maturity in July 2012.

1.3 To respond to higher financing needs, the World Bank and the government decided to convert a DPO under preparation for €50 million into another PBG, repeating the experience of the first PBG in 2011. The planned DPO was designed based on government’s reform program in public expenditures on health, social protection, and pensions. The DPO focused on improving the targeting of means-tested financial assistance, improving procurement of medicine and medical devices to reduce unit costs, and strengthening the pension system to ensure long-term sustainability. It was converted into a €155 million PEPBG that supported a €250 million commercial loan from Deutsche Bank in January 2013. The policy matrix of the PEPBG also included measures to address the growing problem of fiscal arrears.

1.4 In the years following the approval of the PEPBG, FYR Macedonia experienced a resumption of economic growth aided by overall improvement in regional and global economies. Its fiscal stance in 2013–2015 was relaxed as a result of revenue underperformance, pension increases, and large capital expenditures. The country returned to the international bond market in 2014 with a successful issuance of €500 million. Domestic bonds have become an important source for deficit financing. Public and publicly guaranteed (PPG) debt approached 47 percent of gross domestic product (GDP) by the end of 2015. Implementation of large off-budget infrastructure projects will lift PPG debt as a percent of GDP further in the medium term. Against the background of

\(^2\) The Independent Evaluation Group conducted a separate evaluation of this operation.
political uncertainties, FYR Macedonia saw an increase in the spreads on its international bonds by the end of 2015.

2. Objectives

2.1 The operation supported a broad government program and assisted FYR Macedonia in implementing its borrowing plan within a consistent macroeconomic framework (Loan and Program Summary, page v). For evaluation purposes, the Independent Evaluation Group (IEG) focused on the following program objectives:

- improving the efficiency of public expenditures by strengthening public financial management practices;
- improving the efficiency of service provision in the health sector; and
- strengthening social protection and inclusion.

3. Relevance of Objectives—Substantial

Relevance to the Context

3.1 The program’s objectives were strongly relevant to the context. At program preparation, a high premium was put on prudent macro-management and a sound borrowing plan because of uncertainties in the external environment amid Europe’s debt crisis. FYR Macedonia had a good record of accomplishment in macroeconomic management that helped bring down the debt at a time of strong economic performance in the 2000s. This created appropriate fiscal room to counteract the impact of the global crisis in 2009–2011. Sustaining these achievements required maintaining a prudent fiscal policy and borrowing strategy within a consistent macro framework, an objective supported by the program. This macro objective was also relevant to choosing the instrument—policy-based guarantees have an intrinsic macroeconomic motivation in meeting large financing needs when access to capital markets is difficult. The size of the borrowing operation that the program supported (more than 3 percent of the borrower’s GDP) also highlights the importance of the macro objective.

3.2 With respect to the PFM objective, although the policy-based guarantee approved in 2011 had an objective of strengthening public finance, FYR Macedonia experienced weakening in PFM practices in important areas throughout 2012. Revenue underperformance and lack of adequate response by the authorities led to a deterioration in fiscal discipline and the accumulation of payments and VAT refund arrears in 2012. According to the Bank’s estimates, arrears reached 2 percent of GDP by September 2012. Inclusion of the PFM objective was important for helping the authorities to recognize the magnitude of the problem and undertake measures to address it. In addition, the focus on PFM was relevant to a deterioration in some aspects of budget management in 2010–2012. The government resorted to greater use of off-budget vehicles for implementing PFM functions typical for the central government, such as road infrastructure. Lack of medium-term planning also heightened the risks to the overall quality of PFM. Against this background, the PFM objective was highly relevant.
Relevance to Bank and Government Strategies

3.3 The health sector's reform agenda during program preparation was substantial. Its main aim was to improve procurement and expand access to health services in underserved areas. The government’s reform initiatives focused on improved procurement of medicine and medical devices to enhance the efficiency of public expenditures. The concentration of health service providers in the capital and other urban centers had constrained access to services in remote areas, and the government’s reform program included actions to address this situation. In the area of social protection at the time of program preparation, the government was implementing a set of actions aimed at better targeting in social protection and more incentives for inclusion and participation through active labor market programs. These followed the government’s earlier actions, such as adoption of the Law on Social Protection in 2009 and introduction of the Cash Benefits Management Information System (CBMIS) in 2011.

3.4 With respect to the relevance of the objectives to the World Bank’s strategy in FYR Macedonia, the country strategy partnership for 2011–2014 directly supported two out of four program objectives. Cluster 3 on human development had specific goals in strengthening social protection administration and health expenditure management.

4. Relevance of Design—Modest

4.1 The relevance of design is assessed as modest based on policy content in relation to objectives and choice of instrument. Strengths included the relevance and institutional depth of most prior actions. The design mostly suffered from lack of operational focus on macro risks as well as the relatively narrow scope of the PFM reform agenda during heightened risks to overall PFM quality.

Choice of the Instrument

4.2 Use of the guarantee instrument by the World Bank has been limited. FYR Macedonia is the only country that has benefited from two PBGs under which €255 million of the Bank's guarantees leveraged €380 million in commercial loans, which comprised about 9 percent of FYR Macedonia's outstanding public debt as of 2015. The reason behind the repeated use of PBGs in FYR Macedonia was a belief that the country complied with specific eligibility criteria on macro, debt, and financing while at the same time experienced limited access to markets for debt refinancing.

4.3 The country's financing needs were sizeable due to revenue underperformance, lack of fiscal adjustment, and debt refinancing needs. The choice of the instrument allowed the Bank to provide financing well beyond a typical DPO and without exceeding the country exposure limits of the International Bank for Reconstruction and Development (IBRD).

3 Long considered as a “hybrid” operation, the guarantees were fully incorporated under Bank’s OP 8.60 on DPOs in 2014, formally becoming a subset of the Bank’s development policy financing.

4 Borrowing €250 million from the market in December 2012–
January 2013 without the Bank's interest rate "subsidy" through the guarantee would have been costly for FYR Macedonia. In this respect, the use of the instrument could have helped to reduce borrowing costs.

4.4 The financing gap in early 2013 reflected the fact that the government intended to clear the arrears accumulated mostly as a result of weakened commitment control in the second half of 2011 and first half of 2012 (estimated at €200 million) without fiscal adjustment. Moreover, toward the end of 2012, the government’s spending plans for 2013 became more ambitious as it embraced, among other initiatives, the controversial idea of an ad-hoc increase in pensions that added an estimated €40 million, or 0.4 percent of GDP, to the deficit in 2013.

4.5 In mid-2012, the government wanted to borrow €250 million from Deutsche Bank for deficit financing and repayment of Eurobonds in January 2013 but was able to mobilize only €75 million at terms it deemed acceptable. When the government approached the World Bank and Deutsche Bank for a repeat guaranteed loan at the end of 2012, its financing objective remained at €250 million notwithstanding the fact that it had already borrowed €75 million a few months prior. This is an indication that the government's spending plan expanded toward the end of 2012 against the backdrop of available financing.

