

# Convergence to the European Union: Challenges and Opportunities



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## ABBREVIATIONS

**ALMP** Active Labour Market Policies

**CAP** Common Agricultural Policy

**CARDS** Community Assistance to Reconstruction, Development and Stabilization

**CEE** Central and Eastern Europe

**CEFTA** Central European Free Trade Agreement

**CNDP** Compensatory National Direct Payments

**CPC** Commission for Protection of Competition

**CPI** Consumer Price Index

**EBRD** European Bank for Reconstruction and Development

**ECTS** European Credit Transfer System

**EEC** European Economic Community

**ERDF** European Regional Development Fund

**ERM II** Exchange Rate Mechanism II

**ESA** Employment Service Agency

**ESF** European Social Fund

**EU** European Union

**FDI** Foreign Direct Investment

**GDP** Gross Domestic Product

**GLOBALGAP** Global Good Agricultural Practices

**HACCP** Hazard Analysis Critical Control Points

**IACS** Integrated Administration and Control System

**IFI** International Financial Institution

**IPA** Instrument for Pre-Accession

**IPARD** Instrument for Pre-Accession Rural Development

**JIM** Joint Inclusion Memorandum

**MFN** Most-Favoured Nation

**NMS** New Member State

**NTB** Non-Tariff Barriers

**NUTS** Nomenclature of Territorial Units for Statistics

**OECD** Organization for Economic Co-operation and Development

**PES** Public Employment Service

**PHARE** Poland and Hungary: Assistance for Restructuring of Economies

**PIRLS** The Progress in International Reading Literacy Study

**PISA** Programme for International Student Assessment

**PPL** Public Procurement Law

**PROGRESS** Community Programme for Employment and Social Solidarity

**R&D** Research and Development

**SAA** Stabilization and Association Agreement

**SAPARD** Special Action Programme for Agriculture and Rural Development

**SAPS** Single Area Payment Scheme

**SFP** Single Farm Payment

**SME** Small and Medium Enterprise

**TFP** Total Factor Productivity

**TIMMS** Trends in International Mathematics and Science Study

**TOKTEN** Transfer of Knowledge Through Expatriate Nationals

**WTO** World Trade Organization

# CONTENTS

<b>PREFACE</b>	<b>6</b>
<b>INTRODUCTION</b>	<b>8</b>
<b>SUMMARY OF RECOMMENDATIONS</b>	<b>10</b>
<b>CHAPTER I: ACCESSION OF MACEDONIA TO THE EU:</b>	
<b>OVERVIEW OF ISSUES AND CHALLENGES</b>	<b>20</b>
<b>Introduction</b>	<b>20</b>
1 General Criteria for EU Membership and the Accession Process	20
2 Brief Review of Macedonia's EU Integration Process	22
3 Overview of Challenges for Macedonia on its Way to the EU	24
4 The Nexus of Transition – Economic Challenges of EU Accession	26
<b>CHAPTER II: MACROECONOMIC CONVERGENCE</b>	<b>32</b>
<b>Introduction</b>	<b>32</b>
1 Conceptual Framework	32
2 Real Convergence	33
3 Nominal Convergence	35
4 Policy Implications of Convergence	36
5 Quality of Institutions for Macroeconomic Regulation	36
6 Post-Accession: Toward the Euro	38
<b>CHAPTER III: BUDGETARY IMPLICATIONS OF EU ACCESSION</b>	<b>42</b>
<b>Introduction</b>	<b>42</b>
1 EU Public Finances and Financial Flows Between the EU Budget and EU Members and Candidate Countries	42
2 Fiscal Implications of EU Accession	43
3 A Case Study of Slovenia	44
<b>CHAPTER IV: INTERNATIONAL TRADE AND FOREIGN DIRECT INVESTMENT</b>	<b>46</b>
<b>Introduction</b>	<b>46</b>
1 Immediate Impact of the EU Accession on Foreign Trade	46
2 The Long-Term Foreign Trade Impact of EU Accession and FDI	47
<b>CHAPTER V: INDUSTRY AND NON-FINANCIAL SERVICES</b>	<b>52</b>
<b>Introduction</b>	<b>52</b>
1 EU Accession – The Requirements	52
2 Macedonia – Industry	53
3 Macedonia – Non-Financial Services	55
4 Policy Implications	57
<b>Chapter VI: AGRICULTURE</b>	<b>60</b>
<b>Introduction</b>	<b>60</b>
1 Macedonian Agriculture and Food Sector in a Comparative Perspective	60
2 Rural Poverty and Public Transfers	62

3 Policy	63
4 Implications of EU Enlargement: Lessons From the NMS	63
<b>CHAPTER VII: FINANCIAL SERVICES AND CAPITAL FLOWS</b>	<b>70</b>
<b>Introduction</b>	<b>70</b>
1 Capital Flows and Foreign Ownership	70
2 Coping With Foreign Ownership	71
3 EU Membership and Risks of Excessive Credit Expansion	72
4 Domestic Sources for Local Operations	73
5 Lending and Borrowing in Foreign Currencies	74
6 Supervisory Issues	75
7 Is There a Separate Role for a Financial Stability Objective?	76
<b>Chapter VIII: LABOUR MARKET</b>	<b>78</b>
<b>Introduction</b>	<b>78</b>
1 Participation, Employment and Unemployment in the NMS and in Macedonia	78
2 Reforming the Labour Markets in the NMS: Lessons for Macedonia	80
3 Structural Funds for Employment Creation by the European Union	81
4 Active Labour Market Policies	82
5 Conclusions and Overall Recommendations	84
<b>CHAPTER IX: EDUCATION REFORM</b>	<b>86</b>
<b>Introduction</b>	<b>86</b>
1 Slovenia's Experience	86
2 Lessons for Macedonia too?	90
3 Large Gains from EU Pre-and Post-accession Programs for Education Require Domestic Investments.	91
4 The Tasks Ahead	92
<b>CHAPTER X: MIGRATION</b>	<b>96</b>
<b>Introduction</b>	<b>96</b>
1 The Impact of Migration on The Economy and Society of Sending Countries: General Considerations	96
2 Migration Experience of Transition Countries That Have Joined the EU in 2004 and 2007	97
3 Migration and Remittances in Macedonia: Experience and Perspectives	98
4 Policy Recommendations	100
<b>CHAPTER XI: SOCIAL IINCLUSION</b>	<b>104</b>
<b>Introduction</b>	<b>104</b>
1 Translating the European Social Agenda Into Domestic Policies: Policy Considerations	104
2 Social Inclusion in the Context of macroeconomic policies	108
3 Conclusions	109

## PREFACE

### *Distinguished Reader,*

One of the main driving forces in determining the direction, as well as the implementation of reforms in the Republic of Macedonia is the national priority for obtaining fully-fledged EU membership. Whereas the Republic of Macedonia has accomplished a lot in terms of attaining its strategic priority, there are number of challenges remaining. Hence, it is important for the country to strengthen capacities and to observe the potential social and economic implications of the integration process. The Ministry of Finance of the Republic of Macedonia and the United Nations Development Programme (UNDP) conducted a joint study "Convergence to the European Union: Challenges and Opportunities" as the need for anticipating the obstacles and opportunities arising from and along the EU convergence process have brought about the idea for preparation of this study.

To a certain level, the study uses the experience of the new EU Member States for accelerating the integration process of the Republic of Macedonia in the EU, as well as raising the awareness about the changes that come on the road to (as well as, after) acquiring EU membership. This study should also contribute to instigating an expert debate on the specific reforms, measures and activities the Republic of Macedonia should additionally undertake on its path to the EU. The study speaks in favour of the full commitment of the Republic of Macedonia to successful implementation of the reforms necessary to complete the integration process.

In this regard, the study analyzes recent developments and pays attention to the measures to be additionally undertaken for the purpose of macroeconomic convergence, i.e. real convergence of the national level of per capita income to the average level in the EU Member States. Such convergence will have to be accompanied by additional structural adjustments of the principles and

the mechanisms of the economic developments in the country. In addition, convergence of prices, inflation rates and interest rates is a process evident immediately prior and shortly after the accession into EU.

Moreover, although the structure of the Macedonian financial system is close to the one existing in the EU Member States, the accession process will bring about new qualities, as well as series of challenges. As analysis has shown regarding financial services and capital flow: "Benefits materialize during the accession phase as the countries implement institutional improvements and these make the system more stable and credible," but "EU entry will bring numerous challenges for regulators and supervisors."

