

Report No: AUS0001657

Republic of North Macedonia: Action Plan for Recovery of Growth and Jobs

June 2020

The World Bank



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Acknowledgements

The Government of North Macedonia has identified a need to accelerate efforts to reduce unemployment and bring more citizens of North Macedonia into the labor market. It recognizes the complexity of this task, which requires a holistic approach, a long-term development vision and careful identification of priorities and sequencing of policy actions and support programs. The Government has requested World Bank support in outlining the **Growth and Jobs Agenda**.

This report, building on the past and new analytical work, takes stock of the factors at play in the **Growth and Jobs Agenda** for the country, and identifies challenges and opportunities to address this agenda going forward. It also sets the framework in a holistic policy matrix to help inform policy options, institutional reforms, and support programs that may be needed to respond to the challenges of the **Growth and Jobs Agenda**.

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Acronyms

ALMPs	Active Labor Market Policies	MNCs	Multinational corporations
ASE	Agency for Support to Entrepreneurship	MSME	Micro, small, and medium-sized enterprises
BRR	Business Regulation Review	NEET	Not in Employment, Education or Training
CIT	Corporate Income Tax	NIS	National innovation system
CMT	Cut-Make-Trim	NTB	Nontariff barrier
CPC	Commission for Protection of Market Competition	ODM	Original design manufacturer
EBRD	European Bank for Reconstruction and Development	OEM	Original equipment manufacturer
ECA	Europe and Central Asia	PCG	Partial credit guarantee
ESA	Employment Services Agency	PCIE	Peripheral Component Interconnect Express
ETF	European Training Foundation	PES	Public Employment Services
EDIF	Electronic Design Interchange Format	PIT	Personal Income Tax
FITD	Free industrial and trade development	PMR	Product Market Regulation
G2B	Government-to-business	RIA	Regulatory Impact Assessment
GCI	Global Competitiveness Index	SCD	Systematic Country Diagnostic
GMA	Guaranteed Minimum Assistance	SDP	Supplier Development Program
GPA	Government Procurement Agreement	SME	Small and medium enterprises
ILO	International Labour Organization	SOE	State-owned enterprise
IPA	Investment Promotion Agency	STEM	Science, technology, engineering, and math
ITS	Investor Tracking System	STEP	Skills towards Employment and Productivity
KfW	German state-owned development bank	SWC	Social Work Centers
KPI	Key performance indicator	TFP	Total factor productivity
LFS	Labor Force Survey	TFPR	TFP of revenue
LMSO	Labor Market and Skills Observatory	TIDZ	Technological and industrial development zone
M&E	Monitoring and evaluation	TVET	Technical and Vocational Training
MB	Management Board	WBG	World Bank Group
DBNM	Development Bank of North Macedonia	WBL	Women, Business and the Law

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EXECUTIVE SUMMARY

North Macedonia has made considerable progress in recent decades, moving from lower-middle to upper-middle income status, and from a planned to a functional market economy. Since the early 2000s, the country has undertaken major reforms to promote private investment, among them initiatives to reduce the burden of business regulations and attract foreign direct investments into manufacturing around the technological and industrial zones. The government led reforms that made the labor market more flexible, improve the land cadaster and real estate registry, and reinforced the financial system and its regulation. As a result, since 2004 North Macedonia has improved its *Doing Business* coming in at a remarkable 17th of 189 countries in 2019 and outperforming the average European country.

Despite these reforms, the domestic economy still lacks the needed dynamism to move into higher-income status, as evidenced by a declining and low productivity challenge. Firms owned by domestic investors, which are mainly micro, small, and medium, show low and stagnant productivity levels in recent years. These firms sell mainly to the domestic market; they have few links to regional or global value chains. Macroeconomic data also show that the contribution of total factor productivity to economic growth has been negative in recent years. Moreover, there is evidence that misallocation of production factors has contributed to this low productivity growth in North Macedonia, and, in fact, a second sign of resource misallocation is that many large firms are less productive than smaller firms.

Compounding this challenge, the economy also faces a low employment and skills challenge. Because of the subpar performance of domestic firms, employment creation has been insufficient to improve the poor labor market outcomes observed since independence. Despite recent progress, North Macedonia continues to show high levels of unemployment and low labor force participation, as well as sub-par indicators of employment quality. In 2019, barely half of people of working-age in North Macedonia were employed. Youth unemployment and NEET shares are considerably high, reflecting challenges to gain a foothold in the labor market for newcomers. Firms also face difficulties finding workers with the right skills, as the training provided in the educational system does not match adequately the needs of firms.

To address its productivity challenge North Macedonia will need to continue to attract FDI and engage in an ambitious strategic regulatory and firm-level reform agenda. Growth in productivity will depend critically on how well the country can attract high-value-added FDI and build a strong, outward-looking, export-oriented private sector. While continuing to attract FDI, North Macedonia needs to push its private sector to venture into the global market and create an enabling environment for current exporters to grow, become more productive, or exit the market, and for new firms to emerge and succeed or fail fast and cheaply. North Macedonia must therefore embark on an ambitious strategic regulatory and firm-level reform agenda to stimulate growth and increase productivity, particularly to:

- Further improve regulatory environment,
- Boost the effectiveness of the competition and state aid policy framework and enforcement,
- Ensure access to finance to SMEs,
- Attract and retain higher value-added investments,
- Strengthen FDI linkages, and
- Improve domestic firm capabilities.

North Macedonia will need, as well, to continue supporting the development of a skilled and well-trained labor force that can match the upcoming demands of the private sector. Improving labor market outcomes will require to accompany the interventions aimed at spurring investment and firms' growth with interventions on the supply side of the labor market. These efforts will require interventions focused on improving young workers readiness for the labor market and employability,

while also supporting the institutions needed to facilitate the smooth functioning of the labor market, as well as the decision making related to career choices. Relaxing labor market regulations affecting young workers and promoting the activation of inactive workers will also play an important role to improve labor market outcomes. Altogether, the reforms needed to improve the poor labor market outcomes will require a strategy with actions in the short and medium term aiming at:

- Facilitating youth acquisition of labor market experience,
- Addressing skills shortfalls,
- Strengthening labor market intermediation,
- Disseminating more labor market information,
- Issuing conducive labor market regulations, and
- Improving the employability and earning opportunities of social assistance beneficiaries.

Finally, the current context of the COVID-19 crisis requires the economy to adapt to a new normal. The COVID-19 pandemic required countries to take immediate measures to protect lives and livelihoods. The lockdown and containment measures undertaken brought most of the economies into a recession and required a massive support to households and firms for job protection (Box 1). Besides financial support to affected firms and households, for the recovery phase structural adjustments are needed in North Macedonia (as in other countries) to strengthen resilience of firms, households and the economy.

Box 1. Countering the Negative Effects of the Pandemic in North Macedonia

The government of North Macedonia have implemented different actions to counter negative economic impacts since the start of the pandemic. By March 2020, the National Bank had lowered the base rate in two steps to a historic low of 1.75 percent, provided additional liquidity to banks by lowering the amount of C-bills auctioned, reactivated the unconventional measure related to the reserved requirements instrument to support most affected sectors and several regulatory measures aimed to maintain the banks' credit cycle. By June, to support people and firms the government implemented a package of measures amounting to about 2 percent of GDP. It includes increased spending on health care, medicines, and equipment, partial social contributions and wage subsidies to all affected firms, unemployment benefits and social assistance to the people affected, delayed revenue collection and subsidized loans to smaller businesses. For the recovery phase, there is an additional 1.5 percentage points of GDP package announced.

While the detailed policy matrix Among the key short-term priorities to build back better and recover faster are the following:

- i. To accelerate corporate restructuring, the legislative framework needs to be amended to further encourage tackling distress on time, eliminate (or significantly amend) the law on out-of-court settlements, improve the institutional framework for insolvency practitioners, remove the incompatibility with other professions, and create an efficient mechanism for licensing and monitoring of their performance.
- ii. To ensure a level-playing field, an inventory of State aid, including *de minimis* aid, should be established under the authority of the Commission for the Protection of Competition to start reforming the state aid towards horizontal support measures.
- iii. To ensure access to finance for SMEs, the analysis of setting up a credit guarantee scheme under DBNM is needed, along with enacting a unified legal framework for creating security over all types of movable assets and establishing a centralized collateral registry for security interests in movable property to remove obstacles for acceptance of movable collateral by banks.

- iv. To attract investments that look for nearshoring, development of a targeted FDI promotion strategy aimed at attracting investments that would lead to export promotion, job creation, and green economy would be useful.
- v. To facilitate youth acquisition of labor market experience and address skills shortfalls, the government may want to adjust VET and university class schedules to better match company needs for students and interns, and establish a sustainable structure for employers (business organizations and industry chambers) to contribute to regular curriculum reforms in vocational schools, such as biannual roundtables.
- vi. To strengthen labor market intermediation, the government may explore outreach and promotion of ESA services in secondary schools (general and technical) to increase use of services by the low-skilled.
- vii. To make the labor market regulations more conducive, the government could include employers in consultations about setting the minimum wage and introduce a methodology for calculating the minimum wage based on labor productivity and other fundamentals of the economy.
- viii. To avoid scarring and improve the employability and earning opportunities of GMA beneficiaries, it would be important to prioritize adults under 35 years old as the program starts, as this group is a sizable share of beneficiaries and has slightly fewer challenges than other groups identified for activation.

To deliver fast on the needed priorities, issues of coordination across ministries, problems of collective action, issues of information frictions between the public and the private sector (including in the skills agenda, for example) remain very relevant. Some countries set up a special delivery unit within the Cabinet to help deliver the complex and multi-sectoral policy agenda, as well as monitor and report results.

A. GROWTH AND JOBS CHALLENGE

1. **Since its independence in 1991, North Macedonia has advanced from lower-middle to upper-middle income status, and from a planned to a functional market economy, aspiring to EU membership.** The initial pace of its reforms after independence was faster than in other Western Balkan countries. The largest gains, which took place in the 1990s, were in trade, price liberalization, foreign-exchange management, and privatization. Since the early 2000s, the country has undertaken major reforms to promote private investment, among them initiatives to reduce the burden of business regulations and attract foreign direct investments into manufacturing around the technological and industrial zones. The government led reforms that made the labor market more flexible, improve the land cadaster and real estate registry, and reinforced the financial system and its regulation. As a result, since 2004 North Macedonia has improved its *Doing Business* coming in at a remarkable 17th of 189 countries in 2019 and outperforming the average European country. Along the same path, it attracted investments from the global car-supply chain which helped halve the unemployment down from its peak in 2006 of 36 percent.

2. **However, the country's *Doing Business*-related reforms have not infused expected dynamism into the domestic economy.** Domestic firms, which are mainly micro, small, and medium, sell mainly to the domestic market; they have few links to regional or global value chains. Firms have also suffered from unstable regulation in aspects not covered by the *Doing Business* report, such as regulation of enforcement, transparency, and predictability; and there is evidence that market entry and exit are not easy. Representatives of the private sector express concerns about slow contract enforcement and the efficiency of courts, ineffective insolvency procedures, the collateral regime for movable assets, which is based on an outdated law on contractual pledges rather than a modern secured transactions system, uneven digitalization of agencies and ministries responsible for day-to-day business procedures, the limited evidence base for rulemaking and the lack of transparency and predictability of government-to-business (G2B) services, particularly for business inspections. Additionally, unfair competition, skills, access to finance and political instability are rated among biggest obstacles by firms in North Macedonia in 2019 (Table 1).¹

Table 1. Biggest Obstacles to Firms in North Macedonia in 2019 (percent of firms choosing an obstacle)

	North Macedonia	Europe & Central Asia
Political instability	28.6	10.7
Practices of the informal sector	13.9	13.3
Inadequately educated workforce	13.0	13.0
Access to finance	10.1	9.8
Transportation	7.3	4.7

Source: World Bank. Enterprise Survey 2019.

3. **The COVID-19 pandemic required immediate measures to protect lives and livelihoods, and the lockdown and containment measures brought economies into a recession.** North Macedonia is not an exception:² restrictions on movement and social distancing have affected labor supply and demand, transport and travel in unprecedented ways. Whole sectors of economy have been shut down—restaurants, hotels, nonessential retail trade, tourism, transport, and much manufacturing. Despite government support packages, businesses throughout the economy are suffering losses that threaten their operations and solvency. The most affected are small and medium-sized firms and informal businesses, and employment contraction has started. The magnitude of the adverse impact will depend on the evolution of the crisis—whether recovery is V-shaped, L-shaped, or U-shaped; and how effectively government measures would protect jobs and firms. Nevertheless, North Macedonia

¹ World Bank. Enterprise Survey 2019.

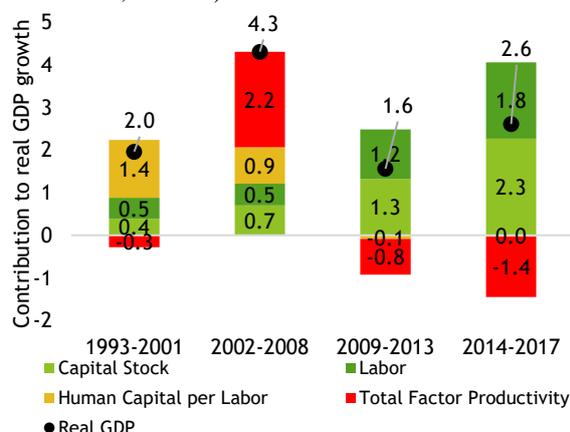
² World Bank Regular Economic Report, Spring 2020.

will need to return to sustainability and find a growth model that would help the economy emerge out of this unprecedented crisis swiftly.

Declining and Low Productivity Challenge

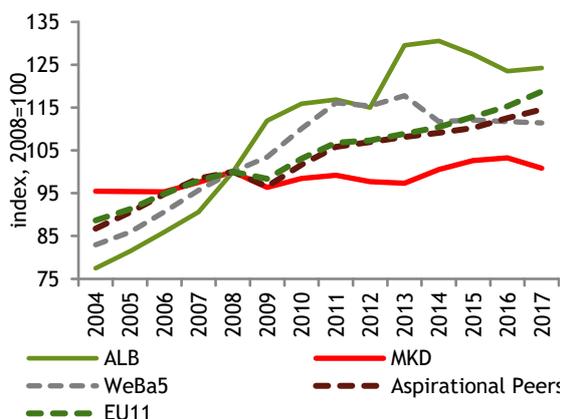
4. **Even before the COVID-19 crisis, the potential growth has been declining.** North Macedonia has seen positive levels of economic growth since its independence in 1991, but growth rates have been lower than those of neighboring countries. A key contributor to this low growth rate has been low and sometimes negative growth in productivity. Between 1993 and 2001 and after 2009 the contribution of productivity of total factor productivity to overall economic growth has been negative (Figure 1) and the growth of labor productivity has been much lower than that of neighboring countries (Figure 2).

Figure 1. The contribution of total factor productivity has been negative in recent years
(Contribution to GDP Growth, pp, by Factors of Production, Percent)



Source: World Bank (2018), based on data from the national authorities and Eurostat.

Figure 2. Contrasted with comparison countries, labor productivity has been low
(Value Added Per Worker Index, 2008=100)

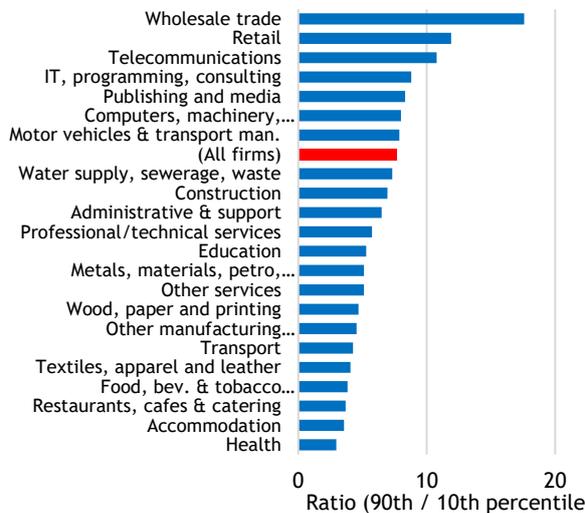


Labor productivity is calculated using the annual growth of value added per worker.

Source: World Bank (2018), based on data from the national authorities and Eurostat.