4.6 The €250 million commercial loan from Deutsche Bank with an interest rate of 3.9 percent guaranteed by this operation consisted of an IBRD guaranteed component of Euro 155 million with seven years maturity, and a non-guaranteed component of Euro 95 million with five years maturity. The aggregate interest rate of 3.9 percent on the loan was lower than the non-guaranteed loan of July 2012, which had 6.3 percent interest rate. The terms were better than what Macedonia could have received in the market without the guarantee. Although estimating the counterfactual is difficult, it is believed that the interest rate of a loan with similar parameters could have been as high as 7 percent.

4.7 However, comparing the aggregate interest rate of PBG-supported financial instrument with market rates available to the borrower may not be enough for assessing the extent of reduction in the borrowing costs associated with the guarantee transaction as the interest rate of the guaranteed instrument by definition should be lower than the rates of “clean” instruments without guarantees. A more comprehensive approach would be to assess the change in market’s perceptions of sovereign risk because of the underlying macroeconomic and structural policy program supported by Bank’s policy lending. This could be done by estimating the implicit interest rate on non-guaranteed component of the loan by isolating non-sovereign risk factors associated with the transaction (IBRD risk, liquidity premium, etc). Although IEG does not look at these aspects for performance evaluation purposes, this evaluation highlights the importance of developing an approach to comprehensively assess the impact of PBGs on client’s borrowing terms.

5 The World Bank has not yet developed an approach for such an assessment in spite of scaling-up of PBGs since 2011. IEG will look it this and other important aspects of PBGs as part of a learning product, which will draw on this and other PPARs.
Policy Content and Results Framework Analysis

4.8 Analysis of policy content and the results framework focuses on the links between objectives, outcomes, and policy actions and the relevance and quality of policy actions to measure the extent to which outcomes are likely to be achieved.

4.9 The strengths of the program's results framework included strong links between prior actions, outcomes, and objectives and satisfactory institutional depth of most prior actions. The program included important actions for achieving the outcomes such as the inventory and clearance of arrears, changes in treasury manuals to strengthen PFM, changes in procurement practices in health sector, and improved targeting in social protection. In terms of the relevance and additionality of prior actions, the prior action in the health sector on reference prices and centralized procurement was implemented more than 12 months before the program's approval (not directly motivated by the program), which somewhat affected its additionality in this policy area.

4.10 The design shortcoming was that the policy content of the program did not include actions needed to address heightened macro and fiscal risks. Because of lack of information about the extent of payments arrears accumulated because of deterioration of commitment control, there was no certainty about the implications of arrears clearance on the 2013 budget. In addition, during program preparation it became known that the Government is planning to sign a large loan agreement with China for highway construction, which further added to macro and fiscal risks. These factors contributed to higher risks to the consistency of fiscal framework that required risks mitigation.

4.11 Additionally, the impact of possible savings on fiscal sustainability from improved procurement of medicine, for example, would be much less if the saved resources are used to increase non-priority expenditures such as pensions and non-productive capital investments. Possible actions that could support the objective included a credible and debt-stabilizing medium-term fiscal framework and, possibly, a fiscal rule.

4.12 It is important for the World Bank's operations to facilitate rather than postpone necessary adjustments. The Bank's support for clearance of arrears without fiscal measures affected the rationale for the intervention and created conditions for higher deficit in 2013. Additionally, the fact that FYR Macedonia allowed the IMF's precautionary line of credit to expire in January 2013 put a higher premium on the Bank's operational focus on macro and fiscal framework. The operation was the only vehicle for macro and fiscal policy dialogue with the Bank and, in this respect, it was expected to inform implementation of the single-sector competitiveness DPO being prepared in parallel with no macro and fiscal objectives. Against this background, the lack of macro and fiscal policy actions to underpin fiscal sustainability affected quality of design.

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6 According to the Bank’s Operational Policy OP 8.60, substantial macroeconomic risks should be addressed through DPOs as a pre-condition of Bank’s budget support.

5. Implementation

5.1 The PEPBG was the second PBG operation in FYR Macedonia. Both the Bank team and government counterparts had previous experience with various aspects of PBGs, such as identifying the commercial lender, negotiating loan terms, and finalizing the deal after approval of the operation. It was approved by the Bank on January 8, 2013 and became effective on January 11, 2013. The €250 million commercial loan with Deutsche Bank was finalized within a week after the program became effective.

5.2 Preparation of the operation also required strong cooperation among various units of the Bank, including the core PBG team, the Bank’s lead network (Poverty Reduction and Economic Management), the Bank’s Human Development network, FPD, Treasury, FINCR, and the country team. The Ministry of Finance, as the implementing agency, played a coordinating role. The National Bank of the Republic of Macedonia, the Ministry of Labor and Social Policy, and the Ministry of Health were also closely involved.

5.3 The operation triggered no safeguards. The Poverty and Social Impact Analysis of the original DPO that was converted into the PBG under review provided an adequate assessment of possible adverse social and distributional effects of the policies supported by the operation.

5.4 The implementation was supervised by the Bank staff in the region and through missions in March and September of 2013. Implementation was mostly focused on verifying the clearance of arrears, which was completed in the first half of 2013. Policy dialogue during implementation resulted in publication of the medium term fiscal strategy in 2013. Implementation also benefited from parallel activities, such as preparation of the public expenditure review.

6. Achievement of Objectives

Macroeconomic Developments in 2013-2015 (not rated)

6.1 Growth was relatively strong in 2013-2015. FYR Macedonia's domestic and international borrowing terms improved in recent years against the background of overall moderation of risks in the region. However, the overall fiscal policy stance was not fully consistent with debt-stabilization and fiscal sustainability. This evaluation finds that in the current political and institutional context characterized by a lack of credible fiscal responsibility institutions and political uncertainties it will be difficult to achieve consistent macroeconomic framework.

6.2 The generally prudent and countercyclical fiscal stance that characterized FYR Macedonia throughout the 2000s has disappeared since 2013. The central government's budget deficit increased to 3.9 percent in 2013 and further to 4.2 percent in 2014 while remaining elevated in 2015 notwithstanding relatively strong economic growth. These figures, however, do not show the actual extent of fiscal expansion because since 2013 road infrastructure expenditures have not been included in the central government budget.
As major infrastructure projects implemented by off-budget State Owned Enterprises through external borrowing have been gradually expanding in recent years, the actual fiscal stance might be more expansionary than the headline budget deficits would suggest.

6.3 The data on public debt (public and publicly guaranteed debt) may provide a better indication about the overall fiscal stance in recent years. It includes SOE borrowing with government guarantees for the implementation of transport infrastructure projects. FYR Macedonia’s PPG debt was around 47 percent of GDP by the end of 2015, which is 8 percentage points higher than in 2012. It is substantially higher than expected at the time of program preparation. The government’s letter of development policy for this operation from December 2012 stated that the medium-term plan is to keep the public debt below 35 percent. According to the government’s fiscal strategy, public debt will reach 53 percent of GDP in 2018, which is substantially higher than estimated under the most pessimistic debt sustainability scenario prepared at the time of approval of the guarantee.