Experience has shown that EU approximation process leads to increased foreign direct investments, although there is no consensus about the direct factor for attracting investments: is it the EU membership process itself or the reforms being implemented during the EU approximation process. Therefore, experts would say "the prospects of EU accession and the institutional reforms implemented contributed to attracting FDI."

Harmonization and adjustments prior and after the EU membership inevitably bring changes in the policies that contribute to industrial production growth. In particular, the analysis suggests that "Domestic savings will have to increase and the economy will have to be managed in such a way that the private sector is able to identify a steady stream of profitable investment opportunities in diverse sectors of the economy," but one should bear in mind that "Not only must the volume of investment increase, but its average quality, the productivity and competitiveness of the firms in which the investment occurs, too, must improve".

Taking into account the significance of agriculture and agriculture policy within the EU, and given that the decisions related thereto are made at EU level, Government of the Republic of Macedonia has set an objective to meet the integrative requirements related to agriculture by the end of 2010, as well as to continue implementing additional structural and institutional reforms so as to increase their competitiveness on the European markets after EU membership.

High unemployment rate is one of the most burning issues in the Republic of Macedonia. Recommendations on labour market point out that structural changes in the economy will inevitably be reflected on the labour market, which will face a big challenge for further increase of flexibility and adjustments to the new conditions following EU membership. Taking into account the strong positive connection between the level of education, employment and social cohesion, education is considered to be an important factor in improving the developments in these areas. In addition, free movement of labour is one of the basic principles in EU, which the Republic of Macedonia has to fully respect. Though, Republic of Macedonia faces the challenge of finding the way to prevent the potential loss of highly-edu-

cated persons who emigrate (brain drain), and at the same time, to stimulate highly-educated persons who emigrated to return to the country, bringing the knowledge, experience and social network they acquired abroad (brain gain).

In summary, the convergence is a natural companion in the EU accession process. Identification of possible challenges on that path and the awareness of the possible alternatives are undoubtedly useful for more successful evolvement of this process. I believe the authors of the Study accomplished the tasks set. In this regard I would like to express my gratitude to the United Nations Development Programme (UNDP) for their tremendous support and constructive recommendations during the whole preparation process that contributed greatly to the quality of this study. Government of the Republic of Macedonia appreciates experts' recommendations in the areas covered in this Study, and will endeavour to implement them. It has learnt the lesson on optimal respond to challenges in the EU approximation process. The study and its implementation will contribute a lot to the accomplishment of our strategic goal – full EU integration, and better prosperity of the society as a whole!

**Yours Sincerely,**

**Trajko Staveski Ph.D.**  
**Minister of Finance**



## INTRODUCTION

The accession of the Republic of Macedonia to membership in the European Union will be the culmination of over two decades of economic, social and political transformation. Membership in the European Union will bring many benefits to Macedonia and its citizens, including increased prosperity, more intense connections with their European neighbours and a voice in shaping Europe's political, social, and economic development. The accession process is a long and difficult one, in part because of the need for the new member country to adopt the many laws and regulations of the European Union that are contained in the *acquis communautaire*. It is perhaps even more difficult because the acceding country has to prepare itself for the major changes in its economy, its external relations and in the way in which its society functions that are required for, or that will follow from, accession. These changes are needed if the new member is to take full advantage of the benefits, as well as to meet the responsibilities, that membership in the European Union brings.

This European Union Convergence Study focuses on the latter aspect of accession and asks what Macedonia must do to prepare for membership and what changes are required in society, in the economy and in the functioning of the government. The Study covers all aspects of society that will be affected by accession. As expected, economic issues take up a large part of the Study, but accession will also bring with it challenges and opportunities in education, labour, migration and social solidarity, and these are also extensively treated in the Study. As the reader can quickly see from the list of recommendation and conclusions that follow this introduction, there are many difficult and complex tasks to fulfil, and these tasks will call on not only the efforts of the government but also on those of businesses, trade unions, social organizations, schools and individual Macedonian citizens. Moreover, the Study stresses that those efforts to meet the accession criteria and to prepare

for the effects of membership must begin well in advance of accession and must be carried through with a sense of urgency.

The citizens of the Republic of Macedonia strongly support membership in the European Union, and they hold out great hopes for the benefits that membership will bring. The Study uses the experience of other countries that have recently joined the European Union to show that these benefits are, indeed, within the Republic of Macedonia's reach, but it also cautions that whether these potential benefits will be realized or not depends on Macedonia's ability and political will to implement a united and resolute effort to prepare the country for European Union membership.

Political will, based on a broad consensus that there is a need to adapt the social and economic structures of the country to the opportunities offered by European Union membership, is crucial for the convergence process. To foresee and meet head-on any negative effects of EU accession and to make best use of the positive effects and possibilities, policy makers can benefit from the experience of other countries that have joined the European Union and from the advice of experts who can analyze these experiences and draw out their implications for Macedonia. The production of the EU Convergence Study benefited from all of these. Once the key areas that needed to be addressed were identified – and each key area is treated in a separate chapter in the Study – lead authors for each of the chapters were selected. All these individuals have the requisite academic background as well as expertise in providing policy advice, in many cases to the countries that became European Union members in the last enlargement. Moreover, some of these experts serve or have served in governments of recent European Union entrants or have participated in the negotiations leading up to the accession of these countries into the European Union.

The European Union Convergence Study was mandated by the Ministry of Finance of the Republic of Macedonia, and we thank Minister Trajko Slaveski sincerely for his foresight in recognizing the need for such a Study, for his support of its execution and for his extensive discussions with the experts, which helped to put the experiences of the other European Union accession countries into the Macedonian context. The experts also had the opportunity to meet extensively and to share their views with a range of Macedonian colleagues and experts, including those from relevant Ministries and the Central Bank, to better understand the progress that Macedonia has made in preparing itself for membership and to take into account the policies that are being implemented or considered for the future. We very much appreciate the contributions of these individuals. We are particularly grateful to Dr. Nikica Mojsoska-Blazevski who represented the Ministry of Finance in the development of the study's scope and objectives and whose commitment and contributions to the Study's successful outcome represented a very important element of its completion. Finally, it is a pleasure to acknowledge the contribution of the Czech Trust Fund Programme, which financed the participation of the Czech experts in this Study.

In a very direct way, this Study builds on the Blue Ribbon Report for Macedonia, which the UNDP commissioned and published in 2006. Many of the recommendations of that Report have been adopted and have had a positive impact on Macedonia's readiness for European Union membership, particularly in the economic sphere. In a number of areas, there is considerable continuity from the Blue Ribbon Report's policy recommendations to the recommendations of this Study if we account for the successful implementation of many of the Blue Ribbon Report's recommendations and the broader scope of this

European Union Convergence Study.

The European Union Convergence Study consists of three interrelated parts. The first of these is the Summary of Recommendations, which follow this introduction. This section sets out the key recommendations of the experts. Because preparing for accession is a complex process where many different policies and initiatives have to be coordinated, these recommendations give policy makers and citizens an understanding of all the things that must be accomplished more or less at the same time, thus showing the magnitude and interconnectedness of the task ahead. Following these recommendations are eleven chapters that summarize in greater detail the social, economic and European Union context in which the recommendations are framed and the arguments for the recommendations themselves. Thus readers who are concerned with understanding or implementing policy in, say agriculture or education, can turn to the respective chapter to gain a fuller understanding of the actions that Macedonia needs to take. These chapters are themselves distillations of comprehensive analytical policy papers – to be published in their full length separately – prepared by the experts. The individual policy papers provide the full analysis of the experts, backed by independent research of the experts, their experience with European Union accession in other countries and their understanding of conditions and developments in Macedonia and in the European Union member countries. They also contain references to, and build on, the reports of international agencies, governments, the European Union, with regard to the experiences of other countries that have recently joined the European Union. These extended studies thus provide a platform for further discussion and analysis by Macedonian experts.