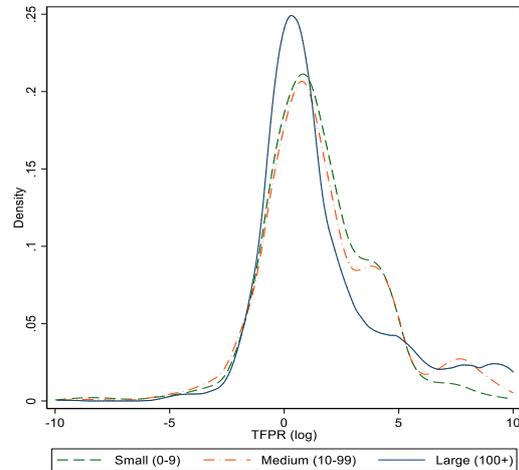
5. **There is evidence that misallocation of production factors has contributed to the low productivity growth in North Macedonia.** Despite high investment levels, economic growth has been low, suggesting that capital is not invested where it results in the highest returns. The rate of return on investment has fallen since 2000 and this decline has been larger than in some neighboring countries (World Bank 2018). Furthermore, the movement from labor-intensive to more-productive sectors has been slow: there have been few changes in the sectoral allocation of labor and much of the employment is still found in the less productive agricultural sector (Koettl-Brodmann et al., 2018).

Figure 3. Production dispersion is high, especially in the service sector.
(Productivity Ratio between the 10th and the 90th Percentile, 2011-2016 Average)



Source: Author's calculations: Background paper prepared for this report by Cusolito, Davies, Hernandez, and Pena (2018), based on data from the North Macedonia's firm registry.

Figure 4. Larger firms are not more productive than smaller firms, except for a small group of firms at the top end of the distribution.
(Distribution of TFPR by Firm Size, 2011-2016 Average)



6. **The firm-level data confirms the pattern of low and stagnant firm productivity found by macroeconomic assessments.** Firm productivity growth was low or negative between 2011 and 2016: on average across all firms, total factor productivity of revenue (TFPR) fell by 2.8 percent and value added per worker by 0.6 percent. The considerable dispersion of productivity among firms in North Macedonia suggests that productive factors are inefficiently allocated. While this dispersion can be explained by differences in the degree of technology adoption, management capabilities, worker skills, product quality, and markups—its magnitude is a sign that gains can be made by moving capital and labor from less productive to more productive industries.³ In advanced economies like the United States, firms in the 90th percentile are only twice as productive as firms in the 10th percentile.⁴ In North Macedonia, the dispersion is significantly larger: firms in the 90th percentile are 7.6 times more productive than firms in the 10th percentile (Figure 3). In wholesale, retail, and telecommunications, a firm in the 90th percentile is more than 10 times as productive as one in the 10th percentile (Figure 4). In manufacturing, the largest dispersions can be found in machinery and equipment (8 times), motor vehicles (8 times), and materials (5 times).

7. **A second sign of resource misallocation is that many large firms are less productive than smaller firms.** When factors of production are allocated efficiently, productive firms expand by taking on additional labor and capital, which makes them more productive than smaller firms due to economies of scale.⁵ However, many large firms in North Macedonia are less productive than small and medium firms: the median large firm (100 or more employees) is 41 percent less productive than the median medium-sized firm (10 to 99 employees) and 47 percent less productive than the median small firm (less than 10 employees). A third sign of resource misallocation is that most of the growth in TFPR in North Macedonia is explained by TFPR growth in existing firms (within-firm productivity associated with the upgrading of firms' internal capabilities by innovating and adopting new technologies and better managerial practices), rather than by capital and labor moving to more productive firms (between-firm productivity).

³ Hsieh & Klenow 2009.

⁴ Table 2, Hsieh & Klenow 2009.

⁵ See Cabral and Mata (2003).

8. **Policies that would underpin productivity growth of firms are important for creating better and more jobs.** More productive firms pay higher wages, therefore creating better jobs. Current job growth was almost exclusively underpinned by the large state aid and low labor costs which is not sustainable model. Long-term increases in earnings in industry or agriculture—the source of employment and livelihoods for many of the poor—can be achieved only by increasing worker or farmer productivity. Workers will leave informal self-employment only if earnings in the formal sector merit the shift. Hence, the route to generating good jobs transits directly through a sustained agenda to raise productivity. In addition, productivity-driven cost reductions reduce the prices of key products consumed by the poor and thereby increase household purchasing power, helping poorer households get more for less.⁶

Figure 5. Wages tend to be higher at more-productive firms...

(Employment and average level of wages by within-industry TFPR quintile, 2013-2016)

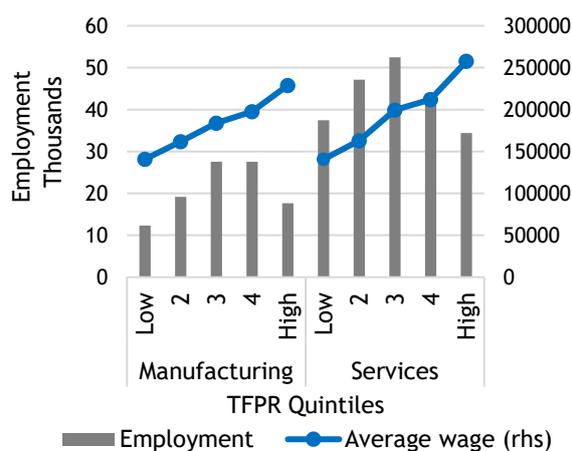
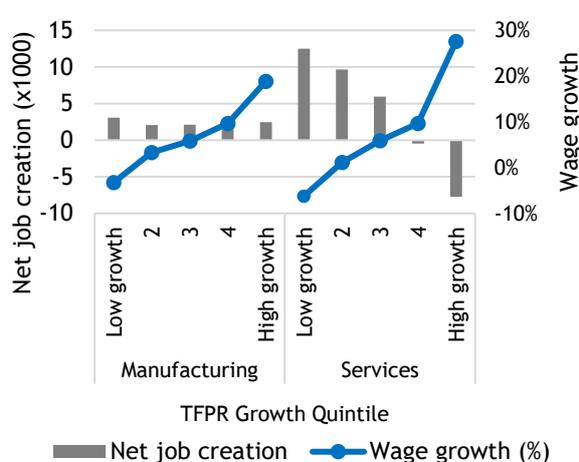


Figure 6. ...and wage growth is associated with productivity growth.

(Net job creation and wage growth by within-industry TFPR growth quintile, 2013-2016)



Source: World Bank (2019) Systematic Country Diagnostic.

9. **In advanced economies, firm entry and exit are important drivers of productivity growth, but in North Macedonia both rates are relatively low and contribute little to productivity growth.** New firms usually heighten productivity by introducing new technologies, filling gaps in the market, and increasing market competition; the exit of unproductive firms improves productivity by freeing up resources.⁷ In North Macedonia, the rates of firm entry and exit are lower than in peer and OECD countries (Figure 7). This lack of business dynamism may play an important role in preventing productivity growth. Note that the exit component is generally negative: relatively productive firms are leaving, while less productive firms stay.⁸

10. **Compared to peer countries, North Macedonia has few high-growth firms, especially in the service sector.** High-growth firms are the dynamic core of an economy, set apart by their disproportionate ability to generate output and create jobs. Evidence for high-income countries shows that these firms form a small share of the total number of businesses—often less than 10 percent—but account for more than half of the entire change in employment and output.⁹ Firms that sustain consistent employment growth over time are an important source of jobs and productivity growth in advanced economies. In the United States, high-growth firms create over 60 percent of new jobs.¹⁰ In

⁶ Cusolito A.P. and W.F. Maloney (2019). Productivity Revisited, World Bank Group

⁷ See Foster, Haltiwanger and Syverson (2008).

⁸ When separating entry and exit in the decompositions, entry contributes positively to productivity growth in most industries, indicating that entry boosts productivity. New firms establish themselves in more productive industries but tend to be less productive than established firms in these industries.

⁹ Goswami A.G., D. Medvedev, E. Olafsen (2019). High-Growth Firms, World Bank Group

¹⁰ Haltiwanger et al. (2016).

North Macedonia, 10.4 percent of manufacturing firms and 5.5 percent of medium-sized service firms experienced an average annual growth in employment of more than 10 percent over a three-year period (Figure 8). These shares of high-growth firms are significantly lower than in peer countries like Estonia, Lithuania, Latvia, and Slovakia, especially in the service sector.

Figure 7. The rates of firm entry and exit in North Macedonia are below those of peer countries.
(New Firms as Percentage of Total Firms, 2015)

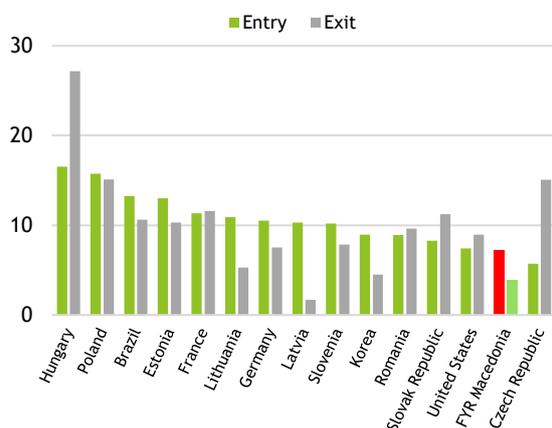
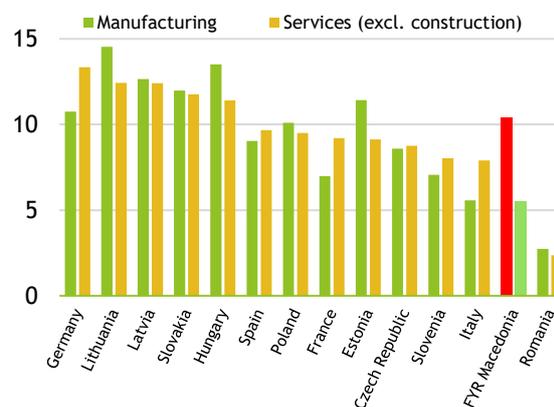


Figure 8. Many high-growth firms are in the manufacturing sector, and only few are in services.

(High-growth Firms as Percentage of All Firms with 10 or More Employees, 2015)



Source: Author's calculations, Cusolito, Davies, Hernandez, and Pena (2018), based on the North Macedonia firm registry; for other countries: OECD Structural and Demographic Business Statistics (SDBS).

11. **Growth in productivity will depend critically on how well the country can attract high-value-added FDI and build a strong, outward-looking, export-oriented private sector.** In recent years the arrival of foreign investments has not yet brought about a visible, sustained increase in growth, productivity, and use of technology in domestic firms. Rather, North Macedonia appears to have a dual economy in which strong foreign direct investment (FDI) drives export growth and contributes to job creation, but domestic firms are neither productive nor competitive. Domestic firms suffer from coordination failures and management capability challenges; inadequate knowledge of international markets, innovation, and international standards; limited access to finance; and problems of corporate governance that make it difficult for them to link with the foreign firms. To address these issues, the country would benefit from a better-targeted strategy to promote FDI in higher-value-added sectors and activities and improve the cost-effectiveness and transparency of investment incentives.

12. **Competition policy needs to be reinforced.** Informal practices need to be dealt with, while state aid in general should be reformed given large imbalances in its size and structure relative to EU standards and evidence that it is not effective, especially in agriculture and manufacturing. To address human capital development, R&D, and innovation, reforms should transition from sector-specific to the horizontal types of state aid that predominate in the EU. Government programs and instruments that provide firms with access to funding for activities to help them grow are falling short of their objectives. Unfortunately, these programs generally subsidize inputs rather than upgrading firm capabilities; the programs are atomized and spread across multiple institutions, some of which overlap in their policies and activities; they are also too small to substantially heighten a firm's capabilities and ability to upgrade. Moreover, due to the lack of rigorous empirical evaluations, the impact of most of these programs is not known.

13. **Accessing finance is also difficult, particularly for micro and small firms and start-ups;** though banks have ample liquidity, their collateral requirements are high. The Development Bank of North Macedonia (DBNM) needs to strengthen its role in promoting economic development and exports by facilitating SMEs' access to finance; and the insolvency and creditors' rights system needs to be reformed.

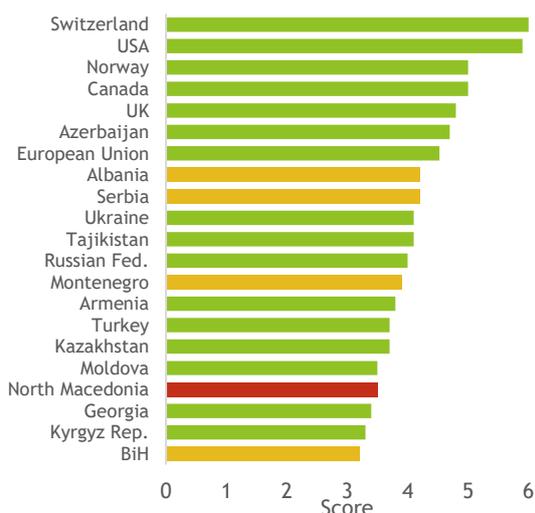
14. **While continuing to attract FDI, North Macedonia needs to push its private sector to venture into the global market and create an enabling environment for current exporters to grow, become more productive, or exit the market, and for new firms to emerge and succeed or fail fast and cheaply.** North Macedonia must therefore embark on an ambitious strategic regulatory and firm-level reform agenda to stimulate growth and increase productivity, particularly by:

- Making business regulations more effective and predictable by ensuring private sector engagement and increasing transparency;
- Making competition policy more effective, e.g., by keeping the public sector neutral;
- Accessing finance more effectively;
- Attracting more efficiency-seeking FDI in higher-value-added segments;
- Increasing links between foreign-funded and domestic firms; and
- Helping firms to build their capabilities and adopt the international quality standards and technology necessary to join global value chains.

Low Labor Participation and Skills Challenge

15. **The country’s reforms have neither contributed substantially to improve the poor labor market outcomes observed since independence.** Despite recent progress, North Macedonia continues to show high levels of unemployment and low labor force participation, as well as sub-par indicators of employment quality. In 2019, barely half of people of working-age in North Macedonia were employed, product of high unemployment rate (17.4 percent in 2019) and high inactivity rates (33.7 percent). Unemployment and inactivity cause workers to waste about 25 years of productive employment during their lifecycle (World Bank, 2018). Youth unemployment is considerably high, reflecting challenges to gain a foothold in the labor market for newcomers. The poor labor market situation of young people is also reflected in high rates of the youth population not in education, employment or training (NEET) (24.9 percent in 2017). These grim prospects for youth represent a challenge, as prolonged spells of unemployment and inactivity in these early years negatively affect subsequent labor market outcomes.

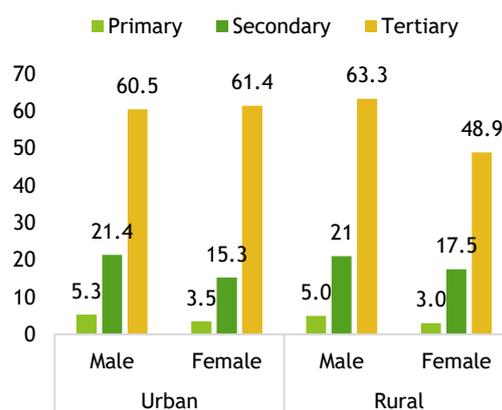
Figure 9. Firms report employee skills shortfalls. (Global Competitiveness Index, 2018)



Source: World Economic Forum, GCI 4.0 (2018). Graduates skillset adequate [1=Not at all; 7=To a great extent].

Figure 10. Use of ESA services is higher among the more educated.

(Unemployed registered at ESA, 2017)



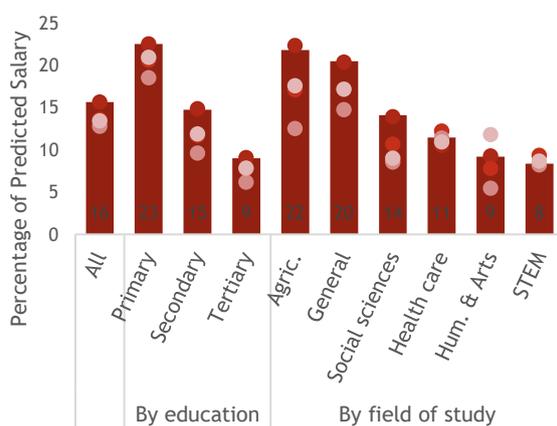
Source: World Bank (2019), based on 2017 LFS. Ages 15 to 29 years old.

16. **Due to the weak labor market performance, waves of outmigrants have left the country looking for opportunities abroad.** Based on census data from destination countries, current emigrants from North Macedonia, mainly settled in Turkey and Western Europe, already constitute 25 percent of the population, and the number has been rising for the last 10 years. Because emigrants are self-selected, they tend to be motivated workers in their most productive years, and their departure is a severe blow to productivity (World Bank, 2018).

17. **Improving labor market outcomes will require to accompany the interventions aimed at spurring investment and firms' growth with interventions on the supply side of the labor market.** A critical component of these interventions should be focused on improving young workers readiness for the labor market and employability. Lack of experience among young workers is as a key constraint for firms intending to hire, hence measures aiming at facilitating the acquisition of work experience while in school and ensuring flexible forms of employment for entry-level jobs will be important to relax this constrain. Firms also face difficulties finding workers with the right skills (Figure 9), as the training provided in the educational system does not match adequately the needs of firms. Solving this problem will require more involvement from the private sector for the design of curricula, identification of skills needed (including socio-emotional) and even in the provision of on-the job-training.