6.4 Larger than expected debt accumulation since 2013 has taken place due to a combination of revenue underperformance and new expenditure initiatives. Revenues underperformed in 2013 and 2014 because of tax policy choices, such as tax expenditures for investments promotion, and tax administration issues. The government did not adjust fiscal spending to respond to the revenue shortfall. In contrast to previous years, the revenues overperformed in the first half of 2015 because of phasing out of corporate tax privileges introduced in 2009. Instead of strengthening the fiscal buffers, the government introduced new spending initiatives in July 2015 in an amount exceeding revenue overperformance. This highlights the government’s pro-spending preferences and existing risks to fiscal consolidation.

6.5 The institutional framework governing fiscal policy remains weak, and it contributes to debt accumulation at a time of relatively strong economic growth. The government has proposed a fiscal rule for parliament’s approval that introduces caps for the budget deficit at 3 percent of GDP and for public and publicly guaranteed debt at 60 percent of GDP. However, the authorities’ decision to approve these rules as a constitutional norm that requires broader political support (two-thirds vote in parliament) made its approval in 2015 impossible, while prospects for 2016 also seem uncertain. At the same time, the potential effectiveness of the proposed fiscal rule is questionable with respect to the budget deficit as major infrastructure expenditures will be off budget for the years to come.

6.6 FYR Macedonia went back to the international bond market in mid-2014 with an issuance of €500 million Eurobonds having a 7-year maturity and an interest rate of 3.95 percent (an estimated spread of around 3 percent against German 10-year bonds). In early 2015, FYR Macedonia repaid the IMF credit well in advance of the schedule using receipts from Eurobonds. The spreads on the country’s international bonds fluctuated between 3 and 6 percent in 2013–2015, staying at around 6 percent as of November 2015, higher than most regional comparators. Several large bullet repayments are scheduled in 2016 and 2017, suggesting it is important to create fiscal buffers including cash deposits.
in the Central Bank to address the risks of market volatility at the time of debt refinancing.

6.7 Since 2012, FYR Macedonia has substantially expanded the use of domestic bonds, which is a welcome development. There has been a shift toward longer-term government bonds with maturities reaching 15 years at an interest rate of around 4 percent (as of October 2015). Interest rates on short-term bonds (3 to 6 months) were around 1.5 percent.

6.8 With respect to the country’s sovereign credit risk, Standard & Poor’s downgraded its credit rating in May 2013 following a similar rating cut for Croatia in February 2013. Although the overall regional trends played a role, the rating cut was also driven by country-specific factors such as deteriorated fiscal transparency, the fiscal stance, and large nonproductive investment projects. In August 2015, Fitch Ratings changed the outlook of FYR Macedonia from stable to negative because of heightened political risks and debt dynamic.

**To Improve the Efficiency of Public Expenditures by Strengthening Public Financial Management Practices—Modest**

6.9 Results were mixed under this objective. The program’s focus was mostly on clearance of arrears that became a major problem in 2012 because of revenue underperformance and slippages in fiscal discipline. The program helped to achieve clearance of those specific arrears as planned by early 2013 and to introduce changes in treasury practices to address the problem more systematically. However, FYR Macedonia’s PFM has not been strengthened substantially, and there is no evidence of overall improvement in the efficiency of public expenditures. Among achievements are the reintroduction of the Medium Term Expenditure Framework in 2013, public sector wage control, and improved reporting on public debt. Problems in PFM, including arrears at the municipality level and in the health sector, and efficiency of capital expenditures were still present by the end of 2015. New problems emerged, such as the transfer of public road expenditures to off budget and replacement of the indexation mechanism for pensions by ad-hoc increases, that have heightened the risks to fiscal sustainability.

**Clearance of Arrears**

6.10 As the result of revenue shortfall and slippages in the fiscal discipline in 2011 and 2012, the government accumulated VAT refunds and payments arrears of at least 2 percent of GDP. Clearance of these arrears became the cornerstone of the program because of its negative implications for the quality of PFM and for the overall business environment. The program helped the government identify arrears and make a commitment for their clearance. In addition, the government implemented amendments to the *Manual on Treasury Operations* to specify procedures for reporting multiyear commitments of budget users to the treasury, improve procedures for reporting liabilities

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9 For more information, see [https://www.fitchratings.com/site/fitch-home/pressrelease?id=989810](https://www.fitchratings.com/site/fitch-home/pressrelease?id=989810).
on concluded contracts, and improve procedures for validation of commitment reports by internal auditors. These changes were supported by an upgrade to the treasury information system that further strengthened commitment control. The Law on Financial Discipline, according to which the invoices should be settled within 60 days of receipt, strengthened the framework to avoid the re-occurrence of arrears.

6.11 In spite of these reforms, the system in use does not record the dates the invoices are received by the budget users thus creating room for accumulating arrears against the invoices that are not yet submitted to the treasury. This shortcoming precludes a comprehensive centralized record of financial liabilities and reliable information about the extent of arrears. Furthermore, there is evidence of accumulation of payment arrears in local governments. Various estimates put the arrears accumulated by municipalities at 1 to 2 percent of GDP, which is quite high compared to the combined budget of local governments of around 5 percent of GDP. Arrears in the health sector have not improved. The first policy-based guarantee of the World Bank implemented in 2011 aimed at reducing the arrears in the health sector to below 0.4 percent of GDP by the end of 2012, which was achieved. However, the results were not sustained. As of the end of 2015, health sector arrears stood at 0.7 percent of GDP.

### Fiscal Transparency

6.12 There is mixed evidence on fiscal transparency. The decline in the open budget index in 2010–2012 was not reversed in 2013–2015. FYR Macedonia’s index remains low by regional standards because of limited engagement with the public in the budget process and limited budget oversight by the legislature. There were, however, improvements in the publication of public debt data. In 2014, the government restarted the practice of quarterly publication of public debt that had been discontinued in 2010. The reports cover the external and domestic debt of the central government, the SOEs, and the municipalities.

6.13 As a major change in fiscal institutions in 2012, the government established the Public Enterprise of State Roads (PESR) through the amendments to the Law on Public Roads that assumed the responsibilities of the Agency for State Roads. The PESR is responsible for the planning, construction, and maintenance of public roads and management of state roads. It receives transfers from the state budget (as a share of excise tax revenues on fuel) and collects revenues from public toll roads and vehicles registrations. The PESR is the main vehicle of scaling up of road infrastructure spending. It has extensively borrowed externally with government guarantees. Implementation of PESR projects will add at least 5 percent of GDP on the country’s debt stock over the medium term. This change—moving road infrastructure spending to off-budget—has undermined FYR Macedonia’s public financial management system in many aspects.

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10 PEFA Assessment of the Former Yugoslav Republic of FYR Macedonia, December 2015.

11 Based on interviews with health ministry officials.

12 For more information, see [http://www.internationalbudget.org/](http://www.internationalbudget.org/).
including the increased risks to credible fiscal planning, efficiency of capital expenditures, and fiscal sustainability.