## SUMMARY OF RECOMMENDATIONS

### Critical Tasks and Strategic Options for the Socio-Economic Convergence of Macedonia to the European Union

#### OVERVIEW OF ISSUES AND CHALLENGES

- The process of the EU accession will accelerate Macedonia's further transition. Clearly determined commitments accompanied with a precise time-table of the course of the EU accession negotiations will mobilize policy-makers and the public at large for effective implementation of reforms that have to be done irrespective of the country's joining the EU.
- Macedonia will have less difficulty meeting the first Copenhagen economic criterion, transforming the country into a functioning market economy, but significantly more problems in meeting the second economic criterion of making its economy fit for effective competition on the enlarged EU single market.
- Even though the process of the accession to the EU is often called a "negotiation" it is really a process of "adjustment." The initiative to join the EU comes from a candidate country and not from the EU. Therefore, a large part of the accession process is in fact a process of adjustment of the candidate country to the acquis. The only subject of negotiations is exemptions from the rules of the game in the form of transitional periods or, exceptionally, in the form of derogations.
- Macedonia's advancement from one EU accession stage to another is critically dependent on fulfilling the Copenhagen political criteria in the pre-negotiation period. Political stability and therefore meeting political criteria is a precondition for starting the EU accession negotiations. If there is no political stability, it is not realistic for an acceding country to address seriously

the EU accession economic and acquis issues. There will be ample time to address these issues in detail throughout the negotiation process.

- Two or three years ago, that Macedonia would negotiate its EU accession individually or in a loose group with Croatia was a realistic scenario. This is no longer the case, but some other Western Balkan countries have significantly reduced the advantage Macedonia used to have in terms of their EU accession trajectory. Montenegro has already submitted its EU application and Serbia is expected to do the same in the course of this year. Macedonia must thus be prepared to move toward the EU in a convoy type of the negotiation with these countries according to a schedule that it does not entirely dictate.

#### MACROECONOMIC CONVERGENCE

- EU membership requires convergence of the Macedonian economy with that of the EU in:
  - » real terms, meaning in per capita income and economic structure;
  - » nominal terms, meaning convergence of prices, inflation and interest rates.
- Macedonia is not converging in real terms, and needs to accelerate growth through higher levels of investment, employment growth and increases in total factor productivity. Domestic investment and FDI are both important, especially the former if FDI flows do not increase following the world crisis.
- Faster GDP growth will cause structural change, moving labour from agriculture and industry to services. Macedonia must prepare for the social and

economic effects of these shifts.

- Accession may increase FDI inflows and these and faster growth will cause higher levels of inflation. The current exchange rate regime will be stressed and should be reevaluated.
- Macedonia should increase prices of energy, public utilities, etc. to levels that reflect their costs as soon as possible to avoid inflationary pressures after accession.
- Neither activist monetary nor fiscal policy will be very effective in fostering economic growth or managing aggregate demand. Prudent macro policies combined with business-friendly reforms promoting domestic capital formation should be followed.
- Macedonia should follow international best practice in the formulation and execution of the government budget in order to maintain fiscal balance.
- Greater efficiency in administrative tasks should be pursued while strengthening the capacity of Ministries to undertake more strategic activities connected with EU accession. Use of information technology should ensure the efficient management of own and EU funds.
- Macedonia must aim not only for accession but also for rapid entry into the Euro zone, and this means working toward meeting Maastricht criteria even before accession. The current exchange rate regime may not be appropriate for safe Euro adoption.
- Conditions after the end of the current crisis may force Macedonia to rely more on domestic sources of capital for investment and less on foreign sources.

#### **FISCAL EFFECTS OF EU ACCESSION**

- Decisively strengthen the absorption capacity to use EU funds, in order to obtain all available pre-accession assistance in the period before entering the EU and even more so to be ready for effective absorption of significantly larger volumes of EU funds for structural purposes available to an EU member state.
- Prepare a simulation of financial flows between Macedonia and the EU budget in the pre-accession and early post-accession period in order to get an orientation about the magnitude of the flows.
- Strengthen the administrative absorption capacities for the use of EU funds both before and after accession. The process should involve: (1) activities aimed at increasing project preparation capacities within the country; and, (2) activities aimed at strengthening institutions and procedures that are required for effective absorption of EU funds.
- The ability to make effective use of EU funds does not depend on the central government alone, and thus all levels of government must strengthen or develop the capacity to apply for and use EU funds. Furthermore, non-governmental organizations, schools, universities and individuals such as farmers teachers and students must also be assisted in developing the capacity to apply for and utilize available EU funding.
- If administrative absorption capacity is not established at an appropriate level, Macedonia may even become a net contributor to the EU budget in the early post-accession period – it will receive less from the EU budget than it contributes.
- Prepare systematically for those fiscal costs of EU accession that go beyond contributions into the EU budget as an EU member. Introduction of the *acquis* is associated with the increase of some categories of national budget expenditures, such as for Schengen, transportation, agriculture, the environment, and so on; while, on the revenue side, EU membership will mean a reduction of certain categories, such as customs.
- Restructure the expenditure side of the

budget, so that it will be able to accommodate the effect of EU membership on the total volume of the budget, as well as on its expenditure structure. Funds from the EU budget are available only for financing certain categories of expenditures, such as agriculture and regional development, etc. The actual use of these funds is preconditioned on the availability of sufficient national co-financing.

- Realign line ministry budgets in a way that allows all available funds in the EU budget to be actually used while the macroeconomic stability of the country is not compromised.

#### **INTERNATIONAL TRADE AND FOREIGN DIRECT INVESTMENT**

- Macedonia should continue foreign trade liberalization in line with the Stabilisation and Association Agreement with the EU.
- The immediate effect of the EU entry on foreign trade volume will not be large.
- Macedonia needs to increase agricultural trade with the EU prior to accession by supporting investment into the food-processing industry.
- Macedonia should negotiate favourable production quotas for key commodities.
- Food prices may increase moderately after EU accession.
- Progress toward EU accession will increase FDI inflows into manufacturing sector.
- Political considerations with the neighbouring countries need to be taken into account with regards to facilitation of cross border investment. In addition, Macedonia should be prepared for the further eastward reallocation of manufacturing from CEE countries and the southern part of the EU.
- A Macedonian FDI incentive scheme should be closely monitored to strike a balance between costs and benefits, and it has to be consistent with EU state-aid legislation. Incentives should be linked

to active labour market policies and infrastructure development.

- FDI incentives should achieve some diversification of the industrial base.
- Labour market flexibility should be increased and employees' skills enhanced in order to improve the available pool of labour for prospective foreign investors
- Once Macedonia succeeds in attracting FDI inflows and speeding up GDP growth, the Denar will face strong appreciation pressures. The current Macedonian exchange rate regime may become unsustainable and inconsistent with maintaining low inflation, one of the preconditions for the future euro adoption.

#### **INDUSTRY AND NON-FINANCIAL SERVICES**

- Macedonia must seek faster GDP growth from higher investment and greater engagement with the world economy, especially with neighbouring countries in South-East Europe and the EU.
- Pursue further market-friendly reforms to improve the business environment and attract more FDI.
- Use industrial policy to accelerate structural change towards more productive activities using horizontal policies, as envisaged in the Government's draft Industry Policy (February 2009).
- Where selective industrial policies are used, as in supporting clusters and other new developments, set clear conditions for support and withdraw it if they are not met.
- Macedonian industry and industrial exports are less diversified than those of many small New Member States, and Macedonia should promote diversification.
- Macedonia should support the modernization and upgrading of its major established sectors such as textiles and metal products.

- Cut back on direct and indirect subsidies to business (state aids), both to improve the competitive environment and to conform better to the acquis.
- Boost R&D spending to strengthen Macedonia's ability to use and adapt new technology, both in established industries and in potential new ones. This requires strengthening R&D capacity in universities and research institutes.
- Increase and restructure infrastructure spending on transport to reflect the increased role of the automobile and freight transport by road in the last two decades.
- Tourism has massive potential for Macedonia and the country should aim for visitor numbers more ambitious than those in the official tourism development plan.
- To achieve higher visitor targets the country should:
  - » Market itself as a safe and attractive destination;
  - » Improve the infrastructure and services that visitors use, including hotels, restaurants, retail establishments, historical sites, nature reserves and so on;
  - » Gradually make the country more accessible for visitors, notably by air where links are currently limited.