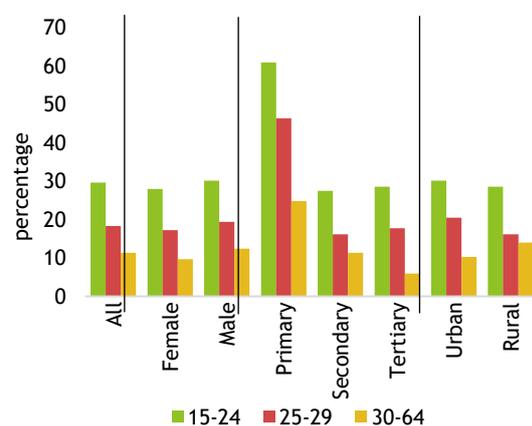
18. **Actions to improve intermediation and increase the amount of information available about labor markets can also contribute to improve labor market outcomes.** Labor market intermediation remains mainly informal in the country, as the most prevalent method used for finding employment is the use of personal networks, like friends, relatives or acquaintances. Moreover, employment services are only used significantly by those with high education (Figure 10). In addition, the limited capacity of state institutions to use an otherwise well-developed system for labor market intelligence limits the responsiveness to employers' demands, and the availability of information for jobseekers and students. This lack of information contributes to the disparities observed between expected salaries and what is observed in the market (Figure 11).

Figure 11. Workers expect higher salaries than what can be expected according to qualifications. (Gap between Worker Reservation Wages and Predicted Salaries, by Education and Field)



Source: Petreski et al. 2019. Bars and dots represent results of using slightly different methodologies.

Figure 12. Youth are more likely to work under temporary contracts (Workers Employed on Temporary Contracts, by Education and Age Group, 2016)



Source: WB calculations based on 2016 LFS

19. **Relaxing labor market regulations affecting young workers and promoting the activation of inactive workers will also improve outcomes.** Rigid regulations on short-term contracts as well as on apprenticeships contracts disproportionately affect youth (Figure 12). In addition, the minimum wage may be binding for youth, particularly those with low education. Worryingly, the level of minimum wage in recent years has increased at a faster pace than labor

productivity, which may discourage hiring of young workers, affecting especially those with low education. With respect to activation of inactive workers, work-able beneficiaries of Guaranteed Minimum Assistance program are expected to participate in programs for social activation, with the objective of reducing benefits' long-term dependency by becoming active and taking up jobs. This activation efforts can have a positive impact on labor market outcomes, albeit their magnitude is conditional on a substantial expansion of employment in the country.

20. **North Macedonia needs to continue supporting the development of a skilled and well-trained labor force, that can match the upcoming demands of the private sector**, while also supporting the institutions needed to facilitate the smooth functioning of the labor market (for instance, in transitions in and out of unemployment), as well as the decision making related to career choices. These actions will also reflect in better prospects for employment in the country, addressing one of the main reasons for the continuous flow of outmigrants. All these areas constitute components of a strategy for the development of the work force that should consider salient issues, such as:

- Youth labor market experience acquisition
- Addressing skills mismatches
- Strengthening labor market intermediation
- Increasing labor market information
- Promoting conducive labor market regulations
- Activation of income-support program beneficiaries.

21. **Businesses in North Macedonia suffered substantial revenue losses from the COVID-19 crisis.** Negative demand shocks have been very strong. Based on the survey conducted by the Economic Chamber, 81 percent of businesses experienced a reduction in revenue due to the cancellation of already agreed upon work. Further, about a third of the respondents indicated that such revenue reductions were above 50 percent. Approximately half of percent of respondents cited liquidity as a major challenge, and in addition, many businesses were indirectly affected as they were unable to collect payments from firms already suffering from liquidity problems.

Box 2. Not Just Jobs, but *Inclusive Jobs*

The actions outlined in the policy matrix developed in this report are intended to work horizontally, benefiting also women, long-term unemployed and other vulnerable groups. While it is true that the issues presented may affect different groups differently, the focus of the report is on proposing actions that will benefit all groups. For instance, the actions aiming at facilitating youth labor market experience acquisition will benefit both male and female graduates, same as the actions to improve the availability of labor market information will also benefit both genders and specific groups, such as people with disabilities or rural population, when making their decisions for careers choices and job searches. In addition, actions in support of improving the employability of income-support program beneficiaries address a particularly vulnerable group, as are the poor in long-term unemployment or completely detached of labor markets. In this sense, the actions do not just support jobs, but they support inclusive jobs that can benefit people from different groups in the country.

22. **While firms will have to adapt their business models to the new normal, for the recovery phase structural adjustments are needed to strengthen resilience of firms, households and the economy.** The following Action Plan that focuses on stimulating demand and supply of labor aims to offer a roadmap of possible policy actions to accelerate recovery.

B. SUPPORTING PRIVATE SECTOR DEVELOPMENT

23. **Higher firm-level productivity is a prerequisite for enhancing North Macedonia's long-term economic growth prospects.** The 2018 Systemic Country Diagnostic for the Republic of North Macedonia found that declines in total factor productivity (TFP) pose a serious threat to GDP growth, and that low growth in productivity and human capital deficiencies are undermining the country's growth prospects.¹¹ TFP declined in 2009–17, labor productivity has been stagnant, and the contribution of human capital has been minimal or negative since 2002 as education and skills formation deteriorated. Firm-level TFP declined between 2011 and 2016 (latest data available): across all firms, TFP of revenue (TFPR) fell by an average of 2.8 percent and value-added per worker fell by 0.6 percent. Firm-level productivity level in North Macedonia also trails that of regional comparators. To address the country's job challenge, firms also need to create higher-productivity jobs.

24. **Even within North Macedonia, there is a broad variation in productivity.** Firms in the 90th percentile are 7.6 times more productive than firms in the 10th percentile. In contrast, in the United States, firms in the 90th percentile are only twice as productive. This shows that there may be missing productivity-promoting elements for firms in North Macedonia. It is therefore necessary to (1) improve the productivity of firms active in the market, and (2) enable the least-productive firms to leave the market.

25. **In addition to its critical role for economic growth, productivity also matters for wages.** In North Macedonia, more-productive firms pay more, and wage growth is linked to productivity growth. While more productive firms contribute fewer jobs to the economy than less-productive ones, their jobs pay more. In services, wages paid by the most productive firms are 88 percent higher than those paid by the least productive. Similarly, a rise in productivity is associated with high-quality, better-paid jobs.

26. **Among the barriers to more productive factor allocation are labor and capital adjustment costs, taxation, informality, property rights, government regulations, and financial frictions.** Recent World Bank analysis has found that regulations and other business climate dimensions have a significant impact on productivity in North Macedonia. For example, the costs of customs red tape, measured as the average number of days it takes to clear customs, reduces firm productivity: each additional day reduces the productivity of the median firm by 8.6 percent.¹² Red tape costs for permits and tax inspections also reduce productivity: one more day in the average time needed to obtain a permit reduces the productivity of the median firm by 4.2 percent and an additional tax inspection reduces it by 5.5 percent. Other business climate dimensions, such as having access to credit (a 13 percent increase in productivity) or foreign technology (+ 4.5 percent) or being an exporter (+ 7.9 percent), are associated with higher productivity. Clearly, policy matters to productivity.

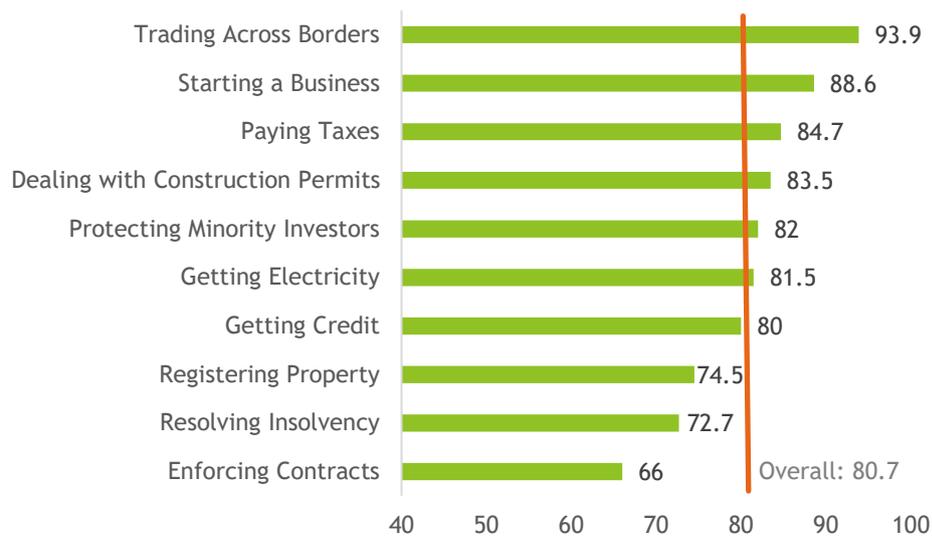
B.1. Beyond Doing Business: Regulatory Quality

27. **Since 2004 North Macedonia has improved its *Doing Business* ranking by 70 places, reaching a remarkable rank in 2020 of 17th of 189 countries.** However, its performance varies significantly by area of business regulation: The country is particularly good in starting a business and trading across borders, but it is far from best international practice in contract enforcement, resolving insolvency, and registering property (Figure 13).

¹¹ World Bank 2018.

¹² This reflects the marginal effect (in percentage terms) of a change in a specific variable on the TFPR of the median firm. Interpretation of the results varies according to how the variables are defined: some are dichotomous, others are continuous, in line with Enterprise Survey questionnaires.

Figure 13. Doing Business Score for North Macedonia, by Categories, 2020.



Source: www.doingbusiness.org

28. **According to the World Economic Forum, inefficient government bureaucracy ranks only 5th among major concerns for businesses**, behind (1) policy instability, (2) access to finance, (3) an inadequately educated workforce, and (4) a poor work ethic in the national labor force.¹³ In public procurement the country has recently moved to harmonize national laws with the EU acquis and other globally recognized good practices. North Macedonia has been an observer to the WTO Government Procurement Agreement (GPA) since 2013 and is currently negotiating accession,¹⁴ which indicates that its procurement regulations are aligned with GPA good practices. The country enjoys centralized e-procurement, mandatory certification and training of procurement officers, and well-structured and comprehensive laws.

29. **However, how the laws are applied leads to regulatory unpredictability.** Frequent changes in procurement laws and regulations, lack of transparency, and inconsistent interpretations of rules create an unpredictable environment that deters the private sector from participating in tenders. By 2017 the Public Procurement Law 136/2007 passed in November 2007 had been amended nine times, heightening supplier uncertainty. In January 2019, the Parliament adopted a completely new Public Procurement Law aligned with EU Directive 2014/24/EU, but concerns have been expressed about favoritism in the award of public contracts. Moreover, while the law specifies that the contracting authority must process payments within 20 days (in line with international good practice), in fact it takes 31 to 90 calendar days from submission of the invoice for suppliers to be paid.¹⁵ Beyond public procurement, regulatory transparency and predictability in general needs work. In the latest edition of the WBG's *Global Indicators of Regulatory Governance*, North Macedonia scored only 3.75 of 5 points, which though better than Albania and Bosnia-Herzegovina (both scored 3.5) is worse than Montenegro (4.25), Serbia (4.0), and Kosovo (4.75). Corruption and lack of transparency seem to be significant problems for North Macedonia, which with Kosovo ranks 93rd of 180 countries¹⁶ on Transparency International's latest Corruption Perception Index with a score of 37 out of 100 (with 0 = highly corrupt and 100 = very clean).¹⁷

¹³ http://reports.weforum.org/pdf/gci-2016-2017/WEF_GCI_2016_2017_Profile_MKD.pdf

¹⁴ North Macedonia sent the WTO GPA its official bid for accession in February 2018.

¹⁵ World Bank Benchmarking Public Procurement 2017.

<http://pubdocs.worldbank.org/en/121001523554026106/BPP17-e-version-Final-compressed-v2.pdf>.

¹⁶ <https://www.transparency.org/country/MKD#>.

¹⁷ For more information on the Index, see <https://www.transparency.org/cpi2018>

30. **Representatives of the private sector have corroborated the finding that investors are less concerned about the quality of business laws and regulations than about how they are applied, whether they are transparent and predictable, and how well contracts are enforced.** They say that the lack of transparency is a larger problem than any gap between different levels of jurisdiction or between well-designed regulations and their actual application.¹⁸ There is a need for clear guidelines and checklists for procedures not directly captured by international benchmarks. Moreover, the informants claim that most ministries and agencies do not respect standards for delivery of services to businesses and citizens. Obtaining a VAT refund, for instance, may take more than 36 weeks.

31. **Lack of transparency and predictability is a particular concern with business inspections.** Inspectorate mandates often overlap, inspection criteria are not clear, and officials have too much discretion in interpreting laws and imposing fines. Business representatives agree that consolidating inspectorates, clarifying rules and guidelines, recalibrating fines, and streamlining trade-related inspections would have a positive impact on investment in North Macedonia. A new Law on Inspection Supervision, enacted early in 2019, created a new legal basis for risk-based inspections and introduced good practices (e.g., warnings and grace periods for infractions, use of checklists and risk criteria) to increase inspection predictability and transparency.

32. **Public sector engagement, evidence-based rulemaking, and public consultation could also be improved.** The mechanisms for private sector engagement in rulemaking are not very effective, and ministries and public agencies rarely adopt forward regulatory plans (i.e., issuance of a list of anticipated regulatory changes or proposals for review within a specified time). The quality of reporting of public consultations could also be improved. Moreover, there are no criteria for determining which regulations should be subject to impact assessments, and ex-post reviews are neither mandated by law nor typically carried out.¹⁹

33. **Other areas of concern for businesses, in line with Doing Business data, are contract enforcement and the efficiency of the courts.**²⁰ According to the businesspeople and lawyers interviewed, the problems stem from incomplete automation of the courts and poor case management. Also of concern was that agencies and ministries dealing with day-to-day business procedures are not all fully automated and their capacity varies.²¹ For instance, while the procedure to transfer property at the Agency for Real Estate Cadaster (AREC) can be carried out either online or within 3 days, City of Skopje assessment of the property sales tax takes on average 3 weeks because the city lacks digital titles and cadaster maps. Similarly, the variances in the automation of courts and judicial services to some extent explain poor court performance. Now being discussed are three draft laws (on e-governance and electronic services, the electronic registry of citizens, and electronic documents) that may eventually relieve some of these problems.

34. **North Macedonia's ineffective insolvency system has a bad reputation among creditors, especially banks, which prefer enforcement or bilateral restructuring.** There is a general perception that courts are slow and lack the specialization and resources they need. Few in the business community use the insolvency regime to resolve financial distress or to restructure viable companies.

¹⁸ Implementation gaps are gaps between the different levels of regulations or jurisdiction (e.g., local vs central, or regional vs. central) and gaps between well-designed regulations and their application in practice. It appears from the interviews this is not a primary concern for entrepreneurs in North Macedonia. However, regulations could still be improved, and so can the transparency and the provision of ICT services.

¹⁹ These findings are consistent with the WBG Global Indicators of Regulatory Governance. For more information on North Macedonia, please see <http://rulemaking.worldbank.org/en/data/explorecountries/macedonia-fyr>.

²⁰ Enforcing a contract in North Macedonia takes 635 days, more than in Bosnia-Herzegovina (595 days) or Kosovo (330 days).

²¹ In the latest ICT Development Index (2017), North Macedonia ranks 69th of 176 economies, better than Bosnia-Herzegovina (83rd) and Albania (89th) but worse than neighboring Serbia (55th) and Montenegro (61st). For more information see: <http://www.itu.int/net4/itu-d/idi/2017/index.html>.

As a result, most insolvency cases are not commenced until there is little economic value to save; the result is piecemeal liquidations.