**Medium Term Fiscal Planning**

6.14  The government discontinued the practice of publishing the Fiscal Strategy, a three-year expenditure framework, in 2010 amid uncertainties in the medium-term outlook and fiscal parameters. It was reintroduced in 2013 because of policy dialogue under PEPBG.13 This was an important achievement with the potential of strengthening the fiscal framework and signaling the needed fiscal consolidation plan. The benefits of this change, however, were dissipated by persistent expansion of fiscal deficits since 2013 (figure 6.1). This has resulted in uncertainties about key parameters of the medium term fiscal program. The removal of key infrastructure expenditures from the central budget in 2013 also undermined its overall usefulness in establishing a credible medium term fiscal framework.

**Figure 6.1. Fiscal Deficit according to Three-Year Fiscal Strategies**

![Fiscal Deficit chart]

*Source: Ministry of Finance of FYR Macedonia.*

**Efficiency of Public Expenditures**

6.15  This evaluation finds a lack of evidence about tangible achievements in improving the efficiency of public spending in 2012–2015. Moreover, developments in the areas of pensions and capital expenditures have affected the quality of public expenditures and intensified the risks to fiscal sustainability.

6.16  In the area of pensions, pension-related spending has steadily increased from 8.8 percent of GDP in 2007 to 9.6 percent in 2014. This was largely driven by ad-hoc pension increases that were implemented in addition to the formula-based annual indexation. The annual formula-based indexation was dropped in 2015, and the system

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13 Based on an interview with the task team leader.
now depends on discretionary policy decisions. As a result, more risks to the stability in the pension system emerged. The World Bank’s first PBG specifically addressed this area by establishing a target value of 9 percent for pension spending in GDP. It was not sustained because of ad-hoc increases. This evaluation finds that the increase of the pensions share in total expenditures has not only elevated the risks to fiscal sustainability but also negatively affected the effectiveness of public expenditures and the equity of public resource use. Pensioners as a group are relatively well off compared to the rest of the country, with only 14 percent of pensioners living below the poverty line, compared to 27 percent for the total population.

6.17 Efficiency of capital expenditures has remained hampered by major shortcomings, while the introduction of several large investment projects has created new challenges. Most stakeholders interviewed for this evaluation shared a view that the quality of capital expenditures has declined in recent years. Planning of investment projects is not fully integrated with the annual budget process, while the practice of comprehensive cost-benefit analysis is still lacking. The result has been the implementation of several controversial large investment projects such as the Skopje’s urban beautification project (known as Skopje-2014 project). The government created more risks to the efficiency in public expenditures by taking out some large public investment projects from the budget and creating disconnect between these investments and the overall fiscal framework.

Improving the Efficiency of Service Provision in the Health Sector—Substantial

6.18 The program aimed to achieve this objective through improving procurement of drugs and equipment and creating incentives for expanded service delivery in underserved areas. This evaluation finds that on balance the program has substantially achieved the objective. The unit prices of pharmaceutical and some medical equipment have declined to a considerable extent. This, however, did not translate into actual budget savings in 2013–2015 because of an increase in prescriptions that offset the positive impact of unit price reduction. The new framework to rationalize service provision is expected to direct more resources to underserved areas.

PROCUREMENT OF PHARMACEUTICAL AND MEDICAL EQUIPMENT

6.19 In the area of procurement of prescription drugs, the revision of methodology for reference prices and publication of prices on annual basis since 2011 (the prior action) has resulted in substantial savings of €30 million to €45 million in 2012–2014 through a 30 percent average reduction in prices. Additional savings were generated by introduction of pooled procurement and international tendering for some pharmaceutical and medical devices purchased by hospitals, which was a prior action for the operation. The program aimed at a 30 percent reduction in optical medical devices, which was achieved in 2013. More reductions occurred in 2014 and 2015. As of the date of this evaluation, the average unit price of optical devices was 50 percent lower on average than in 2011.14 The impact of lower unit costs on the budget savings, however, was offset by an increase in the number of prescriptions in recent years. In fiscal terms, no savings have been

14 Based on interviews with health ministry officials.
generated. Procurement of medicine and medical devices used by hospitals remains decentralized with possible implications for the efficiency of health expenditures.

**SERVICE PROVISION IN UNDERSERVED AREAS**

6.20 Throughout the 2000s, health service providers concentrated in the capital and large urban centers. This trend was fueled by a capitation-based financing formula of independent service providers that encouraged concentration of service providers in large settlements. The government established the so-called Medical Network that balances the number of service providers over the medium term across the regions (the prior action). This action established ceilings on the number of concessions in overserved areas while increasing the number of quotas in underserved areas. At the same time, it established caps on the maximum number of patient per primary healthcare providers.

6.21 Positive results came from the implementation of the plan. Underserved areas have seen an increase in service provision through new concessions issued to primary health providers, pharmacies, and dental service providers. The government is optimistic about the service providers’ interest in concessions in underserved areas, and the numbers of obtained concessions are expected to increase. At the same time, the Ministry of Health has not increased the number of concessions in overserved areas. In addition, the government has introduced specific targeted programs such as the Rural Doctor and Health for All programs for underserved areas. In 2014, these programs delivered health services in 64 rural communities and served more than 5,000 patients.

**Strengthening Social Protection and Inclusion—Substantial**

6.22 The overall achievement of this objective is substantial. The program supported improving effectiveness of the government’s active labor market programs and strengthening social protection by improving the access of vulnerable groups to social services and generating fiscal resources through better targeting to enhance financial assistance to beneficiaries. The specific results sought by the program were achieved by 2013 as projected and were sustained throughout 2013–2015.

**ACTIVE LABOR MARKET POLICIES**

6.23 The program addressed the need to strengthen incentives for social safety beneficiaries to seek employment opportunities. As a result of the revisions made in the 2012 social safety net, beneficiaries were given an opportunity to participate in active labor market programs including public work programs, employment subsidies for firms, training, and loans for self-employment (a prior action). These modifications were supported by an increase in fiscal allocations to active labor policies as an important measure at the time of economic downturn.

**Table 6.1. Number of Participants and Budget Allocations**

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Number of participants</td>
<td>7,247</td>
<td>7,565</td>
<td>5,213</td>
<td>9,472</td>
<td>10,279</td>
<td>16,226</td>
</tr>
<tr>
<td>Total allocations, Denars million</td>
<td>525</td>
<td>497</td>
<td>501</td>
<td>554</td>
<td>552</td>
<td>629</td>
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</tbody>
</table>

*Source: Ministry of Labor and Social Policy.*

6.24 The number of beneficiaries of labor market programs has increased since 2012 (table 6.1). The government introduced new programs in recent years, including in training, subsides for job creation, and conditional cash transfers for employment. The Macedonia Employ project, one of the main vehicles of active labor market interventions that covered 8,700 beneficiaries as of the end of 2015, was introduced in 2015 and has five different categories of interventions based on age and professional background of recipients.