## AGRICULTURE

- The most important constraints facing Macedonia's agricultural and rural development are broader structural problems in output markets and rural factor markets.
- Focus on policies that have broad effects and distort markets and choices as little as possible. Avoid supporting one commodity over another.
- Over-employment in agriculture constrains needed farm consolidation. Growth of the non-agricultural economy is crucial to absorb the surplus labour in agriculture. Policies targeted at rural areas, including vocational training programs, are very important. In addition, the social security programme of the government needs strengthening to move pensioners out of part-time farming.
- Investment in irrigation and roads contributes more to agricultural growth than do other forms of public spending on agriculture. The National Strategy for Rural and Agricultural Development 2007-2013 should be pursued vigorously.
- Implement EU and private quality and phytosanitary standards to capture gains from integration into the EU. The Macedonian Government should expand assistance and financial support to increase the implementation of EU standards and make sure that the support is targeted to all processors and producers, including smaller ones.
- Credit associations and micro-finance institutions can help small and weakly capitalized farms. The private sector can also supply finance to farms through contracting and trade credit. The Macedonian Government should use the pre-accession phase to remove obstacles to food industry and agribusiness investments and to stimulate the flow of trade credit to the agricultural sector.
- Rural infrastructure and quality control systems, along with educational efforts to explain the importance of quality production, need to be promoted, as do farmers' associations. This will contribute to a more rapid shift to modern supply chains.
- The lack of awareness by farmers about eligibility for support and the complexity of the application procedure was a serious constraint for the New Member States in the uptake of SAPARD funds for farms, especially for small farms. Part of the budget should be used for information campaigns to inform producers and processors of the EU mini-

mum standards and how assistance funds can be used to meet them. The government should also provide technical assistance to help farmers and food processors to apply for these funds and to lower the administrative burdens of accessing these payments.

- More than half of household farms are smaller than 1 ha, and these farms will not benefit from the EU payments if they are introduced in the same way as in the NMS, where the threshold was set at 1 ha. A lower threshold would reduce inequality but increase administrative costs. Experience is in favour of SAPS payments or the regional model of the SFP. Administratively, this is simpler and more in line with how direct payments will evolve in the EU.
- Develop sufficient and well-trained staff to meet the requirements of the EU related to CAP payments. The government also needs to tighten control over EU subsidies.

#### FINANCIAL SERVICES AND CAPITAL FLOWS

- Macedonia should gradually remove limits on households' investment abroad, which have already been foreseen in the Foreign Exchange Law and the Stabilization and Association agreement between Macedonia and the EU. Macedonia will have a very limited room for negotiating with the EU for temporary exceptions concerning the free movement of capital.
- Policymakers should prepare for real convergence pressures following EU membership. If real appreciation pressures emerge, currency revaluation or abandoning the de-facto peg in favour of a floating rate regime should be considered.
- Strengthen regulatory and supervisory powers for macroeconomic stabilization and limiting the risk of a credit-led boom and bust.
- Monitor and discourage foreign cur-

rency (or indexed to foreign currencies) loans to households.

- Develop a system of housing finance and sources of its funding to promote long-term savings. Covered bonds may be an attractive vehicle.
- If Macedonian authorities support private savings, as for housing, they should avoid creating specialized institutions.
- Strictly regulate the costs of client acquisition by insurance and pension funds and press for efficiency in administration.
- Create a framework that would ensure the capability to analyze, regulate and supervise the financial system in a comprehensive way.
- Establish a supervisory structure integrating the oversight over all financial sectors in Macedonia within the central bank.
- The Macedonian banking sector regulator should prepare a comprehensive framework for the regulation of liquidity management of local banks, including tools for potential restrictions on cross-border liquidity during times of stress.

#### LABOUR MARKET

- Labour market policies that increase the flexibility of the labour are only a complementary tool to sound macroeconomic and investment policies and policies to create a favourable business environment.
- The major problem in the Macedonian labour market is the large number of unskilled workers who linger on in unemployment and who seem hardly employable without major government intervention.
- Nearly half of all unemployed are unskilled or low-skilled workers. It is, therefore, important to increase the employment rate of these workers by

ensuring a low tax wedge at the lower end of the skill distribution.

- Skills shortages constrain employment growth. Reforming vocational education after consulting firms should be a priority. It is, however, vital to survey of firms' skills requirement based on a nationally representative sample.
- Tax policies to make part-time work more attractive to employers should be pursued.
- Increase the skill level of the workforce by targeting young new labour market entrants.
- Do not retrain and further-train youngsters who have dropped out of school or were low performers in school and are for these reasons unemployed. Such programs are ineffective.
- Other ALMP measures that were found relatively effective in the NMS, like employment incentive schemes, should be predominantly targeted at young new labour market entrants.
- One instrument of ALMP that should not be used in a major way is public employment schemes.
- Since strong economic growth will eventually come to Macedonia, do not "deactivate" too many older displaced workers.
- A strong system for monitoring unemployment is also important given that the vast majority of the unemployed are long-term unemployed. Especially this latter group should be monitored regarding informal work in the underground economy.
- Reform of the ESA should ensure that it concentrates its activities on 3 areas: paying out benefits, administering active labour market policies and monitoring activities of the long-term unemployed. When possible, these activities should be undertaken by separate units.
- Very little is known about worker and

job flows in the Macedonian labour market, search behaviour of the unemployed, informal employment relationships and other important issues. Policy makers need, however, to make informed decisions, which can only be made when an increased effort of data collection and analysis is undertaken. The Macedonian Statistical Office should make the Labour Force Survey available to outside academic researchers. The EU authorities would also view this openness regarding labour market data favourably.

## EDUCATION REFORM

- Education is one of the most important factors for future social cohesion internally and Macedonia's global competitiveness.
- The ethnic and cultural diversity of Macedonia gives additional importance to education. Support interethnic tolerance and joint (multi-ethnic) education "projects" in addition to the current ethnically separate approach to education.
- De-politicization of education is crucial. Not taking this step means damaging the long-term interests of the nation.
- Institution- and capacity-building for future participation in EU education policy design and EU education funds is crucial at the national and local level as well as for schools, students and teachers.
- Analytically based, consistent long-term education policy goals are crucial to reform success. Persistent long-term goals in the process of reform cannot be overestimated.
- Frequently it is better to inaugurate less profound reforms with a higher degree of consensus than deeper ones through political majority. Open, informative and informed communication with the media is, in this respect, important.
- Social partnership is needed. A struc-



tured arena that provides a degree of common interest: (1) enables policy measures that are a solid compromise in line with the values and interests of the stakeholders, and (2) reduce tensions that can endanger the reform.

- » Teachers are crucial partners in the process. Their inclusion ensures their ownership, and thus success, of the reform;
  - » Experts are also important. The reform leaders should consult experts that exist in the country even if they belong to an opposing political (ideological) spectrum. In a small country, national expertise is both essential and scarce. International comparative studies are very beneficial. Trade unions as partners are important. If they engage and take ownership of the reform – accepting and correcting, opposing where necessary – then the nation is a lucky one. The same goes for parents;
  - » Industry and other sub-systems of society are important. Yet education is far too important to aim only at employment.
- Structured self-evaluation should enable each educational institution to answer simple questions such as: How good are we? How do we know? And to improve their quality based on that information.
  - Substantial investment in education from 5.5% of GDP upwards is needed for good education.
  - Provide adequately high and diversified salaries, based on years of work, participation in training, quality of work in the classroom, etc.
  - A basic standard of facilities and equipment should be met around the country. Computerization should never take place without properly trained teachers.

- Invest in teacher training. There will be plenty of opportunities with EU funds.
- Provide subsidized childcare, meals, textbooks etc. as an important element of equity and efficiency in education. If budget limitations are an issue, a targeted approach toward socially deprived minorities, such as the Roma, is suggested. Early childcare with at least 50% of the population enrolled is necessary for equal opportunity.

## MIGRATION

- Macedonia should improve data on migration flows, on the characteristics of migrants and the Macedonian Diaspora abroad. Furthermore, the inflow of remittances should be documented according to the standards of the IMF, and information on the transfer and use of these funds should be obtained.
- To address the emigration of highly educated people, the retention of knowledge-based links between skilled emigrants and R&D institutions at home should be supported. Additionally brain circulation, i.e. encouraging highly skilled persons who have gone abroad for some years to return should be promoted.
- Brain drain among young highly skilled persons could be reduced by encouraging them to stay by improving salaries and working conditions in R&D institutions at home while at the same time encouraging short-term research stays at foreign research facilities.
- Disincentives to the emigration of highly-skilled individuals are likely to have negative effects on Macedonia, especially if appropriate work at international salaries for educated individuals is not available at home. Disincentives to migration reduce the welfare for those who could earn higher incomes abroad, reduce remittances, and by reducing the private return to education in Macedonia, create a disincentive to acquire human capital among all Macedonians.