Policy Actions

- *Assess court processes and the legal basis for handling commercial cases to identify and address what causes delays.* Ideally, that should involve mapping out both the procedures required by law and court rules and those actually applied from filing of a case through enforcement of decisions. This exercise would help identify unnecessary administrative tasks required of court staff, judges, and court users and opportunities for improvement with and without changing any laws. It could also help identify how resources should be allocated to enhance efficiency and cost-effectiveness. The exercise would be particularly useful because time and cost of enforcement are both higher than averages for OECD economies and the ECA.
- *Assess the ICT capacity of all agencies providing G2B services and draft a strategy to better integrate them into a complete business regulation value chain.* An important aspect of the assessment will be evaluating which systems and platforms are inter-operable. Also, important will be opportunities for integrated rule-making, business planning, registration, licensing, inspection, business life events, and eventually exit; this will allow North Macedonia to unlock investments and deliver integrated regulatory services while safeguarding public policy concerns and mitigating risks. The initial assessment will be used to identify possibilities for improvement, supported by a roadmap and a thorough plan for following through. The assessment will also explore how delivering regulatory services can benefit from the use of disruptive technology and agile regulatory models.
- *Conduct a systematic Business Regulation Review (BRR) starting with priority sectors.* The BRR would gather data for a customized assessment of business regulation opportunities and constraints in North Macedonia: policies, institutions, laws, regulations, and procedures that affect the business lifecycle. The review can also inform project and policy design, offer a context for further analyses by sector of what stands in the way of investment and growth, and identify reform priorities. It should include a granular assessment of business regulations that function as barriers to entry and growth in priority sectors.
- *Draw up clear guidelines, checklists, as well as delivery standards for G2B services and procedures that are not captured by the Doing Business indicators.* To make entrepreneurs effective partners in compliance, the government should make the services provided by its ministries and agencies more transparent, especially in areas of business regulation or administrative procedures that fall beyond the scope of the Doing Business indicators.²² Priority areas could be identified in collaboration with Chambers of Commerce and the legal community. For each area and procedure, not only laws and agency regulations but also decision-making criteria, complete application requirements, and approval processes should be in plain language so as to be fully transparent and actionable. Agencies should also make available on their websites all the information officials use to make decisions on applications. All relevant agencies should agree to service delivery standards that spell out the specific delivery targets for each agency and the commitments the agency promises to honor when delivering a service. Thus, the standards would describe what an applicant can expect to receive from the agency, and the manner and timeframe for its delivery. To make the delivery standards effective, they should be supported by systems to track compliance, for example by monitoring the performance of the officials responsible for each process and specifying a mechanism to ensure compliance.

²² Doing Business covers 10 areas of business regulation. The methodology depends heavily on case studies, most of which relate to administrative procedures and requirements that affect small-to-medium limited liability companies. For more information on the methodology for each indicator, see <http://www.doingbusiness.org/en/methodology>.

- *In rulemaking, ensure transparency and make use of all available evidence.* More effective engagement of stakeholders in the rule-making process should make the business environment more predictable and ensure that reforms are successful. Useful measures to be considered might be requiring ministries and regulatory agencies to publish the text of proposed regulations before they are enacted, mandating set periods of time for draft regulations to be available to the public for comment, and reporting the results of consultations. Introducing ex-post reviews might also ensure that regulations stay up-to-date, are cost-effective, and continue to deliver the desired policy outcomes.
- *Evaluate how the RIA system is working to identify any weaknesses in current regulations and agency capacity to implement regulations.* Such an assessment would look at how comprehensive current regulations are, RIA capacity throughout the government, and how well the RIA oversight team in the Ministry of Information Society and Administration is working in order to identify measures that will align the country's efforts with best international practices. Many countries recalibrate their RIA systems every few years to respond to shifting stakeholder demands and to remedy design issues that have emerged.
- *Enhance the technical public-private dialogue (PPD) and ensure that both local and foreign companies participate.* This could build private-sector confidence that institutions are inclusive and responsive. To this end, it will be necessary to establish effective PPD mechanisms at all levels. This might mean reactivating the National Entrepreneurship and Competitiveness Council (including domestic firms) or the Economic Council or creating a new body. The PPD mechanism for foreign and domestic firms could be one joint body or two separate ones.
- *Update insolvency-related laws in specific areas.* The corporate Bankruptcy Law is generally aligned with good practices, but there are areas where it can be improved. For instance: (1) the deadline for creditors to prove their claims was shortened to 15 days in 2014, which seems excessively tight, given the documentation that must be filed with the petition. (2) Art. 75 should not mention the word "artisans," since apparently no insolvency process applies to them. (3) Case publication could be streamlined, and costs reduced if instead of publishing the filing in two newspapers, it could be done electronically on the court's main website. (4) Article 68 could better handle no-asset cases to balance the need to prevent fraud with a pragmatic approach to cases where there are not enough assets to cover case costs. (5) Numerous details related to the insolvency administrator would be better addressed by a regulation rather than in the law. (6) Electronic sales (Art. 99) may need an "initial price," which is currently barred. (7) Introducing a conflict of interest provision would prevent a creditor or related person who is registered in the auction from voting in the creditors' assembly on that specific sale.
- *Either abolish the Law on Out-of-Court Settlements or merge it with the Insolvency Law,* because it contains a number of internally contradictory principles. For example, the principle of "voluntariness" seems to be inconsistent with the obligation to start this procedure in cases of financial distress.
- *Remove obstacles to bank acceptance of movable collateral by unifying the laws for creating security interests in all types of assets and establishing a centralized collateral registry for security interests in movable property.* The fact that movable assets and bank accounts are not accepted as primary collateral prevents MSMEs from obtaining the financing they need to grow. Movables are considered "supplementary" security; this collateral provision is based on an outdated law on contractual pledges rather than a modern secured transactions system. The country's procedures for taking, registering, and enforcing movable assets as collateral is far behind international standards.
- *Align the institutional framework for insolvency practitioners with that for other professions and create an efficient mechanism for licensing them and monitoring their performance.* As of September 2018, though 54 insolvency administrators and 2 companies were licensed, there are far fewer active administrators and the profession does not attract skilled young professionals.

Building a more robust cadre of administrators should be a priority for better application of the Bankruptcy Law.

B.2. Competition and State Aid Policy

35. **While the regulatory and institutional framework for competition in North Macedonia follows the EU model, its application is uneven.** A shortage of institutional resources and analytic and procedural tools inhibits effective enforcement. Competition policy shortcomings are evident in the transition indicators applied by the EBRD: North Macedonia scores 2.7 out of 4.33 on the quality of its competition policy, below the 3.3 average of aspirational peers. In 2018 the EC reported that involvement of the government in North Macedonia's markets appears to undermine private-sector development due to numerous inspections, uneven application of regulations, public procurement procedures, and state aid.

36. **Findings from the country's OECD-WBG Product Market Regulation (PMR) assessment suggest that several concerns are limiting competition,** among them (i) failure to apply the competitive neutrality principle that state-owned and private businesses compete on a level playing field, (ii) barriers to entry in network sectors, and (iii) undue restrictions on regulated professions. It is thus critical for North Macedonia to coordinate its policy efforts to generate a competitive business environment and to promote open markets.

37. **Market dominance is perceived as the most significant concern for competition.** In the 2018 Global Competitiveness Index (GCI), of all the market efficiency indicators, North Macedonia does worst on extent of market dominance (67th of 138). Data from the 2013 World Bank Enterprise Surveys reveal relatively high market and output concentration in manufacturing, where the top five firms accounted for a very large share of total sales. Interviews with representatives of the private sector also confirm a perception that the major competition concerns are market dominance and limited opportunities for new entrants in some product and service markets.

38. **In sectors where SOEs are active, competitive neutrality is not guaranteed.** State ownership of public utilities is common, and direct state interference undermines their governance. And even though SOEs are subject to antitrust scrutiny, they may enjoy certain privileges that create distortions and act as disincentives to private investment, such as failure to incorporate as limited liability companies.

39. **Network services industries like electricity, gas, and telecommunications are critical to growth of the economy, but in North Macedonia their organization is not consistent with global best practices.** In those industries, barriers to entry and regulatory protection of incumbents are concerns. In services, restrictions on regulated professions can reduce competition. Although international best practice reflects the importance and effects on productivity of promoting effective competition in professional services, regulation or self-regulation can enable price-fixing cartels. There are binding minimum fees for lawyers, notaries, and accountants; engineers and architects charge for some services according to nonbinding, but recommended prices set by their associations. The effects of price regulation are exacerbated by other restrictions, such as legal limitations and territorial restrictions on the number of notaries.

40. **Budget fluctuations and concerns about the Commission for Protection of Competition (CPC) independence have been reported as critical problems for preventing anticompetitive practices.** The CPC, which enforces the Law on Protection of Competition, is an independent body mandated to detect and sanction anticompetitive behavior, control mergers, grant exemptions to agreements, and promote competition through advocacy. It can impose fines and require remedies, both structural and behavioral, to restore market competition. Merger control processes can be time-consuming, expensive, and resource intensive. Although few mergers have significant market effects, merger review requires that competition authorities divert considerable resources from other enforcement activities. Other issues identified are that (1) the few decisions indicate that the CPC is not regularly called upon; (2) the CPC has limited ability to collect evidence through, e.g., on-site inspections; and (3) decisions are published without full explanations, so the quality of CPC analyses

cannot be adequately assessed. Finally, the CPC has yet to use its advocacy powers to foster open markets and keep the public informed about market failures that could be ameliorated through legislation or regulation.

41. **State aid creates additional competition challenge.** In recent years North Macedonia's sector and producer subsidies through state aid have averaged about 2 percent of GDP (2.4 percent in 2018). This is triple the EU28 average, and double that for new EU member states. Moreover, state aid amounted to 6.7 percent of all general government spending in North Macedonia—quadruple the EU28 average and again double that of new EU member states. Yet there is little evidence that all this aid has done much to improve the performance of targeted sectors. On the contrary, low and sometimes deteriorating indicators suggest that state aid is ineffective, especially in agriculture and manufacturing. There thus appears to be significant scope for rationalization by, e.g., eliminating the most inefficient subsidies, such as product subsidies in agriculture or manufacturing. This will contribute to fiscal consolidation, improve efficiency, and heighten welcome competitive pressure in these sectors.

42. **Well-designed support and effective state aid instruments can help efficient and innovative companies grow stronger and also encourage the orderly exit of inefficient firms.** Given the large imbalances in the size and structure of North Macedonia's state aid relative to EU standards, reforms should transition from sector-specific to the horizontal types of state aid that predominate in the EU. North Macedonia's reliance on sectoral aid (40 percent) compared with the EU's (6 percent) suggests considerable scope to reform state aid to EU standards. It also implies significant cuts could be made in state aid to such currently privileged sectors as manufacturing (including FDI), transport, tourism, and culture. Sectoral state aid has largely been directed to FDI and more recently to local companies, but there are deficiencies in terms of ensuring equal treatment and transparency. While FDI helped the economy to diversify, increase net exports, and improve the trade balance, foreign investors are benefiting from sizable direct and indirect subsidies, such as about €225 million in cash grants (for constructing factories and training employees for new jobs created)²³ and sizable tax exemptions (CIT, PIT, excises, and sometimes social contributions). In addition, as of 2018 there is a state aid program to support investment and employment, giving firms a subsidy for each new employee paid more than the average salary or providing a partial return on investment in new machines and equipment. There are concerns about the sustainability, market distortions, and redundancy of these programs.

43. **State aid in North Macedonia is neither transparent nor evaluated.** Public and private scrutiny would benefit from publication of the amount of state aid, the granting agency, the main beneficiary sectors, the identity of individual beneficiaries, the expected benefits, and the aid intensity (aid received as a percentage of the eligible costs). Publishing such information would not only increase transparency but would also make it possible to analyze, for instance, the extent of concentration in a specific sector or region, whether another form of aid might be more effective or less distortive, and the evolution of state aid over time.

Policy Actions

- *Reinforce competitive neutrality to avoid distortions that prevent equal treatment for all companies, public and private.* That can be done by
 - i. *Removing privileges that insulate SOEs from competitive pressure, such as their access to financing not available to private competitors, which also prevents SOEs from making economically-sound cost-minimizing decisions as private firms must.*

²³ Government of North Macedonia estimates, <http://vlada.mk/node/13391>, accessed 25 April 2018.

- ii. *Reviewing the governance of SOEs to limit or abolish direct government interference*, since some SOEs (like in water, roads, and gas sectors) are both operators and regulators—a temptation to discriminatory treatment in favor of the public sector.
- iii. *Ensuring equally strict enforcement of antitrust regulations* for both private and public companies (SOEs are subject to the antitrust laws).
- *Reform and introduce pro-competition regulation in basic network industries that have a natural monopoly*. To guarantee that those industries can sustain the investment needed to satisfy future demand, countries worldwide have migrated to pro-competition regulation that allows private firms to provide the service and recover their costs, while keeping tariffs as close as possible to recovery costs. North Macedonia could bring its network industries in line with international best practice by
 - i. *Introducing pro-competition by deregulating market segments in the electricity sector* that still holds a monopoly in residential and small commercial markets.
 - ii. *Introducing measures to regulate gas and electricity retail markets* on the basis of actual costs (as researched by the regulators) and enable the ERC to issue sanctions and penalties to enforce its findings.
 - iii. *Even though the ICT industry is dominated by private firms, drafting regulations to protect users' data* in digital services so that the noncompetitive advantages of incumbents are removed.
 - iv. *Ensuring that competition policy is applied effectively in regulated sectors* through close cooperation between regulators and the CPC.
- *Decrease information asymmetry and restrictions on geographic mobility in professional services*. Minimum prices for a range of professional services, enforced through professional associations, create a distortion that leads to an excess of services offered and promotes informal transactions. To correct the distortion and ensure that higher earnings for professionals come from gains in labor productivity, not anti-competitive behavior, North Macedonia should:
 - i. *Ban minimum or recommended prices for professional services*, which should lead to more transactions and more competition
 - ii. *Evaluate whether entry and territorial restrictions for notaries and lawyers could be limited* to responses to actual needs by letting more productive professionals relocate to where there may be more demand for their services.
- *Improve compliance with antitrust regulations*. An effective competition framework requires an authority that can (1) tackle anti-competitive agreements that raise the costs of both inputs and final products; (2) prevent anticompetitive mergers; (3) combat anticompetitive conduct and abuse of dominance; and (4) advocate for competition and build a competition culture. There are several ways North Macedonia could reinforce its competition framework; it could:
 - i. *Fight against antitrust violations* by using more on-site inspections to gather direct evidence of violations; supporting design of a more effective enforcement program by identifying gaps in current regulations and guidelines; increasing the use of economic analytics to build solid antitrust cases; and publishing with decisions the analytics underpinning the investigations. For these reforms, the CPC would require appropriate human and budgetary resources.
 - ii. *Optimize the merger notification system* by providing methods for preventing mergers that have a high probability of significant harmful impacts on market competition. This can be done by replacing subjective merger notification thresholds based on market shares by a combination of individual and objective thresholds based on turnover or value of assets to trigger merger notification; simplifying the merger review process for concentrations less likely to have an impact on competition in order to minimize undue burdens on the private sector and use limited CPC resources most effectively; undertaking a benchmarking exercise

to identify optimal notification thresholds based on turnover; and evaluating the possibility of eliminating merger notification thresholds from the competition law itself to allow for periodic review and more flexibility for regulators.

- iii. *Build a competition culture* using a systematic analysis to identify and advocate for the removal of anticompetitive regulatory restrictions in both new and existing laws, regulations, and policies.
- *Harmonize state aid law and regulations:*
 - i. *Harmonize the laws and regulations related to state aid with international standards* and best practices, particularly with the EU state aid rules, EC practices, and case law generated by the EU Court of Justice.
 - ii. *Resolve internal inconsistencies in the different laws covering state aid* so that all are aligned with the Law on State Aid.
 - iii. *Establish an inventory of state aid*, including *de minimis* aid, within the CPC.
 - iv. *Identify a mechanism for regular analysis and publication* of the fiscal implications, effectiveness, and efficiency of incentive programs.
- *Restructure state aid programs:*
 - i. *Restructure state aid overall* by moving from sectoral to horizontal aid targeted to specific goals (e.g., building human capital, heightening productivity, investing in R&D).
 - ii. *Phase out TIDZ tax holidays* and replace them as needed with performance-based incentives.

B.3. Access to Finance

44. **Micro and small firms, which are most constrained financially, have more difficulty than medium-sized firms in accessing financing.** Firms rely heavily on bank financing—on average, banks provide 17 percent of their external financing for investments. But *perceived* are considerably higher than *observed* financing constraints.²⁴ According to the Enterprise Surveys data (2019), loans were approved for 90 percent of firms that applied for them—but 27 percent of firms interviewed had not applied despite needing external financing, and 40 percent of these reported that interest rates were the main deterrent.²⁵ This is a reduction compared to 2013, aligned with the overall interest rates decline.

Table 2. Access to Finance

	% that are financially constrained (observed financing constraints)	% that consider access to finance as an obstacle (perceived financing constraints)
Micro	83.33%	66.67%
Small	24.43%	28.57%
Medium	24.60%	36.64%
Large	12.79%	15.56%

Source: Enterprise Survey 2019.

45. **Commercial banks have increased their involvement in SME lending, striving to diversify their risk beyond large corporations.** In 2017, SME loans averaged 32 percent of bank loan portfolios generally,²⁶ and more than 70 percent for banks specialized in SMEs. Loans to micro firms comprised about 2 percent. While large banks have the largest SME portfolios in terms of

²⁴ Firms with perceived financing constraints are defined as those firms that consider access to finance as either a moderate, major or very severe obstacle to their business operations.

²⁵ Percentages based on 75 firms that did not apply for financing.