6.25 An attempt has been made to assess the effectiveness of active labor market programs. An impact evaluation supported by the International Labour Organization (ILO) employing a quasi-experimental method\(^{15}\) has found clear evidence of the effectiveness of several interventions, such as internships, training with participant employers, information technology (IT) training, and self-employment support mechanism. The study has found no evidence of positive impact from wage subsidy interventions.

**SOCIAL PROTECTION**

6.26 In the area of social protection, the Bank supported changes for improving access to the services by reducing the transactions costs for applicants. As a prior action, the government modified the system linking administrative registries of Employment Service Agency, Pension, and Disability Insurance Fund and Social Protection to the CBMIS and reducing the number of documents required for registration or renewal of financial assistance through CBMIS. This step has reduced the transaction costs for applicants. This achievement was sustained through 2013–2015.

6.27 Substantial progress is seen in the targeting of social protection. The program supported a set of measures for improving targeting and using the saved resources for augmenting means-tested social assistance to the most vulnerable groups (a prior action). This policy area also has benefited from the parallel investment lending project of the Bank in strengthening the IT system of social administration, which created mechanisms for data exchange with other agencies, such as tax administration, Central Bank 9 (for remittances), and the Ministry of Agriculture (agricultural subsidies). This has resulted in a substantial improvement in targeting as thousands of noneligible households were dropped from the system. Improved information exchange also resulted in a positive self-selection by applicants as many noneligible applicants stopped applying for financial assistance. Means testing was strengthened in 2014. As a result of these measures, the overall number of beneficiary households receiving social financial assistance has declined to 28,500 in 2015 from more than 70,000 in 2007.

\(^{15}\) Impact evaluation of active labor market programs in FYR Macedonia, 2015, ILO.
Table 6.2 Selected Monthly Assistance

<table>
<thead>
<tr>
<th>Type of Assistance</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly social financial assistance, MDen</td>
<td>2,223</td>
<td>2,334</td>
<td>2,451</td>
<td>2,696</td>
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<tr>
<td>Percent change</td>
<td>5</td>
<td>5</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Monthly permanent financial allowance, MDen</td>
<td>4,669</td>
<td>4,902</td>
<td>5,147</td>
<td>5,662</td>
</tr>
<tr>
<td>Percent change</td>
<td>5</td>
<td>5</td>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>

Source: Ministry of Labor and Social Policy.

6.28 Improved targeting has helped to sustain regular increases in average benefits. The program aimed at increasing the average social financial assistance benefit by at least 5 percent in 2014, which was implemented. The government raised the average benefits further in 2014 and 2015 by 5 and 10 percent, respectively. The freeing of resources from improved targeting, however, has not been used to relax eligibility criteria for financial assistance to cover more vulnerable groups marginally above the threshold. This could have been a step forward for the social protection agenda given that one-fourth of the country’s population, or around 150,000 households, is below the poverty line. The government also introduced new benefits for disabled people which, while addressing certain aspects of vulnerability, were not means-tested mechanisms of social protection.

Table 6.3. Social Assistance Budget by Program, MDen, millions

<table>
<thead>
<tr>
<th>Type of Assistance</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
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</thead>
<tbody>
<tr>
<td>Social financial assistance</td>
<td>1,108</td>
<td>1,066</td>
<td>1,171</td>
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<tr>
<td>Permanent financial assistance</td>
<td>—</td>
<td>71</td>
<td>57</td>
</tr>
<tr>
<td>Other care</td>
<td>1,531</td>
<td>1,514</td>
<td>1,474</td>
</tr>
<tr>
<td>Financial assistance for blindness and mobility</td>
<td>62</td>
<td>302</td>
<td>561</td>
</tr>
<tr>
<td>Special allowance</td>
<td>336</td>
<td>346</td>
<td>376</td>
</tr>
<tr>
<td>Civil disability</td>
<td>98</td>
<td>96</td>
<td>91</td>
</tr>
<tr>
<td>Total social assistance</td>
<td>3,136</td>
<td>3,395</td>
<td>3,730</td>
</tr>
</tbody>
</table>

Source: Ministry of Labor and Social Policy.
Note: — = 2012 data for permanent financial assistance was not available

7. Outcome Rating

7.1 The objectives of the program were substantially relevant to the country’s priorities and the Bank’s strategies at the time the operation closed. The design of the operation showed strengths in some areas, including health-sector reforms and the streamlining of social protection. It did not, however, incorporate adequate measures to ensure consistent macroeconomic framework. On balance, the relevance of design is rated modest.

7.2 Of the three objectives envisaged, one was partly achieved, and two were substantially achieved. The objective of improving public financial management practices was only partly achieved as the initial clearance of existing payments arrears was followed by a deterioration in overall PFM in the areas of capital expenditures and fiscal
transparency. On the positive side, reforms in the health sector led to lower costs of essential drugs and an increase of service provision in underserved areas. Similarly, improved targeting of social protection enabled the government to increase the benefit levels for vulnerable groups.

7.3 On balance the outcome is rated moderately satisfactory.

8. Risks to Development Outcomes

8.1 The risks to development outcomes are rated significant.

8.2 Main risks are due to the lack of a credible fiscal consolidation plan, the government’s ambitious plans in infrastructure projects that are not supported by sound cost-benefit considerations, pensions, and persisting shortcomings in PFM.

8.3 According to the current projections based on the fiscal consolidation plan outlined in the fiscal strategy for 2015–2017, the debt will reach 53 percent of GDP in 2019. However, serious risks are seen in the implementation of the announced fiscal consolidation. As past experience shows, the three-year fiscal strategy is not a credible predictor of fiscal developments. Recent ad-hoc pension increases are yet to be reflected in the fiscal trajectory for the medium term. The absence of a sound fiscal responsibility framework magnifies the risks to the implementation of the government’s fiscal consolidation plan.

8.4 The reduction of the budget deficit, even if it materializes as expected, will not be enough to ensure fiscal sustainability as the government’s program envisages ambitious infrastructure projects to be implemented by SOEs outside the budget. These projects will add to the country’s indebtedness to an extent that the public debt will pass the 60 percent debt ceiling sought by the government. The scenario that combines full implementation of these off-budget projects and lack of fiscal consolidation may lead to unsustainable public debt over the medium term.

8.5 In spite of reforms implemented in the treasury system, serious risks to an efficient PFM exist due to persistent arrears in the health sector and local governments, large-size off-budget activities by SOEs operating with government guarantees, and the decline in the quality of capital investments implemented through the budget.