- Because Macedonia is an accession country of the European Union, Macedonian policy should apply the recent green paper by the European Commission on the management of economic migration which proposed to:
  - » improve the dissemination of information and advice on legal labour migration procedures and on the risks to irregular migrants
  - » encourage brain circulation of the highly skilled
  - » include low skilled labour into circular schemes by developing a framework of bilateral labour arrangements
  - » ensure the protection and support of migrant workers according to international standards.
- Efforts should be made to improve official channels for sending remittances, to increase trust in these channels and to lower transaction costs. Macedonia should establish special financial products for the Diaspora and develop matching funding schemes for remittances with respect to business-start-ups, low cost housing or projects of Home Town Associations (or Migrant Associations). Given the importance of migration and remittances to the Macedonian economy, maintaining strong cultural and economic relations with migrants and the Macedonian Diaspora should be an important concern for Macedonia's foreign policy and for its embassies abroad.

## **SOCIAL INCLUSION**

- Social issues need a stronger political profile in the EU accession process and require more concerted policy efforts by all actors involved.
- A national social inclusion or anti-poverty strategy is needed to create a transparent, effective and strategic policy framework for the fight against poverty and social exclusion.
- In the light of the Accession process, more attention should be paid to good practices and effective policy measures in the EU as well as in EU Member States, rather than following examples from Latin America and Third World countries.
- All key EU documents are to be translated into Macedonian and languages of other ethnic minorities and made available to the public, policy-makers, politicians, activists and other actors. This could be achieved through, for example, an interactive website run in English as well as Macedonian and languages of other ethnic minorities from the Ministry's main website.
- Cross-cutting issues must be addressed and policy-making in those areas institutionalized in a way that supports the effectiveness of these policies. It will be essential to scrutinize every existing or new policy and check its impact on efforts to reduce social exclusion and poverty.
- A systematic study of best practices in the New Member States in the field of social inclusion will help Macedonia to find good policy initiatives and help prepare for the Open Method of Coordination and the absorption of Structural Funds
- A core team should be set up as soon as possible both within the Ministry as well as between the Ministries to coordinate preparation for Accession, such as preparation of the JIM, pre-accession funding, preparation for Structural Fund programming, etc. in the field of social inclusion. The core team should have sufficient resources to commission research, organize conferences, consult with relevant stakeholders, and receive language training, and so on.
- It is absolutely essential that a strategic vision be created on which social policy actors should be supported to improve their capacity to apply for pre-accession or, later, Structural Funds funding, and to allocate enough resources to these

institutions to enhance their project capacities in the future. These absorption capacities will be vital to benefiting from the social inclusion agenda that the EU is pursuing.

- Based on EU principles, every citizen of the European Union should have the right to basic health care, and pension, therefore it is essential that a solution be found for those who are not covered by pension benefit or health insurance.
- Due to the exceptionally high poverty rates in Macedonia, there is a need to have a comprehensive child poverty strategy. Importantly, a major review of the level of child benefits is essential in order to tackle the high level of child poverty. Currently the child allowance is

very low, which reflects the falling share of child protection expenditure as a % of GDP between 2000 and 2005. Child allowances need to be raised immediately, and eligibility criteria clarified. The child allowance should be means-tested. Special measures are required to alleviate poverty for high-risk children's groups.

- A systematic review is needed to check legislative texts currently in force in Macedonia to eliminate negative, stereotypical and discriminatory terms and replace them with more inclusive, accepting and respectful ones. A media campaign could also help to promote a new vocabulary used to describe vulnerable groups and individuals in a way that does not stigmatize them.



## CHAPTER I

# ACCESSION OF MACEDONIA TO THE EU: OVERVIEW OF ISSUES AND CHALLENGES

### Introduction

The ultimate objective of the transition process of the Republic of Macedonia is to develop a modern, democratic society that is based on a market economy and that takes due account of important social and environmental concerns. Because the EU is based on exactly the same values and standards, membership in the EU is proof that the transition process has been completed or has at least reached a very advanced stage. Transition and EU accession are thus two mutually reinforcing processes.

## 1 General Criteria for EU Membership and the Accession Process

The eastern EU enlargement differs in many aspects from the previous enlargements because of the large number of countries joining and because the extent of the *acquis communautaire*, the EU legislation that has to be transposed and implemented, is much larger than it was in previous enlargements. Moreover, systemic differences between the “old” and “new” members are much greater because, in previous enlargements, the new members had a well-established market economy.

The European Council decided that accession of these countries to the EU would take place once they were able to assume the obligations of membership by satisfying explicitly articulated conditions. These conditions, known as the Copenhagen criteria, are: (i) stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities (the political criteria), (ii) the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the EU (the economic criteria), and (iii) the ability to take

on obligations of membership, including adherence to the aims of political, economic and monetary union (the *acquis* criteria). There is no explicit methodology for judging whether a country satisfies the Copenhagen criteria. Nevertheless, a good guide for what is expected from a candidate country is contained in some of the Commission’ documents, especially in Opinions (*Avis*) and the Regular Reports.

The economic criterion consists of two parts. The first is the existence of a functioning market economy. In the most recent EU enlargement process, the candidate countries met this requirement in a rather short period of time. Experiences indicate that the Commission assesses the fulfilment of this sub-criterion by analyzing the following components: (i) existence of a broad political consensus on the essentials of economic policy, (ii) macroeconomic stability, (iii) price and trade liberalization, (iv) a sufficiently developed financial sector, (v) privatization and enterprise restructuring, (vi) elimination of significant barriers to market entry and exit, (vii) the legal system, and (viii) effectiveness of the judicial system.

The second economic criterion, the capacity to cope with competitive pressure and mar-

ket forces within the EU, reflects how well the economy functions, the efficient allocation of resources and the ability to compete against other EU member states' products and services. Achieving the capacity to withstand competitive pressures is a medium-term task and pre-supposes that a functioning market economy is in place. The potential of a country for meeting this sub-criterion is typically assessed over a 5-year period. The following components, of a much more structural character, are typically analyzed by the Commission: (i) a sufficient amount, at an appropriate cost, of human and physical capital, including infrastructure, education and research, (ii) the trade integration a country achieves with the EU before enlargement, (iii) the role of small firms, and (iv) the extent to which government policy and legislation influence competitiveness through trade policy, competition policy, state aids, FDI, support for SMEs, etc.

The internal market with the free movement of goods, services, capital and persons represents the economic backbone of the EU's integration process. A key economic challenge for a candidate country in its pre-accession period therefore is to become ready to cope with the "four freedoms" of the single European market. The most far reaching provision of Macedonia's SAA is the free movement of industrial goods. What is left in the area of trade relates mostly to the measures of the single market, i.e., to the technical barriers to trade. In these areas, Macedonia will have to strengthen its technical legislation and standardization and upgrade human resources, skills and institution building to assure implementation of the legislation.

The freedom to provide services between Macedonian and EU residents is more complex. It requires changes in domestic legislation governing the services sector and the provision of services from the territory of other member state without establishing a commercial presence. The liberalization of financial services has been particularly demanding and has become even more important in the context of the ongoing financial crisis. The SAA also establishes the principle

of free movement of capital between Macedonia and the EU.

The last of the "four freedoms" concerns the free movement of persons from one member state to another. Adjustment to the free movement of persons principle typically requires a candidate country to make significant adjustments in legislation in various areas, including the equal treatment of foreign workers, social systems for migrant workers and mutual recognition of diplomas.

In most EU member states, the eastern enlargement was broadly considered a success and provided an impetus for the aspirations of the Western Balkan countries. Developments since 2005, however, changed the pro-enlargement view dramatically. Causes of this change were the "no" votes on the European Constitution in France and the Netherlands; worries that an influx of workers from "new" member states would aggravate the unemployment problem in old member states; so-called "enlargement fatigue" reflected in the impression that solidarity among the member states has weakened, in the suspicion that Eastward enlargement introduced unfair competition into the single EU market, and in the frustration of the public at large that it was not consulted sufficiently in the case of the 2004 enlargement. A further reason for the growing hesitation has been the issue of Turkish membership in the EU. The hopes of the Western Balkan countries for speedy accession to the EU have been further damaged by the EU's experiences with Bulgaria and Romania. Last but not least, the current financial and economic crisis does not bode well for Western Balkan enlargement. Since early 2008, the EU is focused on how to respond effectively to the negative consequences of the crisis and how to achieve the ratification of the Lisbon Treaty.