²⁶ Small loans are about 20 percent and medium loans about 12 percent.

volume, medium-sized banks devote a larger percentage of their loan books to SMEs. Although bank exposure to micro and small enterprises is limited, the perceived profitability of the SME segment has been identified as an important driver of lending to SMEs by some banks. Banks that are investing in building a true business relationship with SMEs and interacting closely with those clients have been more successful in growing good-quality SME portfolios. They also invest more resources in supporting SMEs by reviewing their financial accounts and business plans.

46. **The most important factors for success in getting loans are good collateral and solid financial accounts.** Banks lend only to MSMEs with at least three years of business records and good financial accounts. They will also provide small loans based only on promissory notes. As of March 2018, about 21 percent of all loans were not collateralized. Larger loans require hard collateral covering at least the value of the loan, which micro and small firms often lack. Banks rarely lend against movable collateral because of deficiencies in the law on contracts, problematic enforcement, and a nonexistent secondary market.²⁷

47. **Savings houses and microfinance institutions strive to fill a serious market gap by serving micro firms, but their reach is limited.** Financing for start-ups is scarce in North Macedonia and factoring and leasing are not developed enough to provide a real alternative to bank financing.

48. **Improving provider diversity could ease financing constraints for smaller firms.** Only a few institutions offer factoring, leasing, private equity, and venture capital, and few firms are even aware that such products exist. Factoring companies would benefit from a separate Law on Factoring or a dedicated section in the Law on Financial Companies; with support from EBRD, the authorities have taken initial steps to make the necessary amendments. Companies that operate under the Law on Leasing serve only consumers. Factoring and leasing companies also report biased tax treatment. The laws governing private equity and venture capital funds are being assessed to align them with EU directives, which should help the industry to grow.

Policy Actions

- *To ease collateral requirements and boost bank lending to MSMEs, design a partial credit guarantee scheme (PCG), guaranteeing repayment of a certain percentage of the loan in case of default.* PCGs are used globally as a relatively market-friendly intervention to spur lending to MSMEs, especially where collateral requirements are too high for them or where secured transactions procedures are inefficient. PCGs can also be used to address market gaps in lending to priority sectors or regions, or to start-ups. However, the PCG must be designed well; the Development Bank of North Macedonia (DBNM)²⁸ could be the host. In fact, DBNM used to offer a credit guarantee scheme, but the last guarantee was issued in 2009. Reportedly, the guarantee scheme was hardly used, and its performance was poor, partly due to the terms. Some banks participating in the EDIF guarantee scheme have reported it as useful to expand their business in the SME segment. Improving firm financial management, managerial skills, and ability to obtain international certifications would also make firms more bankable and ease their access to financing.
- *Streamline DBNM products; currently it offers more than 10 different credit lines and several other products.* It offers credit lines funded by its own resources and loans from international institutions. It has active agreements with most commercial banks and several savings houses,

²⁷ See Insolvency and Creditor Rights for more detail.

²⁸ DBNM is the only development bank in North Macedonia; founded in 1998, it was superseded by a new Law on DBNM in 2009. The bank is a joint stock company owned by the state. It has 38 employees and no offices apart from its headquarters in Skopje. The DBNM strategy is to promote economic development and exports through financing SMEs. It can also finance infrastructure, support regional development, and promote energy efficiency. The bank offers credit lines, guarantees, export credit insurance, and factoring. It is primarily a wholesale lender, granting loans through participating banks but since 2009 it also has had a small direct lending portfolio.

though as yet it has no outstanding portfolio with the latter. The majority of funding is directed to SME lines.

- *Ensure that DBNM development activities address identified market gaps.* Most DBNM products target SMEs, to which banks have a sizable exposure. The products offered appear to be partly supply-driven given the reliance on funds from international institutions. Because it offers a wide range of products, a market-gap assessment would help identify whether current products are meeting actual needs. Targeting products to start-ups and micro and small enterprises may be preferable as a focus for DBNM. It could also increase its collaboration with savings houses and factoring companies, which find it difficult to find affordable financing. DBNM's developmental mandate would greatly benefit from an assessment of the impact and targeting of its programs.
- *Retain DBNM's wholesale focus.* Direct lending is not DBNM's comparative advantage and the market is generally well-served by the private sector. A more appropriate role for DBNM is that of market enabler, ensuring that private financial institutions are given the right incentives to address market gaps. Direct lending by development banks creates a risk of crowding out the private sector and distorting the retail market. It is therefore recommended that DBNM keeps the wholesale focus to address actual market failures.
- *In future credit lines, avoid fixed interest rate ceilings for final borrowers.* Most DBNM credit lines cap the interest rate banks can charge; ceilings for some programs are far below market rates. Capping bank interest rates can deter them from financing clients at higher risk-return frontiers. Banks confirmed in meetings that they are providing loans that would have been financed irrespective of the support.
- *Improve protection of financial consumers by addressing irresponsible practices in lending to individuals and MSMEs.* Significant gaps relate to disclosure, business conduct, and dispute resolution for all product areas. Many financial companies use misleading advertising and nontransparent pricing, charging annual rates of more than 350 percent. Comprehensive laws are needed to enable financial consumers to make well-informed decisions on how best to use financial services, build trust in the formal financial sector, facilitate competition, and build up supervisory capacity to protect financial consumers. Amendments to the Law for Consumer Protection in Consumer Loan Agreements published in January 2019 (Official Gazette number 20/2019) may curtail some market practices, but additional reforms should also be considered. One action for the short term would be to transpose and enforce the consumer protection provisions in EU Payments Services Directive 2 and the EU Mortgage Credit Directive, which is already in progress.
- *Other medium-term actions recommended* are to review the policy objectives and legal framework for savings houses to address market development and proportionality; remove obstacles to bank acceptance of movable collateral; and strengthen MSME accounting standards and financial management practices to help firms access finance more readily.

B.4. Attracting and Retaining Investment

49. **Since 2007, North Macedonia has been able to attract large amounts of FDI;** over 2007–17 the stock of FDI in the country increased from 40 to 53.5 percent of GDP. In 2007, FDI inflows peaked at over 8 percent of GDP, fell back to 2 percent in 2009; and then until 2019 they fluctuated between 2 and 4 percent.²⁹ Compared to regional peers, however, the country's FDI performance is

²⁹ UNCTAD, FDI Statistics, <https://unctad.org/en/Pages/DIAE/FDI%20Statistics/FDI-Statistics.aspx>; World Bank, *World Development Indicators*, https://data.worldbank.org/indicator/BX.KLT.DINV.WD.GD.ZS?end=2017&start=1995&year_low_desc=false.

less impressive. In 2007–19, relative to the size of their economies, Albania and Serbia attracted a larger inflow of FDI as a share of GDP.

50. **Investors have been attracted to North Macedonia for combination of reasons:** (i) Its business environment reforms raised the profile of the country in the minds of international investors and demonstrated government commitment to a sound enabling environment for foreign investors. (ii) Trade liberalization and the country's proximity to the EU attracted manufacturing firms targeting clients and consumers in EU markets. (iii) A proactive government and direct access to decision-makers (because the country is small) influenced investor decisions to locate there. The public-private Economic Council enabled foreign investors to directly address the highest levels of government with any concerns and have them resolved quickly. (iv) Access to low-cost, skilled labor and a competitive wage environment were critical for many investors. (v) Though FDI incentives were a factor in investor decisions, often they were combined with other factors rather than being the driving motivation. (vi) The stable economy, especially the stable exchange rate regime, also influenced investor decisions.

51. **The rise in North Macedonia's FDI has had several benefits.** Since 2007 it has been correlated with higher GDP, and large numbers of jobs were created. FDI in automotive and associated industries has had a powerful effect on North Macedonia's export profile. The new exports had more technological sophistication, while traditional exports of metals and minerals halved.³⁰ However, the bulk of FDI went to low-value-added manufacturing segments; the limited spillovers and few improvements in productivity raised issues of sustainability.

Policy Actions

- *Build on what contributed to North Macedonia's past success.* At the outset nearly 15 years ago, government officials sought out the experiences of other countries both within and beyond the region, internalized good practices, and applied them to move forward. The result was that the full package of North Macedonia's offerings—tax breaks and other incentives, a strong commitment to strategy, and a dedication to high-level service—attracted FDI, especially in the automotive industry; reoriented exports toward more technology-intensive products, and made it possible for exports to make a major contribution to growth and job creation. The country's commitment was demonstrated in investment promotion and the amount of service and attention that was given to investors. Among its success factors were:
 - A long-term commitment to the goals to attract investment.
 - The quality of service and the responsiveness of institutions and officials engaged in FDI promotion.
 - The quality of the post-investment services of DTIDZ and InvestNorthMacedonia (e.g., one-stop shops for registration and construction permit issuance).
 - The level of government access provided to firms, especially those in the TIDZs.
- *However, it is now time to diversify the current FDI mix and to attract higher-value-added investment.* That will require a world-class investment promotion agency and policies to attract more investment. North Macedonia also needs an overarching strategy for leveraging FDI to meet its development challenges. That means clarifying the policy objectives FDI should help to achieve and identifying the economic sectors and value chain segments that have the most promise for spillovers to the local economy.
- *Adopt a strategy that articulates the role of foreign investment and its contribution to North Macedonia's main policy goals (e.g., economic growth, diversification, and job creation).* That will require the country to define specific objectives and investor targets; identify sectors and

³⁰ Source: UN Comtrade. Exports of metals and minerals include those in HS chapters 26, 27, 28, 72, 73, 74, 75, 76, 78, 79, 80, and 81.

activities for which to attract investment: assign investment attraction responsibilities to specific government agencies and other stakeholders; and introduce M&E that has clear KPIs to track progress. The government should also examine opportunities to form natural clusters and identify opportunities to grow such clusters by attracting higher-value investment and promoting backward links.

Box 3. Investment Strategy Guidelines and Best Practices

Steps to an Investment Strategy

- Articulate the national role of foreign investment and how it can contribute to specific major policy goals.
- Define the necessary reform priorities and the related responsibilities of government agencies for attracting foreign investment in terms of entry, retention, and links with the domestic economy.
- Identify priority sectors and activities for which investment is to be attracted.
- Introduce a robust M&E system and set clear key performance indicators (KPIs) and macro, meso, and micro targets for attracting and retaining investment, and specify the benefits sought (e.g., money invested, jobs created, technology attracted).
- Establish M&E tools, such as an Investor Tracking System (ITS), to monitor progress against KPIs and investment goals and measure the efficiency of government spending to attract investment.
- Organize joint production of yearly investment attraction plans by all agencies involved to specify the continuing contribution of each agency.

Step-by-step Guide to Strategy Completion

In line with international good practice, an investment strategy should be the result of a consultative process, central and regional, that engages public and private agencies and other stakeholders. Early engagement of as many people as possible is necessary to ensure buy-in and continuing commitment, and to leverage the knowledge and expertise of different stakeholders in formulating the strategy. Among stakeholders that typically need to be engaged to ensure inclusiveness are national and local government ministries and agencies and private sector associations representing large, medium, and small enterprises.

One agency should be designated to lead the process and given the convening power and resources necessary to manage it and elicit stakeholder contributions. Convening power will not only ensure appropriate engagement of all stakeholders throughout but will also facilitate effective monitoring and realization of the strategy. Typically, this is best achieved when the lead agency is close to the highest level of government and is equipped with the technical capacity and resources it needs to design the strategy formulation process and coordinate stakeholder contributions.

International good practice is to design an investment strategy through an iterative process of stakeholder feedback and consultations to ensure that it leverages policy research and evidence to support checks and balances that yield optimal results.

- *To inform the drafting of the FDI promotion strategy, carry out a thorough scan to identify sectors, activities, and niches that will best attract FDI.* The scan should (i) assess the competitiveness of sectors and value chains in North Macedonia to determine their readiness for investment; (ii) take into account how those sectors and value chains could help the country to achieve its policy goals; and (iii) identify sector-specific obstacles to investment and help design reforms to make those sectors more attractive to investors.
- *Clarify and if necessary, modernize the national capacity for investment promotion.* The investment promotion agency (IPA), InvestNorthMacedonia, should be the initial point of contact for investors and should coordinate investment promotion, but most investors in North Macedonia today approach individual government agencies and ministries directly. The IPA should be actively marketing the country to foreign investors. Finally, it also needs access to accurate data on FDI by sector to effectively inform its promotion and investment facilitation activities.
- *Make investment incentives more transparent.* Currently, North Macedonia provides numerous incentives and its tax rates are lower than those of regional peers. While the laws and regulations are generally harmonized with EU state aid rules, there are problems related to how they are

applied and the capacity of the institutions responsible. Moreover, assessing how cost-effective the incentives are will be particularly important as fiscal pressures increase and the country moves forward to EU accession. Despite positive changes, such as extending incentives to domestic firms, North Macedonia also needs to align the incentives policy with the much-needed FDI strategy. Currently, incentives and promotion efforts are not targeted to sectors with high spillover potential.

- *Direct incentives to achievement of such policy objectives as skills upgrading, R&D and innovation, and development of local suppliers.* For the past decade North Macedonia's investment attraction efforts have been mainly geared to attracting industries that will generate jobs. With policy priorities now focusing tightly on attracting higher-value-added segments of specific value chains, it will be important to adapt incentives policy accordingly. The government might now consider incentives that target developing human capital and innovation support in the short term while longer-term education reforms to address this issue take root. In devising such policies, the government can learn from countries with incentive programs that have succeeded in addressing those specific issues.
- *More actively enforce the laws related to investment and establish a grievance mechanism for investors.* North Macedonia's laws are generally in line with international standards, such as national treatment, but companies complain of, e.g., unpredictable application of laws and regulations; frequent changes to both; failure to consult the private sector about planned changes (see the section on the regulatory environment); and ineffective response to investor grievances. North Macedonia is already the respondent in three investor complaints. This confirms the necessity for policy reform to prevent the proliferation of such cases and increase investment retention.
- *Adopt a method for early identification and prevention of potential disputes.* The government should analyze its current grievance management procedures, determine an approach and a lead agency mandated to identify procedures for tracking and resolving grievances, and monitor their effectiveness. The authorities should also enhance regional sharing of experience on Investment Dispute Settlement System (ISDS) and dispute prevention using the regional cooperation mechanisms of the South East Europe Investment Committee.

B.5. Connecting FDI and Domestic Firms

52. **Foreign investor purchases from domestic firms (“backward links”) have the most impact on domestic firm technology and productivity and can also help improve productivity and growth in the service sector.** In the case of North Macedonia, the backward links developed reflect the composition of the manufacturing sector, as FDI has mainly gone into that sector. Therefore, foreign investors have not only purchased goods that are incorporated into final products (inputs), but also purchased other goods used by multinational corporations (MNCs) but not incorporated directly into their products, such as office supplies and packaging. In addition, foreign investors make use of services that support MNC activities, such as business services (accounting, legal, information technology), construction, catering, security, logistics, transportation, and utilities, such as electricity and water.

53. **In spite of these backward links, the overall development of backward links in the country has been underwhelming.** In fact, foreign investors face substantial challenges to develop backward links. Purchasing orders are very different to the type of order that local producers may be used to. This does not only refer to the types of inputs needed, but also on how sourcing decisions are made—MNCs usually relying on a narrow supply base and is common for sourcing decisions to be made centrally. In addition, domestic companies have inadequate managerial and technical capabilities, in terms, e.g., of marketing and promotion strategies; communications with foreign investors; ability to meet technical standards; adoption of corporate governance best practices; optimization of production processes; and feasibility studies for new investments. Finally, market and coordination failures prevent foreign investors from overcoming these obstacles (e.g., the buyer is not

aware of the extent of a possible supplier's potential). Even after investment in improvement, potential suppliers may not yet be able to supply what the market needs, as business cultures of local small and medium enterprises and multinational companies often differ considerably.

54. **These obstacles prevent to match a latent demand for local suppliers that could benefit both foreign investors and domestic firms.** Investors in the Western Balkans generally are interested in expanding their local sourcing, according to consultations that were part of the proposed South Eastern Europe Light Manufacturing Project.³¹ In interviews investors identified more opportunities for local sourcing in a wide range of inputs, such as:

- Metal processing, casting, and welding
- Small components and small textile parts for seating
- Plastic components, particularly small parts (one large enterprise in the Western Balkans leases molds to suppliers to produce plastic components)
- Small wire harnesses and cables
- Printed circuit boards (PCBs)
- Industrial packaging.

55. **However, among barriers to more such links were:**

- Differential demand from foreign investors, such as the types of inputs needed and how sourcing decisions are made (relying on a narrow supply base or sourcing decisions made centrally).
- Inadequate managerial and technical capabilities of domestic companies, in terms, e.g., of marketing and promotion strategies; communications with foreign investors; ability to meet technical standards; adoption of corporate governance best practices; optimization of production processes; and feasibility studies for new investments.
- Market and coordination failures that prevent enterprises from overcoming these obstacles (e.g., the buyer is not aware of the extent of a possible supplier's potential). Even after investment in improvement, potential suppliers may not yet be able to supply what the market needs. Also, the business cultures of small and medium enterprises and multinational companies often differ considerably.