8.6 With respect to broader economic performance, although FYR Macedonia’s growth performance in 2013–2015 was commendable, there are risks to sustaining the trajectory in the medium to long term. Growth has been driven largely by a combination of FDI-led export sector that was strongly supported by generous tax expenditures given to the “greenfield” industries and sizable construction activities funded by public debt. There are uncertainties about long-term performance of the FDI sector as evidence emerges that some foreign companies may leave FYR Macedonia after expiration of the tax privileges granted by the government. As for the debt-driven domestic demand this evaluation highlights the limits of this growth vehicle as debt-accumulation with the pace observed in recent years would be unsustainable.
9. Bank’s Performance

Quality at Entry – Moderately Satisfactory

9.1 The operation was prepared against the background of a tense fiscal situation in 2012. Authorities were facing a large financing gap as a result of revenue underperformance further aggravated by weak commitment control. This has resulted in accumulation of arrears to an extent that the overall business environment was undermined. Bank’s response to support the authorities through an instrument that provides substantially larger financing than a regular DPO was adequate. The regular DPO of USD 50 million under preparation was converted into the second policy based guarantee in the last quarter of 2012. The Bank worked with the government to develop a program with relevant objectives. Most policy actions chosen by the Bank as building blocks of the operation were relevant to the objective and supported important institutional reforms. The focus on the clearance of arrears was justified from both fiscal discipline and business environment perspectives. The tight time frame of program preparation might have been adequate in the context of authorities’ request to finalize the program and, subsequently, the transaction with the commercial loan before the large bond repayment in January 2013. This urgency, however, might have imposed constraints on the team potentially affecting the coverage of the operation.

9.2 Having said that, this evaluation finds that the conversion of the planned DPO to a much larger guarantee operation took place without addressing substantially elevated macro and fiscal risks. The Bank dropped the policy action in pensions initially incorporated in proposed program due to increased risks of non-implementation as a result of authorities’ intentions to increase pension at ad-hoc basis, an action that run against the spirit of agreed reforms and fiscal sustainability. Additionally, Bank’s response to some other major risks to program’s objectives that emerged during program preparation was sometimes weak. The fact that the authorities allowed the IMF program to expire created major risks for the conduct of macro policies, and, in this context, the lack of operational focus in the program was a lost opportunity undermining the effectiveness of reforms in public expenditures.

9.3 By end of 2012 evidence emerged about the scale of controversial capital expenditures in non-productive areas and the extent of the problem of arrears accumulation as a result of weak commitment controls. In addition, in November 2012, after a long preparation period, the Government signed an agreement with China on a large loan for highway construction followed by a decision to transfer most infrastructure spending to off-budget

Quality of Supervision—Satisfactory

9.4 Supervision was conducted through Bank staff based in the region and the missions in March and September 2013. The supervision was mostly focused on verifying the process of arrears clearance, which was completed in the first half of 2013. Policy dialogue continued during the supervision, resulting in preparation and publication of the 2014–2016 fiscal strategy at the end of 2013. Supervision benefited from parallel activities such as preparation of the public expenditure review.

9.5 The overall Bank performance is rated moderately satisfactory.

10. Borrower’s Performance

10.1 Government performance is rated moderately satisfactory.

10.2 The government demonstrated strong ownership in specific reform actions supported by the operation. It delivered strong results in the clearance of arrears, reforms in health expenditures, and improved targeting in social protection. The arrears identified under these operations (payments arrears of the central government and arrears in VAT refunds) were cleared ahead of the timeline mostly in the first quarter of 2013. The government’s approach to public wage restraint was also commendable. The government continued implementation of the reforms to improve efficiency of health expenditures beyond completion of the program, which is an indication of strong ownership. Similarly, reforms in improving the targeting in social protection continued further in 2014–2015, resulting in savings. As a welcome development, the medium term fiscal strategy was reintroduced in 2013, strengthening the planning framework.

10.3 Despite these strengths in performance, weaknesses were found in the government’s performance that did not allow the translation of important structural reforms in improved efficiency of public expenditures. The government initiated spending programs that jeopardized the fiscal sustainability framework and undermined the efficiency of public resource use. Ad-hoc pension increases, large capital investments in nonproductive areas, and large off-budget investments in roads without strong economic rationale have substantially elevated FYR Macedonia’s indebtedness—neutralizing the impact of the reforms implemented with operation support operation. Fiscal consolidation has been continuously delayed in recent years, while no critical fiscal responsibility institutions have been created. A strong pro-spending bias elevates the risks to development outcomes.

10.4 Implementing Agency Performance is rated moderately satisfactory.

11. Monitoring and Evaluation—Substantial

11.1 Design. The indicators selected for progress monitoring were strongly linked to the policy actions and were generally measurable and quantitative. Some of the results indicators were output oriented but largely adequate for capturing the first round of the effects of policy actions, and they could provide important information about the progress in reform program. The target values established for the results indicators were adequate
from the viewpoint of the program’s stated ambition. Required data were available from the government’s public sources or from the relevant ministries and agencies.

11.2 Implementation. The Ministry of Finance coordinated data collection and reporting. All indicators were reported in the ICR of the project in 2014. The choice of the indicators allowed an update of most of the indicators with more recent data to assess the sustainability of achieved results. The evaluation was not able to update the indicator on payments and VAT arrears because of shortcomings in arrears reporting in the treasury system, which did not allow verification of no payment arrears at the time of the evaluation.

11.3 Utilization. No utilization was reported in the ICR. The evaluation notes that respective ministries continued the monitoring of some indicators after program completion.

12. Lessons

- PBGs can potentially be a useful instrument for supporting clients facing large external financing needs.
- PBGs implemented in a context of challenging macro-fiscal situation and large financing needs need to incorporate a consistent macro-economic framework with necessary macro and fiscal actions for risk mitigation.
- Positive impact of important public expenditure measures (wage control, reforms in health procurement, and better targeting of social protection) can be eroded if the program lacks an overarching fiscal and debt framework. As FYR Macedonia’s case illustrates, fiscal savings achieved through these important measures can be dissipated by introducing non-priority spending such as ad-hoc pension increases or controversial capital expenditures.
- Comparing the aggregate interest rate of PBG-supported debt instruments with counterfactual market rates may not be enough for assessing the extent of reduction in the borrowing costs associated with the transaction. Estimating the change in sovereign risk perception, although a challenging task, may give more accurate assessment of the impact of the program.


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_____ 2015 Article IV

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_____ 2013, Program Document of Competitiveness DPO
Appendix A. Basic Data Sheet

THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA, LOAN: (P133791, G-2170-MK)

Key Project Data (US$, millions)

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<th>Actual or current estimate</th>
<th>Actual as % of appraisal estimate</th>
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Cumulative Estimated and Actual Disbursements

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<tr>
<td>Actual (US$M)</td>
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<td>Not Applicable</td>
</tr>
<tr>
<td>Actual as % of appraisal</td>
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Project Dates