In response to the changed political attitude of many EU member states towards enlargement, in November 2006 the Commission published a revised enlargement strategy. It repeats the EU's political commitments to the Western Balkans, reiterating that each

country has the potential to become an EU Member once it fulfils the necessary conditions. The crucial element of this revised strategy is encapsulated in the last part of that sentence, meaning basically that a Western Balkan country will enter the EU “once it fulfils the necessary conditions.” The problem here is not the wording. It has always been the case that candidate countries were required to meet accession conditions. What, however, is different is the substance of this phrase. “Fulfilling necessary conditions” could now be interpreted very differently. Due to the “convoy-type” of the negotiations characteristic of the most recent enlargement, as well as due to the strong pro-enlargement commitment of the member states at that time, this notion was interpreted rather benevolently. At present, however, there seems to be much less political appetite for such an interpretation. Consequently, the notion of “fulfilling necessary conditions” will be interpreted much more strictly. The ongoing EU accession negotiations with Croatia and Turkey clearly confirm this.

The revised EU enlargement strategy adopted in 2006 is based on the following three principles:

- **Consolidation;** The new strategy is based on the notion that “consolidation” of the EU has to take place before it will consider further enlargement. This means that the EU has to digest its existing commitments towards the countries already in the enlargement process and that it will be cautious about taking on any new commitments.
- **Conditionality;** This principle, closely interlinked with the consolidation principle, is the core of the revised strategy. Conditionality has always been an ingredient of the EU accession processes, but in the future it will be applied more strictly. There will be a much closer link between the progress in meeting the Copenhagen political, economic, and acquis criteria and the overall pace of the EU accession process.

- **Communication;** Ensuring that there is public support for future enlargements is the final element of the Commission’s revised strategy. The EU has to give the story of enlargement the credit it deserves. It has extended the zone of peace and democracy within Europe while the economic dynamism of new member states benefited the EU as a whole.

## 2 Brief Review of Macedonia’s EU Integration Process

The start of Macedonia’s formal relations with the EU was delayed, mainly due to disputes with Greece, and diplomatic relations between Macedonia and the EU were established only in 1995. Unfortunately, the economically difficult situation caused partly by the Greek trade embargo and partly by the UN embargo against the FR Yugoslavia caused further delays both in the transition process as well as in the EU approach to accession. After 1995, Macedonia became eligible for the PHARE and CARDS support programmes. In the late 1990s, Macedonia joined the EU’s Stabilization and Association Process for the Western Balkan region.

Macedonia was the first country in the region to sign the SAA in April 2001, and this marked a new stage in the Macedonian-EU relationship. Since then, EU integration has featured high on the political agenda, and EU membership is an explicit objective of the political elite and of a vast majority of the population, and it has thus served as a point of consensus among the political parties. In parallel with the fulfilment of the procedural and technical obligations and criteria for accession to the EU, the process of gradual political reconciliation within Macedonia also started after the signing of the SAA. One of the boldest reforms was the process set out by the August 2001 Ohrid Framework Agreement. This agreement provided an impetus for solving many difficult issues among Macedonia’s ethnic communities.

The SAA is a complex and legally bind-

ing act, which, in political terms, has made Macedonia a potential EU member, while in economic terms it de facto provided free access for Macedonian goods to the vast EU market. The signing of the SAA also accelerated the restructuring of the Macedonian economy and its adjustment to new conditions. Last but not least, it revitalized the opportunities for speeding up the social and economic development of the Republic of Macedonia, and strengthened political and economic links with the EU member states.

The reforms undertaken within the SAA framework as well as the v of the arrangements with the IMF and the World Bank paved the way for Macedonia to submit its application for EU membership. After a short but intensive public debate about its positive and negative aspects and after a parliamentary declaration supporting the submission of an application, Macedonia officially submitted its application in March 2004. In May of that year, the Commission was mandated to prepare the Opinion (Avis) and in October 2004 the questionnaire was handed over to the Macedonian authorities. Preparation of responses on the questionnaire was the first serious test of Macedonia's administrative capacity. The answers were completed by February 2005, and based on information provided in these answers as well as on information gathered from other sources, the Commission prepared the Opinion (Avis). The Commission made a positive recommendation for making Macedonia an EU candidate country, but it also recommended that *"negotiations for accession to the European Union should be opened with the former Yugoslav Republic of Macedonia once it has reached a sufficient degree of compliance with the membership criteria."* In contrast to previous enlargements, the European Council's decision about the candidacy status of an acceding country was not accompanied by a decision to start accession negotiations.

Now that it is a candidate country, the next step for Macedonia is to obtain a date for the start of the accession negotiations. Unfortunately, this decision has been delayed for more than 3 years and is still pending. Even

though the two regular progress reports issued by the Commission in November 2006 and November 2007 have acknowledged the progress in reforms the country has made in some areas important for EU integration, the documents have not recommended setting a date for the start of accession negotiations because the Commission feels that Macedonia has not yet fulfilled sufficiently its obligations based on the SAA and the Ohrid Framework Agreement and specified in the Accession Partnership. Main issues of concern include weaknesses associated with proper conduct of elections, political dialogue within democratic institutions, effective implementation of the Law on Police, judiciary reforms, anticorruption, depoliticizing and strengthening administration, reducing unemployment and improving the general business environment.

In order to accelerate Macedonia's pace towards the next step in the accession process, the Slovenian presidency articulated eight benchmarks that, once fulfilled, would open the door for setting a starting date for the accession negotiations by the end of 2008. The benchmarks, mainly of a political character, covered essentially the same issues as mentioned above. The parliamentary elections of June 2008 were assessed by external evaluators as failing to meet the necessary standards. As a consequence, proper conduct of elections has de facto been added as the ninth benchmark. In these circumstances, it was not surprising that, in its November 2008 regular progress report, the Commission did not recommend that negotiations begin.

The ongoing delay in setting a starting date for EU accession negotiations is an example of how the EU implements the conditionality principle. The delay is in line with experiences of other countries of the region, such as Bosnia and Herzegovina, Croatia and Serbia, whereby advancement from one EU accession stage to another is heavily dependent on fulfilling the Copenhagen political criteria in the pre-negotiation period. The economic and acquis criteria are of secondary importance in these early stages of the



process because political stability, and, therefore, meeting political criteria is a precondition for starting the EU accession negotiations. If there is no political stability, it is not realistic for an acceding country to address seriously the EU accession economic and acquis issues. Later, there will be ample time to address these issues in detail throughout the negotiation process.

This process is now much more structured and has more benchmarks than was the case in the previous enlargements. Macedonia will become a member of the EU once the EU member states agree that it meets the Copenhagen criteria. Meeting the political criteria, especially the benchmarks set in 2008, will be instrumental for opening the EU accession negotiations, but for their successful completion another political problem, the dispute with Greece over the name, will have to be resolved successfully.

If three or even two years ago, a realistic scenario for Macedonia was that it would negotiate its EU accession individually or in a kind of a loose group with Croatia, now this situation has changed. Croatia is at an advanced stage of the EU accession process – the negotiations are expected to be completed by the end of 2009 or at latest in 2010. This means that its EU membership is realistic in 2012 or at latest in 2013. On the other hand, some other Western Balkan countries have significantly reduced the advantage Macedonia used to have in terms of their EU accession trajectory. Montenegro has already submitted the EU application and Albania and Serbia are expected to do the same in the course of this year. Thus it is possible that accession of the Western Balkan countries will be carried out in a convoy type of negotiation. In the optimistic scenario the negotiations with this group of countries would start in 2010, which means that full membership is not feasible before the middle of the next decade.

Convoy negotiations have very different implications for different countries in the convoy. For example, the accession negotiations involving a number of acceding countries

may generate stronger political pressure on the EU. On the other hand, convoy negotiations could also be harmful especially for candidate countries that are small even though individual treatment of each of the candidate countries is proclaimed as an important principle of negotiations.