56. This list demonstrates that local firms may be able to build or enhance their capabilities to supply parts in demand by a variety of value chains. For instance, several industries, not just automotive, may be in need of metal casting and welding, small plastic parts, PCBs, and packaging. Diversifying may also help to mitigate risks: the type of FDI may change over time as the country's cost advantage, market conditions, and other comparative advantages evolve.

Policy Actions

- *Attract FDI for suppliers to current foreign investors.* This will expand the foreign investor base for North Macedonia companies to supply, particularly for components relevant to multiple value chains. This is also likely to have indirect effects in terms of demand for services and job creation and may offer potential for Tier 3 suppliers.
- *Launch a supplier development program* to address market and coordination failures. This program can facilitate links and upgrade firm capabilities, targeted to adding value to manufacturing in North Macedonia.
- *Incentivize behaviors by firms that increases backward links.* Consider different schemes to support behavioral changes in foreign investors and domestic firms that can lead to increases links.
- *Promote exports to foreign investors in regional value chains* and improve firm capabilities to upgrade and innovate (further developed in the section on firm capabilities).

³¹ Proposed by IFC; the objective is to contribute to sustainable job creation and an enduring increase in local value-addition for light manufacturing [automotive and appliance parts] in South Eastern Europe.

B.6. Firm Capabilities

57. **Management capabilities determine how well firms can innovate, take advantage of technology, and thus become more productive.** Innovation and technological capabilities and production capabilities are distinct sets of organizational and management capabilities. Firms progressively build on their capabilities, engaging in more and more sophisticated innovation over time as they shift from simple technology adaptation of products and processes to more R&D-intensive technology and products. Management capabilities are necessary to, e.g., identify and adopt a new technology, identify and pursue a new market opportunity, and improve internal processes; they are particularly important for introducing innovation. For instance, because innovative firms place greater emphasis on management, human resources, marketing, financing, government programs and services, and production efficiencies they are more successful.

58. **Managerial, innovation, and production capabilities are also necessary to attract and retain foreign investment, which is expected to remain an engine of North Macedonia's economy, and to generate spillovers from that investment.** To build on the success of FDI and benefit from more spillovers, technical and managerial skills need constant upgrading if domestic firms are to qualify to supply foreign investors not only with key inputs but also business and support services. The Government of North Macedonia has expressed its commitment to helping increase firm productivity and competitiveness in such policy statements as the Plan for Economic Growth; the Program for Competitiveness, Innovation and Entrepreneurship; the National SME Strategy; and the Medium-term Program for Financial Support of Micro, Small and Medium-sized Enterprises. However, the programs for small and medium enterprises and innovation have clear weaknesses: (1) They generally subsidize inputs rather than upgrading firm capabilities. (2) They are atomized across multiple institutions, some of which combine policy and implementation activities. (3) The amount of support available through PCIE and the Agency for Support to Entrepreneurship (ASE) is especially small, and thus unlikely to make a substantial difference to a firm's ability to upgrade. (4) The impact of most of these instruments is unknown or questionable.

59. **To prepare firms to innovate and better compete in the global marketplace, the government can reorient some of its policies toward building up capabilities.** This can be done by (1) assessing firm capability gaps and needs and support programs, (2) designing and carrying out improved programs based on the results of the assessment, and (3) improving regulation and institutions to move forward innovation and firm competitiveness.

Policy Actions

- *Assess firm capabilities and programs:*
 - i. *Use the World Management Survey to measure capabilities gaps and needs.* This instrument for benchmarking management capabilities has been proven around the world.³² Conducting it in North Macedonia will more specifically identify firm capability needs, which is crucial for innovation and has not been covered by previous analyses.
 - ii. *Conduct a World Bank Public Expenditure Review (PER) of the government's SME and innovation programs.* A PER examines a country's policy mix and evaluates its quality and coherence in order to identify gaps and redundancies³³; assesses the quality of the design, implementation, and governance of current programs³⁴; and provides recommendations to resolve problems based on international best practices.

³² It has been implemented in 35 countries, with over 20,000 interviews.

³³ This policy note is like the first step in a PER, which labels it "Mapping and Evaluating the Policy Mix."

³⁴ This is the Functional and Governance Review portion of the PER proposed by the World Bank.

- iii. *Examine the impact of government instruments on managerial, innovation, and production capabilities.* This can be done by surveying their beneficiaries to find out how the firms have used the funding and whether it has had a lasting impact on firm capabilities.
- *Design and carry out revised and integrated programs:*
 - i. *Based on the reviews, create fewer, larger programs to build firm capabilities and support upgrading.* This may require consolidating programs, scaling up programs that are working well, or introducing new programs that incorporate firm-level diagnostics and improvement plans.
 - ii. *Design and carry out an export competitiveness program that builds firm capabilities and links with markets:*
 - Enlarge the capabilities of the Agency for Foreign Investments and Export Promotion to provide export intelligence to firms.
 - Adjust the export-related instruments of the Plan for Economic Growth to cover development of capabilities for market links, including long-term planning, marketing and sales, and doing business in foreign markets.
- *Improve regulation and institutions:*
 - i. *Clarify which institutions govern innovation and improve their coordination.* Currently, the Ministry of Education and Science is tasked with leading innovation, but there may be a disconnect with activities of the Ministry of Economy and FITD in support of innovation.
 - ii. *Ensure that institutions implementing government programs (e.g., the Ministry of Economy, ASE, and FITD) themselves have the appropriate capabilities and tools to implement them successfully.*
 - iii. *Amend laws to be more effective as lessons are learned over time.* The Law on Innovation Activity for instance, is rigid and presents obstacles to adjusting and applying innovation instruments that respond to lessons learned (as the Bank team learned in its work with FITD). The Law for Financial Support to Investment specifies aspects of firm-level instruments that might be better regulated through more easily amended rulebooks.
 - iv. *Build up the national innovation system (NIS) by first building skills in STEM (science, technology, engineering, and math), ensure good-quality infrastructure (i.e. metrology, standards, testing), and enhance worker skills.*
 - v. *Adopt policies that provide a more conducive environment for innovation* by protecting intellectual property rights, making business regulation more transparent and predictable, ensuring equal treatment for all competitors, and making trading across borders more efficient.

C. STRENGTHENING SKILLS AND LABOR MARKET

C.1. Youth Labor Market Experience Acquisition³⁵

60. **A major problem for young workers is their lack of experience.** Low employment in North Macedonia is an indication of issues in labor demand and supply, but even when firms are willing to hire, they find it difficult: according to the employer STEP survey (Koettl et al. 2017), only 25 percent of firms (mostly in the automotive industry) had recently tried to hire workers, but almost a third of these had difficulties finding workers with the relevant experience, and this was option was the most cited of nine options given. On the supply side of the market, youth in North Macedonia also attribute their low employment rates to a lack of work experience (World Bank 2014).

61. **Unfortunately, small firms are prevalent and there are no economic incentives for them to offer internships and provide work-based learning.** Small firms typically report that they do not consider internships because the perceived returns are small compared to the opportunity and fixed costs of training interns. Firms also report reluctance to provide work-based training due to the risks associated with the use of equipment by untrained students and the fact that students lack both soft skills and motivation.

62. **Several active labor market policies (ALMPs) have been launched to address the fact that graduates lack work experience.** For the last decade, the Internship Program has been helping people aged up to 29 to gain work experience to improve their employment prospects; and participants have demonstrated that it has had a positive impact (Mojsoska-Blazevski and Petreski, 2015). More recently, the government's Youth Guarantee (YG) scheme has targeted persons younger than 29 who are not in education, employment, or training and have registered with ESA for the first time. It gives special attention to those who must deal with social exclusion, poverty, or discrimination. In the next three years the YG scheme plans to work with 9,500 participants a year. The services offer access to training, internships, and subsidized employment.

63. **Despite government initiatives, few young people have internships.** Despite a mandate that each student in North Macedonia acquire three months of internship while studying, one third of VET students and graduates of higher education do not participate in any (ETF, 2017). In fact, only 36 percent of TVET students currently have work-based learning (North Macedonia VET center), leaving close to two-thirds without critical experience that could help them land a secure job. Moreover, VET and university class schedules are not well aligned with employer needs for interns, which may partly explain the low uptake and could be adjusted relatively easily. Finally, there is not much cooperation between higher education institutions and employers, which may depress not only employer willingness to offer internships but also the quality of internships and the extent to which they improve the youth labor market (Mojsoska-Blazevski and Bartlett 2016).

Policy Actions

- *Measures to facilitate student acquisition of work experience while in school can give them more opportunities to become more employable.* In the short term, one option is to give VET school and university class schedules more flexibility (e.g., offer classes in late afternoon, on night shifts, or on weekends) to better match company and student needs, especially in the last semester when students are approaching the job market. Another option could be a more flexible rule than the current requirement of the number of hours a week student must spend in a firm. The current regulation could switch to a given number of days that the receiving firm could allocate freely over the period of a month or a quarter. Finally, amending the labor law that prohibits formal employment while engaged in full-time regular education can give students and firms more flexibility in making hiring decisions. In the medium term, options might include introducing mechanisms to facilitate small-firm take-up of interns and work-based learners, such as intern-sharing, where students can complete their required time in a semester in two or three small firms.

³⁵ This section is based on World Bank (2019) North Macedonia – Finding Solutions to Youth Unemployment.

This could appeal to firms that are too small to offer an entire semester intern program. Another option could be to offer small and medium firms tax deductions and subsidies, to give them a financial incentive to absorb interns.

- *To enforce regulations, the Ministry of Education and Science could take a more active role to ensure compulsory internships for university students who are still taking courses.* For instance, making graduation or progression to the next grade conditional on completing a one-month internship each academic year could give both students and schools much more incentive to approach the private sector to find opportunities for interning. Also, establishing quality control measures to certify the quality of internships could help to keep them relevant. Finally, closer collaboration between educational institutions and employers on internships by providing space for coordination (e.g., meetings at chambers of commerce) can ultimately build private sector capacity to offer internships.
- *Ensuring flexible forms of employment once schooling ends can also open opportunities for graduates to gain relevant work experience (taking care to avoid abuses of the law).* In the short term, the new law that limits internships to six months, sets a minimum for paying interns, and grants them rights to unemployment and social benefits, provides more flexibility and a clear path for firms to provide opportunities for recent graduates to gain experience. In addition, responsive law enforcement should prevent such abuses as, for instance, keeping interns for more than the six months allowed. Authority to enforce the new internship and labor laws should be assigned to the labor unit of the Ministry of Labor, working in collaboration with the Ministry of Education and Science.

C.2. Skills Shortfalls³⁶

64. **Firms are having trouble finding workers with the right skills.** In 2015, close to half of the manufacturing firms surveyed in North Macedonia reported a skills gap among current employees, which suggests there is a general shortage of the skills a modern economy demands (World Bank, 2019). Throughout the economy both domestic and foreign investors complain not only about the disconnect between their needs and skills taught in the education system, but also about the shortage of vocational and management skills. Firms that recently found it difficult to find qualified employees (because of availability, cost, and quality), singled out skills as their biggest obstacle—outranking wage expectations, the cost of social security, and labor regulations (North Macedonia SCD). The gap was most obvious in automotive components, one of the fastest-growing industries in the country, where 75 percent of firms reported major skills gaps.

65. **Part of the reason for this scarcity is that training provided by the educational system does not match the needs of firms.** Only half the firms responding to the STEP survey believed that the education system meet their needs for up-to-date practical skills. Applicants also lack soft skills like good attitude and self-discipline. VET graduates are considered to have the widest skills gaps (Koettl et al. 2017); the major complaints are that VET graduates lack practical knowledge and skills, and that the VET system does not impart new, updated knowledge (ETF 2010): practical training accounts for only a fraction of program content (as little as 6 percent in some areas) and it is not compulsory (ETF 2019). Moreover, VET students report much less practical training than the curriculum and the law prescribe (Mojsoska-Blazevski and Ristovska, 2013). Business associations and industry chambers in North Macedonia offer training programs, but they are limited in scope and not well promoted to firms. For instance, the Economic Chamber and the Chambers of Commerce have education centers that provide certified training programs, but some member firms have reported that they are not aware of or do not find the training relevant to their needs.

66. **Part of the reason for the mismatch is probably the lack of communication between educational institutions and firms.** Except for the ICT and automotive industries, fewer than 10

³⁶ This section is based on World Bank (2019) North Macedonia – Finding Solutions to Youth Unemployment.

percent of firms communicate regularly with any educational institution. In a rapidly changing workplace where such new-economy skills as the ability to learn new things independently and to communicate clearly are gaining in value, the current VET system, characterized by narrowly defined occupational profiles and little flexibility, is not effective (World Bank 2014).

67. **In addition, only a minority of firms train employees once they are hired or get involved in developing their skills.** In their strategic documents governments of North Macedonia have placed high priority on workforce training, continued education, and skills development, so that skills training is supported by programs funded by the government and donors. However, because as yet there is no evidence of how these programs affect productivity, value addition, and staff retention, firms lack incentives to take advantage of them. As an illustration, the state aid schemes set out in the Law on Technological Industrial Development Zones and the Law on Financial Support of Investments would cover the costs of vocational skills training for the staff of eligible companies in and outside the SEZs (TIDZs). However, as yet no firm has applied for this support. In fact, only about 25 percent of firms offer on-the-job training, and these are typically the most productive firms (Koettl et al. 2017). Firms with international links and foreign participation, like those in the automotive industry, or where new-economy skills are in high demand, like those in ICT, are the significant exception: not only do they train workers, they attempt to engage with the education sector (although generally not system-wide). Not surprisingly, the form training takes depends on trainee occupations. For routine skills in jobs built on repetitive tasks, training is internal. For new-economy skills, it is usually external (North Macedonia SCD, Koettl et al. 2017).

68. **Managerial skills are also scarce in the country.** Automotive, textile, and food processing firms must cope with low levels of the managerial and innovation skills necessary to add value; this is emerging as a major area of competitive weakness for North Macedonia's exporters, whether small or large. A pilot SDP showed that firms in the automotive value chain do not yet understand the global market and what foreign investors require. Further, resources are underutilized, and there is a need to optimize production based on lean manufacturing principles and continuous improvement. Investment in training for managers as well as technical, quality, engineering, and sales personnel is essential for sustained long-term development, higher productivity, and links with foreign investors. In contrast, and against the prevalent trends, in the textile industry skills and workmanship are of high quality, which implies potential to upgrade to more complex and sophisticated products.

69. **Given the managerial skills shortages, many foreign investors need to bring in skilled management and workers from abroad, and here they find that the system of work permits is inefficient.** The work permit process has been speeded up, especially for short-term permits, but inefficiencies persist, particularly in terms of the period for which work permits are valid, the lack of systematic information on requirements and types of work permit, and the inability to submit documentation electronically.

Policy Actions

- *Measures to foster instruction in job-relevant technical skills will be crucial to address skills deficiencies, especially in industries that are growing, such as automotive, tourism, and ICT firms.* It will be critical to bring together the private sector and educational institutions to ensure that university education and vocational programs equip students with relevant skills. In the short term, business organizations and industry chambers can be given opportunities to comment on, e.g., curriculum reforms in vocational schools, such as semi-annual roundtables or through local economic councils and sector skills committees. Curriculum modules can also be enhanced by inviting visits of professionals and experts to STEM educational institutions to connect the contents of the lessons with the practitioners' experiences. In the medium term, reviewing the effectiveness of internship and mentoring programs for both schools and firms can be considered in order to evaluate whether the training is properly aligned with skills currently in demand. Also, draw up a market-oriented vocational program to increase the supply of skills needed as market demand evolves. Finally, also in the middle term, the Ministry of Education and Science could

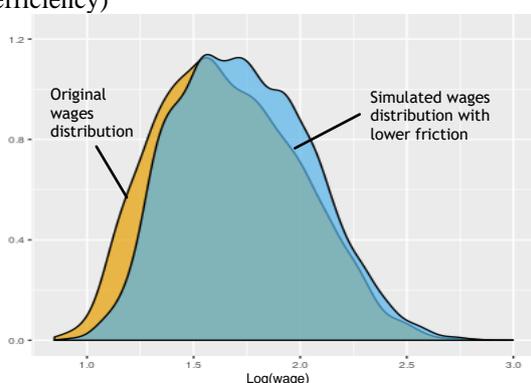
introduce elements of performance-based funding for public and private VET, based on student placement in formal jobs.