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Task Team Member

<table>
<thead>
<tr>
<th>Names</th>
<th>Title</th>
<th>Unit</th>
</tr>
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<tbody>
<tr>
<td>Birgit Hansl</td>
<td>Task Team Leader</td>
<td>ECSP2</td>
</tr>
<tr>
<td>Zeljko Bogetic</td>
<td>Lead Economist</td>
<td>ECSP2</td>
</tr>
<tr>
<td>Simon Davis</td>
<td>Economist</td>
<td>ECSP2</td>
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<tr>
<td>Bojan Shimbov</td>
<td>Research Analyst</td>
<td>ECSP2</td>
</tr>
<tr>
<td>Michael Edwards</td>
<td>Lead Financial Sector Spec.</td>
<td>ECSF1</td>
</tr>
<tr>
<td>Johannes Koettl</td>
<td>Senior Economist</td>
<td>ECSHD</td>
</tr>
<tr>
<td>Gianfranco Bertozzi</td>
<td>Sr. Financial Officer</td>
<td>FABBK</td>
</tr>
<tr>
<td>Lewis Hawke</td>
<td>Sr. Financial Management Specialist</td>
<td>ECSO3</td>
</tr>
<tr>
<td>Anthony Mole</td>
<td>Sr. Counsel</td>
<td>LEGSO</td>
</tr>
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### Staff Inputs (staff weeks)

<table>
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<tr>
<th>Stage of Project Cycle</th>
<th>Staff Time and Cost (Bank Budget Only)</th>
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<td><strong>Lending</strong></td>
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<td><strong>Total:</strong></td>
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## Appendix B. Prior Actions

### Pillar I: Strengthening Public Financial Management

1. The Borrower has established an inventory of its (i) payment arrears and (ii) VAT refund arrears, and has agreed to a timeline and plan to clear the stock starting in October 2012.

2. The Borrower’s Ministry of Finance has taken the following measures to improve the management of financial commitments:
   - Amendments to the Manual of Treasury Operations (Official Gazette No. 118/12, September 24, 2012) to (i) set forth how multi-year liabilities will be recorded, reported and validated, and (ii) prohibit the Treasury Department from approving payment requests if liabilities are not properly registered; and
   - The Amendments to the Manual of Treasury Operations have been circulated to all budget users with a confirmation that the statutory penalties provisioned in the Law of Budgets will be applied for failure to meet the requirements of (i) reporting commitments and (ii) meeting expenditures within the available budget without incurring arrears; and
   - Establishment of a Working Group within the Ministry of Finance (Decision number 04-27553/1) to (i) prepare changes to the Treasury Information System to incorporate entry and monitoring of multi-year liabilities; and (ii) adopt a plan on activities; and (iii) commence implementation of such plan.

### Pillar II: Improving Efficiency of Spending and Service Provision in the Health Sector

3. The Borrower’s Ministry of Health has introduced and published revised reference prices for a list of drugs for which prices were reduced as a result of improvements to the methodology for setting prices for registered drugs (Official Gazette No. 156/11 from November 9, 2011) in order to generate health expenditure savings.

4. The Borrower’s Ministry of Health has concluded centralized international procurement for optical lenses and disposables for 2012-2014 and has commenced centralized international procurement for orthopedic devices in order to generate price savings and improved terms of delivery.

5. The Borrower’s Ministry of Health has introduced criteria defining the standards for health service provision, specifically for contracting providers, in order to expand provider coverage in underserved areas, through adoption of the by-law establishing the Medical Network (Official Gazette No. 81/12 from June 28, 2012).

### Pillar III: Strengthen Social Protection and Inclusion

6. The Borrower has adopted (on June 26, 2012) revisions to the 2012-2013 Operation Plan on Active Labor Market Policies containing additional measures to encourage Social Safety Net Beneficiaries to actively seek employment opportunities, to increase social inclusion.

7. The Borrower’s Ministry of Labor and Social Policy has improved the efficiency of social safety net administration and service access by (i) entering into a Memorandum of Understanding with each of the Employment Service Agency (ESA) and the Pension and Disability Insurance Fund (PDIF) in order to establish a system that links the Cash Benefits Management Information System with the administrative registries of the ESA and the PDIF; and (ii) making such system operational.

8. The Borrower’s Council of Ministers has adopted (on October 16, 2012) the draft Law on Amendments to the Law of Social Protection in order to use savings from improvement of the targeting performance of the Social Safety Net System to increase the level of the means-tested cash benefit.
Appendix C. List of Persons Met

Government

Ms. Suzana Peneva, State Advisor, Ministry of Finance
Mr. Dejan Nikolovski, Public Debt Department, Ministry of Finance
Ms. Verica Prokovic, Head of Budget Department, Ministry of Finance
Ms. Mara Srezovska, Head of Treasury, Ministry of Finance
Ms. Hristina Trajkovska, Ministry of Finance
Ms. Ana Todorovska, Ministry of Finance
Ms. Mara Srezovska, Head of Treasury, Ministry of Finance
Ms. Vesna Svetanova, Macro Department, Ministry of Finance
Mr. Jordan Trajkovski, Ministry of Finance
Ms. Tanja Tripunova, Assistant Head, Budget Department, Ministry of Finance
Ms. Maja Arcirovska, Budget Department, Ministry of Finance
Ms. Liljana Govrovksa, Treasury Department
Mr. Toshe Panovski, Head of Unit, Budget and Budget Policy, Ministry of Finance
Mr. Nexhati Kurtishi, Ministry of Finance
Ms. Bojana Ilievksa, Ministry of Finance
Ms. Biljana Cevlevska, Ministry of Health
Ms. Jasmina Ivanova, CCT Project Director, Ministry of Labor and Social Policy
Ms. Elizabeta Kunovska, Ministry of Labor and Social Policy

National Bank

Ms. Anita Angelovska-Bezovska, Vice Governor

International Monetary Fund

Ms. Jasmin Rahman, Mission Chief, IMF
Mr. Patrick Gitton, Resident Representative, IMF

World Bank Group

Mr. Goran Tinjic, Senior Operations Officer
Ms. Birgit Hansl, Program Leader
Ms. Doerte Doemeland, Lead Economist
Mr. Bojan Shimbov, Economist
Mr. Gianfranco Bertozzi, Lead Financial Specialist

Nongovernmental Organizations

Mr. German Filkov, Center for Civil Communication
Mr. Marjan Petreski, University American College, Skopje
Ms. Blagica Petreski, Finance Think
Mr. Mile Boshkov, Business Confederation of Macedonia
Appendix D. Borrower Comments

To: The World Bank
1818 H Street N.W.
Washington, D.C. 20433
U.S.A.

Attn: Mr. Mark Sendberg
Manager, Economic Management and Country Programs, Independent Evaluation Group

Subject: Policy Based Guarantee Project (IBRD-G-2080) and Public Policy Based Guarantee Project (IBRD-G-2170)
Draft Project Performance Assessment Reports (PPARs)

Dear Mr. Sendberg,

With reference to your letter dated 7th June 2016, transmitting the Project Performance Assessment Reports (PPARs) of the two Policy-Based Guarantee Projects prepared by the Independent Evaluation Group (IEG), please find below consolidated comments from all relevant national institutions included in the implementation of PBG loans.

Comments on the Project Performance Assessment Report for Macedonia Policy-Based Guarantee PPA Report (G-2080-MK, P125837), June 1, 2016

Chapter 1. Background and Context:

- **Section 1.3** The wording on Macedonia’s ranking in the Doing Business Report: "In 2010, it ranked 38th in the world, an exceptional improvement from 92nd position in 2006. It continued to improve its ranking and achieved the 22nd rank in the world in 2012; as of 2015, it still ranked 30th in the world, which remains the highest in the Western Balkans.” has to be updated with the rankings from Doing Business 2016 Report, ranking the Republic of Macedonia as 12th in the world.