### 3 Overview of Challenges for Macedonia on its Way to the EU

#### Judiciary Reform

Macedonia undertook a comprehensive reform of its legal and regulatory systems at the outset of its transition. The country has gone a long way in drafting and adopting legislation in all areas fundamental for economic transformation, but experiences from many transition countries show that this is of limited relevance if not accompanied by all necessary by-laws as well as with an effective implementation and enforcement of the adopted legislation.

In order to modernize and adapt its judicial system to the requirements of the new political, economic and social environment, Macedonia will have to strengthen the training of judges, especially in dealing with cases arising from the implementation of the single market, and eliminate the backlog of pending court cases.

#### Transposition of the Acquis and its Translation

A prerequisite for EU membership is the full adoption and implementation of the acquis, i.e., a body of EU legislation of estimated 80,000-100,000 pages. This process of regulatory harmonization is extremely complex, time-consuming, and costly, especially for the smaller countries. The areas of the EU legislation that have proved to be the most demanding in terms of their transposition into the national legislation are agriculture, including veterinary and phytosanitary legislation, and environment.

Translation of the *acquis* is a particular challenge, again more for the smaller than for the larger EU acceding countries. The process takes several years of hard work. In the translation of an individual area of the EU law, three profiles are typically involved; a translator, a specialist for the area, and a lawyer or legal expert. Translation of the *acquis* is not only time consuming and professionally demanding, but it is also extremely sensitive as the translated text becomes part of the internal legal system once the country becomes an EU member.

### Public Administration

Experiences from many “new” EU member states show that the quality of administration is an extremely important determinant of how successful the acceding country is in acting as an EU candidate. In the pre-negotiations stage, weaknesses in public administration can still be overcome because only a few officials interact with partners from the EU, but this is not possible once the negotiations take on a wider scope. It is of utmost importance that the country embarks on a systematic education of its public administration. This education, using institutions in the country and abroad, must aim at upgrading public officials. One area is foreign languages. Officials involved in the EU accession negotiations must be fluent in English and, if possible in one other EU language. If they are not, they will not be able to harmonize the EU legislation into the national laws or to represent the country’s interests because meetings at the technical levels are carried out in English with no translation. Another area where education is needed refers to the professional area in which a public official works. For example, a person in public administration responsible for a particular area must be fully informed about the European characteristics and trends in this area and also understand EU legislation. If not, the person will simply not be able to contribute substantially to the country’s efforts to achieve an acceptable outcome to the negotiations.

Even though the quality of the public administration is of crucial importance, the process of EU accession usually has also implications for the number of people in administration. Experience, at least in smaller countries, shows that the EU accession process is typically accompanied by an increase in the total number of public officials in central administration. The reasons are two fold. Some new institutions must be created as a consequence of the EU accession, and many institutions must be substantially strengthened as they assume new or broader duties. This increase in administrative personnel accompanied by efforts to improve quality has obvious implications for the country’s public finances.

### Organization of the Negotiations and Managing Public Support for the EU Accession

There are a number of issues for which each country starting EU accession negotiations has to provide country-specific solutions. One important issue is to establish an institutional structure for carrying out of the negotiations. Different approaches are possible:

- **Overall Coordination of the Negotiations;** There are in principle two approaches towards who should coordinate the negotiations in the country. One alternative is that coordination is under the overall lead of the Ministry of Foreign Affairs, and the other alternative is that this role is performed by a government office directly subordinated to the prime or vice-prime minister. There are pro and cons of each of the two alternatives.
- **Core Negotiating Team;** There are also two approaches to the principles on which the core negotiating team should be created. The Slovenian approach here was that the 10-member team consisted exclusively of experts, including senior civil servants, a representative of the Chamber of Industry and Commerce, the central bank, and even a university professor. In the core negotiating team,

headed by the deputy chief negotiator, each member was responsible for negotiations on one or more chapters. They actively participated in all phases of the preparation of the negotiating positions and in carrying out the negotiations. The Slovenian approach of appointing a “team of technocrats” was suitable for a country where there had always been a consensus about the EU issues among all relevant political parties. The team remained unchanged through the five years of the negotiations even though the government changed several times. In most other “new” member states, negotiating teams consisted of high-level government officials who have a strong political constituency behind them. This approach may have advantages in terms of efficiency so long as the government is in office, but the negotiation team is much more exposed to changes when the government changes. In some of the EU-12 member states chief negotiators were changed several times.

- **Working Groups;** A general pattern in the EU-12 negotiations was that the governments appointed working groups for each of the negotiating chapters. A working group consisted of officials from different ministries as well as of representatives of employees and employers. Each working group had the final responsibility for preparing negotiating positions and other platforms for its negotiating chapter.

Another important issue in the process of the EU accession negotiations is the relationship between the government and parliament. Again, the institutional framework for this relationship depends on country-specific characteristics. In most of the accession countries, the process of the negotiations was strongly government based and centralised. In these cases, the position of the parliament was more or less limited to the role of being informed regularly about the progress of the negotiations.

In the case of Slovenia, however, the parliament was involved in a much more operational manner in the negotiations. Before being submitted to the EU, each negotiating position adopted by the government had to be confirmed by the respective parliamentary bodies. This was of course time consuming and created an additional hurdle for the government in meeting the negotiation deadlines. On the other hand, strong involvement of the parliament in the EU accession process combined with a creative public awareness campaign proved a very effective way for keeping the parliament and population informed about the progress of the negotiations.

## 4 The Nexus of Transition – Economic Challenges of EU Accession

### Economic Reforms – Transition

Experience shows that transition economies including all the “new” as well as the Western Balkan candidate countries have by and large met the first of the two Copenhagen economic criteria. All these countries, including Macedonia, are functioning market economies. The differences among them are much larger with respect to the second sub-criterion, the ability to cope with the competitive pressures of the single EU market.

The second phase of transition, market-deepening reforms, involves large scale privatisation and financial sector reforms. Macedonia does better in this respect than do Albania, Bosnia and Herzegovina, Montenegro and Serbia, but at the same time worse than the “new” member states and also Croatia. This means that Macedonia has made a significant progress towards the completion of the second stage of the transition reforms but that there is still a gap to be bridged in these policy areas.

The current global financial crisis will create additional challenges for Macedonia’s financial system and its economy. The threat

of rising inflation experienced in 2007 as a consequence of rising international prices of energy and food has been replaced in 2008 by falling prices of energy and commodities, including metals, which represent an important part of Macedonia's exports. Moreover, the foreign exchange inflows needed to finance the country's current account deficit are likely to decline in the current tight international environment. Last but not least, some of the foreign banks that have entered Macedonia may experience problems at home, which will have a negative impact on their operations in this country as well.

Finally the third phase of transition is market-sustaining reforms, including reforms of governance and enterprise restructuring as well as competition policy and the infrastructure sector. These are all areas that are of crucial importance if an acceding country is to cope with the competitive pressures of the 500 million large single EU market. All transition economies, including the "new" EU member states, still have a ways to go in this area. Like other transition countries, Macedonia has progressed least with the third phase of transition reforms. Thus, Macedonia faces significant transition challenges, and only by addressing these challenges effectively will the country be able to compete successfully on the EU market.

### **Agriculture**

The Common Agricultural Policy (CAP) is one of the cornerstones of the EU. For implementation of the CAP, the EU member states have transferred all their competencies to the EU. This consequently means that agricultural acquis is not only extremely broad but also very demanding. It consists of a large number of binding rules, many of which are directly applicable Regulations. During the EU-12 accession negotiations, the whole agricultural acquis was subsumed within one negotiating chapter. In the ongoing negotiations with Croatia and Turkey, however, this body of the acquis has been split into two chapters; veterinary and phyto-sanitary issues are now negotiated under a

completely separate chapter.

One of the main challenges for any EU accession country is a proper transposition of the agricultural acquis into national legislation including establishment of institutional, personal and technical capacities for its effective enforcement. Putting in place an efficient public administration has proven to be essential for the functioning of the CAP. The agricultural acquis requires the setting up of management systems such as a paying agency and the Integrated Administration and Control System (IACS), the introduction of the capacity to implement rural development actions, and the putting in place an institutional framework required for the effective implementation of veterinary and phyto-sanitary measures. In some cases the agricultural acquis provides more or less detailed specifications for the required administrative structures. Establishment of required administrative structure for the effective functioning of CAP is associated with the challenge of how to finance this growing administrative apparatus.