- *The limited capacity of state institutions to use an otherwise well-developed system for labor market intelligence limits responsiveness to employer demand.* One major problem that reduces the responsiveness of the educational system to employers is the lack of reliable information about demand. This is largely because national institutions have limited capacity to use the otherwise well-developed system for labor market intelligence. Various ministries and donors have invested in a range of systems for North Macedonia to collect regular data on occupational outlooks, labor-market forecast models, and surveys of employers, and in the Skills Observatory (ETF 2019). However, in almost all these activities and projects, state institutions lack the capacity to regularly collect, update, and use the data effectively.
- *Making better use of the information available for skills forecasting in North Macedonia will also be important.* Various ministries and donors have invested in a range of systems for North Macedonia to collect regular data about labor markets, including labor-market forecast models and a Skills Observatory (ETF 2019). The information from these sources could be better used and complemented with more frequent data from private online job-search portals to monitor emerging skills needs. Here, opportunities for firms to comment on current and desired curricula will also be relevant. Along these lines, in the medium term, it will be critical to fully operationalize the labor market and skills observatory (LMSO)/Labor Market information system in order to sustainably monitor the evolution of demand for skills and competencies and identify skills in short supply. This could also help to steer the educational and career decisions of youth to the best opportunities available.
- *Getting firms more involved in the provisions of training can also help to close the skills gap.* Firms, business organizations and industry chambers could get substantially more involved in providing targeted training and certification, in line with their most pressing demands for skills. For this, it might be useful to explore the use of different incentives for employers than the already existing, such as co-funding mechanisms or tax deductions. Different programs could be tested to evaluate the sensitivity of firms to different incentives. A comprehensive program, particularly with an export and FDI focus, that provides matching grants to eligible firms could alleviate acute skills shortages and improve firm capabilities. Another option is to promote training networks of SMEs to help them share costs, work together to design training programs, and achieve economies of scale.
- *Build student socio-emotional skills.* For this, drafting a strategy for soft skills acquisition and development at all levels of education would provide a blueprint to address this shortcoming in recent graduates. Ultimately, embedding socio-emotional development into school curricula will be necessary starting from early ages.
- *Streamline the visa and work permits process to facilitate the hiring of expatriate employees to fill local skills shortages.* Three measures in particular would address current shortcomings in the system: (1) make permits valid for 3–5 years; (2) proactively disseminate information and clarify documentation requirements; (3) allow electronic submission of supportive documents; and (4) factor into the Employment Agency validation process the extent of the subject’s professional experience.
- *Identify local shortages of high-skilled labor and cooperate with those in the diaspora to design a program to attract high-skilled foreign professionals to fill the jobs,* as is done in EU blue-card countries and in Canada. Further, mapping the diaspora by economic/occupational profile may open up prospects for investment, skills training, and learning opportunities.

C.3. Labor Market Intermediation³⁷

70. **The most common way to find employment is the use of personal networks of relatives, friends, and acquaintances; public employment services are not fully utilized.** Just over 40 percent of job-seekers use the Public Employment office, a sizeable share, but still far behind networking, which is used by 80 percent. Usage of the Employment Service Agency (ESA) is especially low considering that by law all job openings must be advertised to the agency. Moreover, only those with tertiary education are heavy users of ESA services. About 60 percent of the unemployed with tertiary education registered with the ESA, compared to only about 20 percent of those with secondary education, and far fewer of those with primary education (World Bank, 2019). These results imply barriers to access, whether demand-side constraints, such as lack of information or difficulty in accessing the services, or supply-side constraints, such as a limited offer of services or the small number of locations.

Figure 14. Improved intermediation could lead to higher incomes via a reduction in unemployment (Simulation results from an increase in matching efficiency)



Source: Robayo, et al (2020), using SIMLAB.

Box 2) shows that an increase in the matching efficiency of 20 percent can lead to a decline in the unemployment rate of 6 percentage points, driven by a shift from unemployment towards informal employment. Higher job finding rates means that workers can find jobs easier and therefore ask for higher wages when accepting prospective matches (Figure 14).

72. **Local public employment service (PES) can improve their efficiency by better allocating financial and human resources across.** PES administrative data reveal that caseloads—the number of unemployed individuals allocated to each PES case worker—vary substantially from office to office. A World Bank study (2018b) of PES efficiency also suggests that equalizing the efficiency of local PES to the best-performing offices, holding resources constant, could increase job placement by 73 percent.

Policy Actions

- *Strengthening the ESA is paramount.* In the short term, to increase outreach to and use of services by unemployed workers with less than tertiary education, the ESA can promote its services in secondary (general and technical) and VET schools. It can also assess the main reasons other than structural (e.g., low demand for low-skill work) for the minimal use of services by low-skilled workers in order to identify changes that could be within its mandate (e.g., customize services to low-skilled workers, better publicize employment opportunities for them). In the medium term, to

³⁷ This section is based on World Bank (2019) North Macedonia – Finding Solutions to Youth Unemployment, and Robayo and Lucchetti (2020) SIMLAB: A Structural Micro Simulation Tool to Analyze Distributional Impact of Policy Reforms: The Case of North Macedonia.

further reduce the caseload ratio the ESA can address capacity constraints by allocating appropriate staff and financial resources to centers outside of Skopje. It may also be useful to introduce statistical profiling of job seekers to improve the targeting and cost-efficiency of ESA services.

- *Public employment services can also be complemented by calling on private providers to facilitate intermediation.* This can take the form, for instance, of piloting performance-based contracting with private providers for selected intermediation services to certain hard-to-serve groups (e.g., vulnerable registered jobseekers).

Box 4. SIMLAB tool

The SIMLAB tool has been developed by the World Bank to provide ex-ante evidence on the potential employment, wage, and distributional impacts of policy reforms. The tool is based on a structural model of the labor market with search and matching frictions, which can simulate a rich array of labor market and macroeconomic variables. Its key objective is to characterize the labor market and to capture the ex-ante effects of selected reforms, capturing both the distributional impact and the macroeconomic effects. The SIMLAB tool aims at answering questions like (i) what are the main drivers behind the high unemployment rate in North Macedonia?; (ii) what human capital policies should be implemented to reduce unemployment and what would be their distributional impacts?; (iii) how important is formalization to reduce unemployment and what are the distributional impacts?; (iv) how important are frictions and information asymmetries?; (v) can policies affecting matching efficiency reduce unemployment and what are the distributional impacts?; and (vi) what is the impact of these set on policies on growth and poverty?; among other questions related to human capital, public-sector employment and formalization. The analysis is marginal and behavioral, in the sense that agents' responses are taken into consideration when simulating policy interventions. The tool will be made publicly available by the World Bank to inform policy decision and contribute to the policy debate

Source: Robayo et al. (2020)

C.4. Labor Market Information³⁸

73. **The limited capacity of state institutions to use an otherwise well-developed system for labor market intelligence limits responsiveness to employer demand.** One major problem that reduces the responsiveness of the educational system to employers is the lack of reliable information about demand. This is largely because national institutions have limited capacity to use the otherwise well-developed system for labor market intelligence. As indicated, various ministries and donors have invested in a range of systems for North Macedonia to collect regular data on occupational outlooks, labor-market forecast models, and surveys of employers, and in the Skills Observatory (ETF 2019). However, in almost all these activities and projects, state institutions lack the capacity to regularly collect, update, and use the data effectively.

74. **The lack of easily accessible information about labor market trends leads to wrong signals.** On one side, analyses show that for labor income, diplomas matter more than skills (STEP). As a result, education does more than skills to explain differences in hourly wages, indicating that employers reward diplomas rather than the actual skills of their workers. An undesirable outcome is that student choices of careers and skills accumulation do not follow market trends. Moreover, the limited career guidance available in VET schools and universities, underpinned by the lack of career orientation at the end of primary school, are likely to exacerbate the mismatch between the youth and employer expectations of the labor market.

75. **Lack of reliable information also contributes to the misalignment of salaries, expectations, and the labor market.** One possible contributor to the biased expectations of youth is that information about the labor market outcomes of VET and university graduates is not available to prospective or current students because it is not systematically collected. In fact, data from the 2016 Labor Force Survey show that for all educational levels, the average salary youths expect is higher

³⁸ This section is based on World Bank (2019) North Macedonia – Finding Solutions to Youth Unemployment, and Petreski et al. (2019) Expectations Set High: Understanding Reservation Wages in North Macedonia.

than the market average (a bias not exclusive to youth). Analysis of the entire labor market using data for 2016 and 2017 found that unemployed workers have a reservation wage close to 15 percent higher than they can expect given their personal characteristics, and the percentage is higher among the low-educated and in sectors associated with low skills (Petreski et al. 2019). Moreover, the variation in the reservation wage is largely explained by personal characteristics, with no reference to labor market factors such as skill- or field- specific employment rates. This may be because local information is not easily available to job-seekers or they are reluctant to accommodate, considering them too low for their expectations.

Policy Actions

- *Improving youth career orientation can support more informed decision-making.* To this end it is recommended that the capacity of career centers be assessed to identify those with adequate advisory capacity and to identify shortages in the resources the career centers need to be effective. In the medium term, other actions for consideration could be to:
 - i. Establish professional orientation centers in all VET schools and career service centers at universities;
 - ii. Mandate career plans for each VET and university student;
 - iii. Systematize the tracking of VET and university graduates by collecting information on job placement, working conditions, and wages of alumni; and
 - iv. Share that information with prospective and current students. The Ministry of Education and Science or the ESA could act as repository and disseminator of this information, which could help to steer the educational and career decisions of youth to the best opportunities available.
 - v. Enhancing the quality of career advice for parents and students in the last year of primary school and expanding professional orientation in secondary school can give students and families valuable information to make informed decisions.
- *Detailed information about labor market conditions will also contribute to more informed decisions.* Campaigns in secondary schools to inform both parents and students about the benefits and future labor market prospects of studying STEM subjects can help steer students to those fields, where there is less unemployment. In addition, centralizing labor market information from employers, the Ministries of Education and Labor, PSA, the Statistical Office, and other stakeholders can facilitate access to and dissemination of such information as job openings, duration of openings, duration of job searches, job placements and wages by occupation, sector of employment, and type of education. Finally, a determined effort to make labor market information widely available to the young and their families, through the ES website or outsourced, can help them access this information at points decisive for their career choices.

C.5. Labor Market Regulations³⁹

76. **Rigid regulations for short-term contracts disproportionately affect youth.** Close to 30 percent of the youth employed are hired on temporary contracts, and this share is as high as 60 percent for those with only primary education (World Bank, 2019). However, the regulations related to temporary contracts, though perhaps more flexible than in other Western Balkan economies, are still more rigid than in more advanced economies in Eastern Europe. The planned reduction in the draft labor law of the period for automatic conversion of temporary contracts should therefore recognize the possible adverse effects on the hiring of youth. Also, certain provisions in the apprenticeship contract may discourage employers from hiring apprentices (e.g., the prohibition of early termination). This could make employers more reluctant to use the contracts: only 5 percent of workers aged 15–29 have been hired on an apprenticeship contract.

77. **A binding minimum wage can slow down school-to-work transitions, particularly for the less educated.** In North Macedonia, the share of workers at or below the minimum wage is larger

³⁹ This section is based on World Bank (2019) North Macedonia – Finding Solutions to Youth Unemployment,

among young workers, peaking at almost one in every three workers aged 15–24. Currently, the minimum wage in North Macedonia is set only after a series of negotiations between workers and the government and it is often affected by the political cycle. Technical calculations to establish the value of the minimum wage are rare, especially in advance of the intended changes (ILO 2019). A current concern is that in recent years the minimum wage has risen faster than labor productivity, which may discourage employers from hiring young workers, especially those with little education.

Policy Actions

- *Actions to maintain employer hiring flexibility while ensuring quality jobs for youth could be considered.* In the short term, maintenance of the automatic conversion of temporary contracts after 5 years, instead of the proposed 6 months is recommended, as this proposal can reduce hiring flexibility and impact negatively on formal employment. An intermediate option might be automatic conversion of temporary contracts after 2 or 3 years. Worth evaluating is whether to abolish the prohibition to terminate the apprenticeship contract (art. 59 of Labor Code) and to align the legal basis of the contract with that of regular employment contracts, to motivate its use for more flexible hiring of youth.
- *The minimum wage should be kept in line with the economy's fundamentals to avoid discouraging low-skilled workers.* In the short term, the minimum-wage-setting consultation process should provide employers with the opportunity to voice any concerns about proposed increases. In the medium term, a more comprehensive reform would be to introduce a methodology for calculating the minimum wage based on labor productivity and other economic fundamentals. This would make the process more transparent and predictable, reducing a source of uncertainty for the private sector.

C.6. Activation of Income-Support Program Beneficiaries⁴⁰

78. **The Government of North Macedonia in 2018 launched a package of reforms to improve coverage of social assistance programs while keeping their targeting accurate.** The most relevant reform was introduction of the Guaranteed Minimum Assistance (GMA), a means-tested comprehensive social safety net for the poor that replaced all previous means-tested social assistance programs. The GMA provides support, using an equivalence scale, equal to the difference between a household's monthly income and a threshold set at MKD7,200 a month (€120, about 28 percent of the median income) for a five-member family. It benefits an estimated 50 percent more households than the previously existing social assistance programs and is expected to raise the incomes of the bottom 40 percent of the population.

79. **GMA beneficiaries able to work will participate in social activation programs to improve their employability and enhance their earnings opportunities.** It is expected that by participating in these programs, GMA beneficiaries will reduce their long-term dependence on benefits and will prevent them from staying on welfare rather than actively seeking jobs. An analysis of the Survey of Income and Living Conditions (SILC) show that a large share of work-able GMA beneficiaries are unemployed men, relatively young (under 35), with little education. Another large group consists of women who are not active in the labor market, and another large group are men over 35 years old. In addition, labor market attachment indicators are quite low among activable GMA beneficiaries, as only 22 percent of them have ever worked. The plans to activate beneficiaries should hence recognize this heterogeneity in the profile of beneficiaries and the different constraints to move from unemployment to employment each group face when designing the services to be offered for activation. Another aspect to be considered is that a close coordination and collaboration between the agencies involved in provision of social assistance and employment services will be required, beyond what is business as usual.

⁴⁰ This section is based on World Bank (2020) Background Note: Inputs for Developing an Activation Strategy for Guaranteed Minimum Assistance Beneficiaries in North Macedonia.

80. **Currently, the European Commission is supporting an ESA pilot program to test a strategy for activating social assistance beneficiaries** (Figure 15). The target population is the unemployed in vulnerable situations and hard-to-employ job seekers. The strategy outlined consists of initial triage by Social Work Centers (SWC), the agency providing social services, followed by design of a plan specific to that beneficiary by ESA, the agency in charge of activation measures. The beneficiary then receives supportive services for 15 months, after which the activation process is finalized. Among the services to be received by beneficiaries are support in the form of counselling and motivation, as well as access to active labor market measures. This design is consistent with the approach followed in Portugal, Croatia, Germany, and Slovenia.

Figure 15. Activation Pathway for a Social Welfare Recipient



Source: European Commission (2018).

Policy Actions

- *Prioritize unemployed young beneficiaries to maximize potential impacts of activation.* Overall, the design of the pilot program is adequate and consistent with international practices. To maximize the impact, however, the program could start by focusing on the GMA beneficiaries that are unemployed men, relatively young (under 35), with low education. This group of activable workers are a better fit to the services offered by the ESA for unemployed workers and outlined by the pilot program, as opposed to older male workers or women inactive in the labor market, which may require some more specific tailoring of the services offered for activation. Prioritizing the first group thus could achieve more initial positive results, though unless many new jobs are created, actual job gains could be small. An option to explore as well is the possibility for some of them to return to mainstream education, in case feasible. In addition, other countries have experimented with signing contracts with beneficiaries to reinforce the notion that the GMA benefit is in exchange for the effort to activate, and that citizens are required to actively participate in income support programs. The program could explore using this approach, as well, to motivate the worker to engage in activation measures.
- *Offer training relevant to beneficiaries that lack very basic skills and motivation.* While some of the beneficiaries may be reasonably well positioned for the job market and the current offer of services from the ESA may serve them well, it can be expected that a large group of the beneficiaries will lack very basic skills and motivation to apply for jobs. For this, the training offered should prioritize building non-cognitive skills and psycho-social support to motivate them to activate. For the first, the training could focus on developing skills for which there is some evidence that education and training can influence their development, such as perseverance/grit, self-control and social skills. For the second, support in the form of individual counseling or mentoring, as well as group counselling led by social workers or psychologist can play an important role to break cycles of inactivity. These efforts could also leverage behavioral economics principles to attain their objectives: For instance, personalized text messages to beneficiaries and close relatives could be tested as reminders or to reinforce counseling and

motivation messages; there is evidence that this has had positive impacts in other contexts. The efforts can also be informed by focus groups on these beneficiaries, which can help to shed light into their openness towards these interventions, barriers or limitations of these services and alternatives for effectively support their activation.