- **Section 1.4** The sentence on unemployment “Labor Force Survey (LFS) data, indicate that unemployment dropped from 37 percent in 2004 to 32 percent in 2009 and further to 28 percent in 2014 (World Bank 2015), but youth unemployment at 35 percent remains very high.” has to be updated with the data available for 2015 and/or Q1 2016 published by the State Statistical Office. Unemployment rate in Macedonia dropped to 26.1 percent in 2015, while the data for Q1 2016 show an unemployment rate of 24.5%.

Chapter 5. Ratings/Outcome: Moderately Satisfactory

- **Section 5.5** With reference to the sentence “The Central Bank would have likely had to tighten policy more in the absence of the PBG, with attendant effects on economic
activity", we would like to emphasize that considering we were in a cycle of monetary accommodation, the more appropriate wording would be: "The Central Bank would have reduced the scope of monetary accommodation in the absence of the PBG, with attendant effects on economic activity".

**General comments on the PPA Report (G-2080-MK, P1255837)**

- We would like to emphasize that the reference 'Former Yugoslav Republic of Macedonia' used throughout the Report should be replaced by the constitutional name of the country "Republic of Macedonia".

Comments on Project Performance Assessment Report for Macedonia Public Expenditure Policy-Based Guarantee PPA Report (G-2170-MK), June 1, 2016

Regarding the overall outcome of the Project, which is rated moderate satisfactory, we would like to stress that the Republic of Macedonia ensured efficient and effective preparation and implementation of all covenants and achieved the development goals determined in the agreements. Main Project development objectives of the PEPBG were to improve the efficiency of public expenditures by strengthening public financial management practices, improving the efficiency of service provision in the health sector, and strengthening social protection and inclusion. All prior actions were completed prior to the Board presentation and all outcome targets were achieved well within the timeframe outlined in the Project document. The design of the operation was very well prepared based on ongoing Government reforms, focusing on three reform pillars, eight prior actions and eight measurable outcome indicators. This reflected Government’s commitment to the Program, as well as the Bank's ability to rapidly respond to the request of the client by providing sound policy advice and leveraging support from other stakeholders. For all these reasons, and the fact that the MoF was in charge of monitoring, coordination and overall implementation of PBG, I strongly believe the Program should be rated as satisfactory and that this rating will be envisaged in the final Report.

**Chapter 1. Background and Context/Section 1.4:**

- Sentence on economic growth: "In the years following the approval of the PEPBG, Macedonia experienced a resumption of economic growth aided by overall improvement in regional and global economies" should be supported by numerical evidence.

- The wording "50 percent" in the sentence "Public and publicly guaranteed debt (PPG) approached 50 percent of gross domestic product (GDP) by the end of 2015", should be replaced with the wording '46.5 percent'. This is according to the preliminary debt data of the MoF.

- With respect to the sentence "Against the background of growing indebtedness, repetitive delays in fiscal consolidation and political uncertainties, Macedonia saw an increase in the spreads on its international bonds by the end of 2015.", we would like to point out that the main driver of increase in the spreads of Macedonian bonds is the political situation and the uncertainty. FY 2015 ended with budget deficit of 3.5% of GDP, lower than the deficit projected in the Supplementary Budget, and growth of 3.7% of GDP. Having in mind these numbers, this sentence should be deleted, since the basis on which the Bank grounds this statement is not clear.

**Chapter 4. Relevance of Design - Modest/Choice of the Instrument:**

- Section 4.2: The wording "10 percent" in the sentence "Macedonia is the only country that..." should be replaced with a specific percentage based on the latest data available.
has benefited from two PBGs under which €255 million of the Bank's guarantees leveraged €380 million of commercial loans, which comprised about 10 percent of Macedonia's outstanding public debt as of 2015" should be replaced with the wording "8.9 percent".

- Section 4.5: The sentence "This is an indication that the government's spending plan expanded toward the end of 2012 against the backdrop of available financing. should be deleted because budget financing in mid-2012 was used for budget financing needs and debt repayment in 2012. PBG2, contracted in January 2013, was used to cover budget needs and debt repayment throughout 2013 and half of 2014, having in mind that the next international borrowing of the country happened in mid-2014 by issuing the Eurobond in the amount of EUR 500 million. The Report, in particular this paragraph, contains conclusions based on lack of information. Making a statement that the Government spending plan expanded in 2012, due to new borrowing in the amount of additional EUR 250 million, without commenting on the financing needs and debt profile for the same period, as well as not indicating the period in which these proceeds were being used, is speculative, misleading and tendentious.

Chapter 6. Achievement of Objectives/Macroeconomic Developments in 2013-2015 (not rated), Fiscal Transparency and Efficiency of Public Expenditures:

- Section 6.1 Text on the economic growth in Section 6.1 should be supported by numerical evidence, indicating the magnitude of its relative strength.

- Section 6.3 The sentence "Macedonia PPG debt is estimated to exceed 48 percent of GDP by the end of 2015, which is 10 percent point higher than in 2012" should be replace with the following sentence "Macedonia PPG debt accounted for 46.5 percent of GDP by the end of 2015, being by 8 percent points higher than in 2012".

- Section 6.5 As regards the sentence "Macedonia went back to the international bond market in mid-2014 with an issuance of €500 million Eurobonds having a 10-year maturity and an interest rate of 3.95 percent (an estimated spread of around 3 percent against German 10-year bonds), the Eurobond (notes due 2021) was issued with a 7-year tenor, so we would like to point out that the wording "10-year" should be replaced with the wording "7-year".

- Section 6.13 The wording "10 percent of GDP" in the sentence "Implementation of PESR projects will add an estimated 10 percent of GDP on the country's debt stock over the medium term" should be replaced with the following wording "around 5 percent of GDP by the end of 2018".

- Section 6.17 The sentence "The result has been the implementation of several controversial large investment projects such as the Skopje urban beautification project (known as Skopje-2014 project), which reportedly cost hundreds of millions of euros." should be deleted.

Chapter 8. Risks to Development Outcomes/Section 8A:

- As regards Section 8A, we would like to point out a general comment that according to the latest 2016 – 2018 Fiscal Strategy, public debt, which includes both general government debt and PPG debt, will reach the level of 52.4 percent of GDP, which is lower that the ceiling of 60 percent of GDP. Additionally, MoF analyses show that public debt is
sustainable over the medium term.

**General comments on the PPA Report PBG (G-2170-MK)**

- We would like to point out that the reference "Former Yugoslav Republic of Macedonia" used throughout the Report should be replaced by the constitutional name of the country "Republic of Macedonia".

- As regards the source of information in some of the tables, saying they are provided by the "Ministry of Social Protection", it should be replaced by "Ministry of Labor and Social Policy, since "Ministry of Social Protection" does not exist.

Sincerely yours,

[Signature]

Minister of Finance