- *Strengthen the capacity of the institutions and professionals involved.* Professionals at the ESA and SWC will need to strengthen their capacity for supporting activation. In the long run, it could be explored whether some of the services are better provided by the NGO sector, or outsource to the private sector.
- *Increase the scope of services offered gradually. It is advisable to start with a smaller number of services, gradually adding more over time as capacity to deliver and monitor the programs is built, avoiding excessively burden the agencies.* With respect to monitoring, it is advisable to establish common tools for following up with beneficiaries even if services are supplied by different agencies.
- *Expand the menu of services tailoring profiles different than young unemployed beneficiaries.* The menu of services in the pilot program is appropriate for younger beneficiaries. As the program expands coverage to inactive women, more mature groups and other profiles, it could consider offering childcare, elder care and health care alternatives, as these groups may be in greater need of these—which may be one of their main reasons for staying inactive.
- *Objectives set for beneficiaries need to be informed by local conditions and beneficiaries' social context.* The objectives set for beneficiaries, especially the more mature and long-term unemployed groups should be informed by the recent trends in the local labor markets (e.g., profile of positions available, average salaries offered) in order to set realistic objectives, while keeping in mind that psychological and cultural biases (e.g. embarrassment, stigma, diminished self-esteem) may play a role in the reluctance of these groups to accept any job offer. The objectives setting could also explore options related to re-qualifications, apply for temporary jobs or seasonal jobs abroad, or part-time work from home alternatives (e.g. edit and proof reading, data entry, child caregiver), treating them as stepping stones towards more desirable positions.
- *Overall, objectives of the activation program should be aligned with conditions of the North Macedonia's labor market.* Being realistic about objectives of the activation program is important. Labor statistics from the State Statistical Office show that 75 percent of the unemployed have been looking for work for more than a year (State Statistical Office 2018). In addition, GMA beneficiaries have only a tenuous attachment to the labor market, which means that full employment after the program ends may be difficult for most beneficiaries, who will be competing with fully active jobseekers for too few positions. More realistic metrics for the program success could be number of jobs applied for, training received, attendance to counseling sessions, or other more concrete measures of engaging with the services offered. A related issue is the situation of graduates of activation programs who are not able to secure a job. For these cases, the income support could be maintained, and monitoring should continue to make sure they keep searching for work, as could be clearly stated in the contracts that beneficiaries sign. If they do not find a job after a period (e.g., two or three years), they could be mandated to again follow the activation program.

D. POLICY ACTIONS MATRIX

Private Sector Development

Short-term actions

Medium-term actions

Objective: Further improve regulatory environment

- Conduct an assessment and mapping of court processes and the legal framework for handling commercial cases to identify and address underlying causes of delays.
- Support the development of a business portal including information on procedures to establish and operate a business.
- Assess the ICT capacity of the different agencies involved in G2B services and elaborate strategy to improve their integration focusing on a complete business regulation value chain, including integrated rule-making, business planning, and registration, licensing, inspection, business life events, and eventually exit.
- Conduct a systematic Business Regulation Review, possibly focusing on specific priority sectors, to gather data and evidence of constraints of business regulatory environment.
- Review the Regulatory Impact Assessment system to identify weaknesses in existing regulations and/or in the implementation capacity of the relevant authorities.
- Amend the corporate insolvency framework to further encourage tackling distress on time, eliminate (or significantly amend) the law on out-of-court settlements, improve the institutional framework for insolvency practitioners, remove the incompatibility with other professions, and create an efficient mechanism for licensing and monitoring of their performance.
- Review laws and regulations for inconsistencies with entry and establishment of non-discrimination principles (Entry Gap Analysis) and publish a consolidated list of legal entry barriers to increase transparency for investors.
- Based on technology assessment identify possibilities for improvements and include a roadmap and high-level implementation program that includes the use of artificial intelligence to automate business name selection, AI-augmented chats about improving dissemination on regulatory requirements (i.e., AI chatbots), and improved inspection targeting.
- Develop clear and actionable guidelines and checklists for G2B services and procedures, develop service delivery standards for each agency and establish the system to track compliance and performance of the public officials responsible for each process.
- Enhance public-private dialogue at technical level, with participation of local and foreign companies alike (at the same time) that could build private-sector confidence in inclusiveness and responsiveness of the institutional environment.

Objective: Boosting the effectiveness of the competition and state aid policy framework and enforcement

- Promote pro-competition conditions in key product markets by strengthening competitive neutrality, promoting access in network industries, and removing barriers to competition in professional services. This includes: (a) strengthening competitive neutrality to avoid distortions that unlevel the playing field; (b) introducing pro-competition regulatory frameworks in basic network industries with a natural monopoly structure; (c) decreasing information asymmetry and restrictions to spatial mobility in professional services.
- Harmonize the state aid legislative and regulatory framework, to be in line with international standards and best practices, particularly with the EU State aid rules, the practice
- Strengthen the effectiveness of the competition policy framework by sanctioning antitrust violations and streamlining merger notifications. North Macedonia should improve compliance with the antitrust regulatory framework by strengthening the fight against antitrust violations and optimizing the merger notification system.
- Adjust the incentives in terms of instruments used, sectors and firms targeted, and policy goals pursued. A regular review and analysis of the programs is essential.
- Institute a legal/policy mechanism for regular analysis and publication of the budgetary implications of incentives programs, their effectiveness and efficiency.

of the European Commission and the case-law of the Court of Justice of the European Union.

- Harmonize internal inconsistencies in the different laws which cover the state aid legislature, so that they are aligned with the Law on State Aid.
- Establish an inventory of State aid, including *de minimis* aid, under the authority of the Commission for the Protection of Competition.
- Establish a legal/policy mechanism for regular analysis and publication of the fiscal implications of incentives programs, their effectiveness and efficiency.

Objective: Ensuring access to finance to SMEs

- Undertake a market gap assessment and realign DBNM's strategy and products to address current market failures; avoid interest rate ceilings for future credit lines.
- Analyze the possibility of setting up a credit guarantee scheme under DBNM.
- Enact a unified legal framework for creating security over all types of movable assets and establish a centralized collateral registry for security interests in movable property to remove obstacles for acceptance of movable collateral by banks.
- Review policy objectives and legal framework for saving houses to address market development and proportionality.
- Establish legal framework for factoring.
- Implement recommendations stemming from the assessment of the legislative framework for private equity and venture capital funds
- Transpose Payments Service Directive 2 into local law.
- DBNM to consider extending wholesale funding to saving houses and finance companies.
- Assess the need to amend tax treatment for factoring and leasing companies.
- Strengthen accounting standards and financial management practices of MSMEs
- Develop a comprehensive legal framework for financial consumer protection
- Transpose and implement consumer protection provisions in EU Payments Services Directive 2 and EU Consumer Credit and Mortgage Credit Directives
- Establish a dedicated consumer protection department within NBRM covering all retail deposit, payments, and credit products, and enhance capacity and resources for financial consumer protection supervision.

Objective: Attracting and retaining investments

- Conduct a sector scan to identify priority sectors and 'desirability' for investment promotion and assess the competitiveness of sectors and value chains in North Macedonia to determine their 'feasibility' or 'readiness' for investment promotion.
- Develop a targeted FDI promotion strategy aimed at attracting investments that would lead to desired policy goals (e.g. diversification, job creation, green economy, etc.).
- Define the roles and responsibilities of key government agencies and other stakeholders in investment attraction, including clear KPIs to track and monitor progress with strategy implementation, mandates and resources for effective investment promotion.
- Design an effective investor grievance mechanism to prevent investment disputes and enhance retention, expansion and linkages from existing investors: (i) map and assess existing grievance management structures and processes; (ii) map and assess current investor grievance profiles; (iii) establish a lead agency for grievance management and define the roles and responsibilities of key government agencies and other stakeholders in grievance resolution; and (iv) introduce a robust M&E framework including clear KPIs to monitor the effectiveness of the grievance mechanism.
- Build capacity of the lead IP agency to design and implement effective investment promotion activities and strengthen cooperation mechanisms and define interfaces with other relevant stakeholders in- and outside the government.

Objective: Strengthening FDI linkages

- Identify the lead agency for a Supplier Development Program and give it the mandate and budget to design and implement a program.
- Give Agency for Foreign Investments and Export Promotion the mandate to increase export promotion efforts and capabilities.
- Increase the capabilities of the Agency for Foreign Investments and Export Promotion to provide export intelligence to firms.
- Design and implement Supplier Development Program to facilitate linkages and upgrade firm capabilities, targeted to increasing the value-added of manufacturing in the country.
- Facilitate broader market linkages by promoting exports to foreign investors located in relevant value chains in the region.
- Redesign the existing instrument of the Plan for Economic Growth that reimburses foreign investors' purchases from domestic firms to align with a supplier development program, as it does not address the capabilities and market/coordination failures.

Objective: Improving domestic firm capabilities

- Measure capabilities gaps and needs in North Macedonia by implementing the World Management Survey to assess firms' operations management, performance monitoring, target setting, leadership, talent management, and other relevant aspects.
- Conduct a Public Expenditure Review of the Government's SME and Innovation programs to evaluate their quality, gaps and redundancies; assess the quality of the design, implementation, and governance of existing programs; and provide recommendations to improve the quality of design, implementation and governance of programs based on international best practices.
- Examine the impact of a selected set of government instruments on managerial, innovation, and production capabilities through a survey of beneficiaries of these instruments to gather feedback on how the firm has used the funding and whether it has made a lasting impact on their capabilities.
- Ensure that the institutional framework governing innovation in the country is clear and improve coordination and improve aspects of the legal framework (like the Law on Innovation Activity and the Law for Financial Support).
- Consolidate existing programs into fewer, larger programs to build capabilities and support upgrading at firms moving away from subsidizing inputs: (i) implement management and technology extension programs; (ii) assess the current support available to early-stage firms through incubators and accelerators, and adjust them to build stronger managerial and innovation capabilities; (iii) design and implement a supplier development program that builds capabilities of SMEs and facilitates linkages with foreign investors in the country.
- Capabilities may need to be built in institutions such as the Ministry of Economy, Agency for Support to Entrepreneurship, FITD, and others depending on the roles they will play in implementing the new suite of instruments.
- Further develop the national innovation system by first developing STEM (science, technology, engineering and math) skills, ensure good national quality infrastructure (i.e. metrology, standards, testing), and link industry and academia.

Labor Supply

Short-term actions

Medium-term actions

Objective: Facilitating youth acquisition of labor market experience

- Adjust VET and university class schedules to better match company needs for students and interns: Make more flexible the rule on number of hours per week interns must spend in a firm, perhaps by requiring a given number of days to be spent in the company that it can allocate freely over a month.
- Introduce mechanisms to facilitate the take-up of interns and work-based learners by small companies, such as shared interns, tax deductions, and subsidies.
- Enforce compulsory internships for university students. Potential measures could be to make graduation or progression to the next grade

- Amend the labor law that prohibits formal employment while engaged in full-time education. Enforce the new law on internships, which limits internship duration to 6 months, ensures a minimum remuneration to interns, and grants them rights to unemployment and social benefits.

conditional on completion of a one-month internship each academic year.

- Establish quality control measures to certify the quality of internships offered to students and build up collaboration between educational institutions and employers on internships. Ensure adequate controls of enforcement of the new labor law, assigning responsibility to the labor unit of the Ministry of Labor in collaboration with the Ministry of Education

Objective: Addressing skills shortfalls

- Establish a sustainable structure for employers (business organizations and industry chambers) to contribute to regular curriculum reforms in vocational schools, such as biannual roundtables.
- Expand delivery of curriculum modules by professionals and visits by experts in STEM education.
- Complement the Skills Needs Analysis and STEP Surveys by collecting more frequent data from private online job-search portals.
- Reactivate local economic councils and sector skills committees that include representatives from the private sector to help shape curricula tailored to private sector needs.
- Give employers incentives to provide training, such as tax deductions or co-funding for firms investing in employee training. First, however, pilot a program to test the sensitivity of firms to such incentives.
- Draft and adopt a strategy for student acquisition of soft skills at all levels of education.
- Further improve the visa and work permits regime to facilitate the hiring of expatriate employees when there are skills shortages in the local labor market: (i) allow a 3–5 year permit validity; (ii) proactively disseminate information and clarity on the documentation requirements; and (iii) allow for electronic submission of the documents.

- Broaden quality assurance systems for public and private education and training providers to the monitoring of delivery after licensing
- Develop a market-oriented vocational program to increase the supply of skills in accordance with evolving demand (market conditions).
- Consolidate into a larger program that co-finances training of new and existing employees and management that has a greater impact on the on-the-job learning, upskilling and productivity.
- Introduce elements of performance-based funding for public and private VET provision, based on student placement in formal jobs.
- Operationalize the Labor Market and Skills Observatory (LMSO)/Labor Market Information System to monitor the evolution of demand for skills and competencies and identify skills in short supply. This could help to steer the educational and career decisions of youth to the best opportunities available.
- Embed socio-emotional development in the school curriculum starting at early ages.
- Identify high-skilled labor shortages on the local market and cooperate with diaspora to attract high-skilled foreign professionals in key sectors facing skills shortage.

Objective: Strengthening labor market intermediation.

- Explore outreach and promotion of ESA services in secondary schools (general and technical) to increase use of services by the low-skilled.

- Address ESA capacity constraints by allocating human and financial resources to ESA centers, especially in regions beyond Skopje, to reduce the caseload ratio.
- Introduce statistical profiling of job seekers to improve ESA targeting and cost-efficiency.
- Pilot performance-based contracting of private providers for intermediation with certain hard-to-serve groups like vulnerable registered jobseekers).

Objective: Disseminating more labor market information

- Use quality assessment to identify gaps in resources for career centers.
- Conduct information campaigns in secondary schools about the benefits of studying STEM subjects to expand future labor market prospects.
- Expand establishment of professional orientation centers to all VET schools and establish career service centers at universities.
- Mandate that each student in both VET schools and universities draft a career plan.
- Systematize the tracking of graduates of VET schools and universities by collecting information on job placement, working conditions, and wages of alumni, and share the information with prospective and current students; information sharing could be centralized in the Ministry of Education. This could also help to steer youth educational and career decisions toward the best work opportunities.
- Enhance the quality of career advice in the last year of primary school and expand professional orientation in secondary school.
- Integrate labor market information from employers, the Ministries of Education and Labor, Public Employment Agency, Statistical Office, and other stakeholders. This might include, e.g., vacancy data, how long vacancies have been open, duration of job search, job placements and wages by occupation, sector of employment, and type of education.
- Make labor market information widely available to youths and families, through the ESA website or through outsourcing.

Objective: Issuing conducive labor market regulations.

- Include employers in consultations about setting the minimum wage.
- Continue automatic conversion of temporary contracts after 5 years, instead of the proposed 6 months; or consider an intermediate option such as automatic conversion after 2 or 3 years.
- Abolish the ban against terminating an apprenticeship contract (Labor Code art. 59) to align its legal basis with that of regular employment contracts and motivate its use for more flexible hiring of youth.
- Introduce a methodology for calculating the minimum wage based on labor productivity and other fundamentals of the economy.

Objective: Improve the employability and earnings opportunities of GMA beneficiaries.

- Prioritize adults under 35 years old as the program starts; this group is a sizable share of beneficiaries and has slightly fewer challenges than other groups identified for activation. Explore the possibility for some of them to return to mainstream education.
- Integrate rosters and information systems for GMA beneficiaries in SWC and ESA to avoid duplications. An intermediate step for this could be providing remote access to each other's information management systems.
- Establish common tools to monitor and follow up with beneficiaries even if services are supplied by different agencies.
- Consider applying behavioral economics principles to interventions for beneficiaries' motivation. For instance, test using personalized text messages to beneficiaries and close relatives as reminders or to reinforce counseling and motivation messages.
- Inform interventions with results from beneficiaries focus groups, to identify barriers or

- Use contracts between the GMA program and the beneficiaries to reinforce the fact that the GMA is in exchange for the effort to activate.
 - Offer training relevant to beneficiaries that lack very basic skills and motivation. Focus on malleable skills, such as perseverance/grit, self-control and social skills, and on psycho-social support in the form of individual or group counselling.
 - Strengthen the capacity of the institutions and professionals involved.
 - Start with a small number of services, adding more over time as capacity to deliver and monitor program delivery increases, avoiding overstretching provision capacity, oversight, and monitoring.
 - Define program objectives in terms of participation rather than effective job placement, considering the profile of beneficiaries and how slowly jobs are created in North Macedonia.
- limitations of these services and alternatives for effectively support activation.
- In the long run, explore outsourcing services to NGOs or private sector.
 - As the program expands coverage to inactive women and more mature populations, consider offering beneficiaries childcare, elder care, and health care alternatives; for these groups such activities may be a powerful reason to stay inactive.
 - Also, the objectives setting for these groups could also explore options related to re-qualifications, apply for temporary jobs or seasonal jobs abroad, or part-time work from home alternatives (e.g. edit and proof reading, data entry, child caregiver), treating them as steppingstones to more desirable positions.
 - Monitor beneficiaries who at graduation cannot find jobs to make sure they continue their job search. If employment is not attained after some time (e.g., 2 or 3 years), they could be required to again follow the activation program

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World Bank Regular Economic Report, Spring 2020