Another important challenge for agricultural production and for the whole agro-industry sector of a candidate country is associated with the opening of the country to foreign markets and especially to competition from other EU member states. While trade with agricultural products has been liberalized for Macedonian producers, they have not been able to take full advantage of the liberalization because of sectoral problems.

In several "new" member states, EU accession has come as shock to a largely unprepared agricultural sector, and this poses a potential challenge for the Macedonian agriculture as well. Some of the problems faced by those countries at the moment of their accession to the EU have included the following: (i) drastic change of the types of support provided to food producers (the CAP rules are completely different from the pre-accession national mechanisms); (ii) low value added of agricultural products;

(iii) weak marketing of agro-industry products associated with the lack of incentive to export. Restructuring of the agriculture and the food sector and preparing it for increased competition in the single EU market will be no doubt an important challenge for Macedonia in the coming years. On the other hand, the authorities will have to pay careful attention to protection of the country's fragile eco-systems against the potentially negative consequences of an intensification of agricultural production.

When it comes to the challenges associated with the EU accession negotiations as such, one should distinguish between two phases of the negotiations on the agricultural chapter. The first one consists of reaching a mutually acceptable agreement on non-financial issues. This stage of negotiations usually requires a large number of technical meetings, and it helps a candidate country if its representatives can support their positions with arguments based on analytical background documents. An integral part of these meeting is negotiations about transitional periods and derogations in the area of agriculture.

The first phase of agricultural chapter negotiations is mainly on the conditions and timing of the candidate countries' adoption, implementation and application of the acquis, and, because adoption of these rules is not negotiable, discussions are limited in scope. There is more room for actual negotiations when the agricultural financial package is discussed. In this phase of the negotiations, the level of future direct payments is set as well as the level of the financial support for rural development. In the EU-12 negotiations the candidate countries have taken very different negotiating strategies in these areas. Main differences were in how quotas and reference quantities have been articulated (some accession countries set them unrealistically high while others have opted for more realistic figures supported with actual data) and also with respect to their attitude towards rural development because many candidate countries had not assigned sufficient

importance to this subject.

## Environment

Environmental protection is an extremely high priority for the EU. The body of the environmental acquis is extremely wide, covering close to 100 directives supplemented with other legal acts. The major areas of the environmental acquis include (i) protection of water and air quality; (ii) waste water and solid waste management; (iii) management of chemical substances; (iv) radioactive contamination of foodstuffs and radiation protection; and (v) management of genetically modified organisms.

Transposition of the environmental acquis into national legislation represents particular challenges for any country that wants to join the EU. The scale and scope of the EU legislation concerning the environment is broad and touches on all sectors of the economy and society. Industrial companies are typically faced with compliance requirements of water supply and treatment, waste management and air quality, while households and local communities have to address systematically environmental problems associated with waste water and solid waste management. Compliance with the environmental directives means not only harmonization of legal acts but also institutional improvements such as adapting institutional structures, changing procedures and increasing management capacity. Enforcement of environmental legislation will be a key challenge and will require strengthened cooperation between ministries and regional and local authorities. Successful enforcement of the legislation is closely associated with well designed and managed monitoring systems. Compliance with the environmental acquis requires substantial investment. According to the World Bank, the costs of meeting environmental requirements for the twelve countries of the last enlargement were "between 23% to 134% of countries' present GDP. In per capita terms the total investments amount to between 760 and 1,760 EUR."

During the EU-12 accession negotiations, there was a broad understanding that acceding countries would not implement the entire environmental acquis before joining the EU. Indeed, the EU has recognized that extended transition periods are needed. Within this general framework, each of the acceding countries has tried to find a balance between the requests for transitional periods and internal efforts towards achieving a rapid implementation of the same level of environmental protection as the one in the EU.

### Cohesion Policy

The main objective of the cohesion policy of the EU is to reduce economic and social disparities between the various regions in the Community. Cohesion policy is implemented through two sets of instruments. The first set consists of the so-called “internal” instruments aimed at supporting cohesion among the EU member states. “Internal” cohesion instruments include Structural Funds (European Regional Development Fund and European Social Fund) and the Cohesion Fund. The common characteristic of these funds is that they provide transfers from the EU budget to eligible territories in less developed member states as well as regions in more developed member states that have been affected by specific external shocks.

The second group of instruments consists of so-called “external” instruments aimed at preparing the acceding countries to apply the cohesion policy effectively and efficiently at the moment when they join the EU. Currently the EU Instrument for Pre-accession Assistance (IPA) is the only instrument available to the Western Balkans and Turkey. The main objective of pre-accession funds is to support candidate countries in their efforts to meet the Copenhagen criteria and to prepare them for effective use of cohesion policy funds once they become members.

There are several important guiding principles for management of the EU cohesion policy funds, including: (i) additionality

– According to this principle, funds from these sources should not be used to replace national funds but in addition to any existing public expenditure in the member states; (ii) programming – The allocation of cohesion policy funds is planned and programmed in accordance with medium-term national development plans; (iii) national co-financing – Funds available for cohesion purposes either for an EU member state or for a candidate country must be co-financed. Even though different national co-financing applies for different types of programs, 20 % is a good estimate at the macro level.

Like other candidate countries, Macedonia is eligible for significant pre-accession funding through the IPA: 58.5 million EUR in 2007, 70.2 million EUR in 2008, 81.8 million EUR in 2009 and 92.3 million EUR in 2010. On average, this means that EU pre-accession funds equivalent around 1% of the country’s GDP was available to Macedonia under the IPA in 2007 EU pre-accession assistance.

One of the biggest challenges of all acceding countries as well as of all “new” EU member states associated with the cohesion funds is so-called absorption capacity for the use of IPA / Structural Funds and Cohesion Fund resources. There are three components of the absorption capacity for using the EU cohesion funds. The first one is macroeconomic absorption capacity. Experience gathered over time has led the Commission to conclude that EU member states have limited capacity to absorb external investment support effectively and efficiently. During the 2007–2013 medium-term financial perspective of the EU, the upper limit for EU funds for cohesion purposes has been set at 3.6 percent of GDP. The second component is financial absorption capacity, which is the ability of the recipient country to co-finance EU supported programs and projects from national resources. The third component of absorption capacity is administrative absorption capacity, the ability of central and local authorities to prepare suitable plans, programs and projects on time, to select programs and projects, to arrange the co-or-

dination among principal partners, to meet the administrative and reporting requirements, and to finance and supervise implementation properly.

Based on experiences of the EU-12, Macedonia is not expected to have problems with macro-economic and financial absorption capacity for the use of IPA funds because the amount allocated is well below the 3.6 % of GDP limit and the 20% national co-financing for the use of IPA funds does not represent a major concern for the budget. What has proved to be the key challenge and main limiting factor for effective absorption of IPA funds in Macedonia is administrative absorption capacity. It is therefore of utmost importance for authorities to address this issue as a matter of top priority; to establish

an appropriate institutional framework for managing these funds and also to generate a credible pipeline of projects to be financed from this funding source. If administrative absorption capacity is not properly established, as is now the case in some new member states, then Macedonia will be exposed to the risk of not being ready for effective absorption of EU funds at the time when it becomes a EU member and consequently gains access to significantly larger amounts of cohesion funds. Under these circumstances, financial absorption capacity for the use of EU cohesion funds might also become an issue. Experiences in some "new" EU member states show that financial absorption capacity is more a problem in those countries with very rigid budget expenditures.





## CHAPTER II

# MACROECONOMIC CONVERGENCE

### Introduction

The accession process for the first group of transition countries to join the EU occurred in a period of steady global growth during which capital was abundant in international financial markets and investors were actively seeking new, promising investment opportunities. International capital flows, both portfolio and FDI, were large, and interest rates in the EU and for the prospective member countries were low. Thus, all of the NMS experienced a buoyant market for their exports within the EU and globally, and their domestic savings were augmented by inflows of capital from abroad, making transition and structural change relatively easy to achieve. This era has now ended, and the challenges of EU accession in the future may be more difficult. Nevertheless, there are valuable lessons for Macedonia from the macroeconomic experiences of the new EU member states. This section draws out these lessons and discusses whether and how these lessons apply in a future period where economic conditions may differ.

### 1 Conceptual Framework

EU accession means convergence toward an EU socio-economic model with legal, economic, social and political objectives that, while giving member countries considerable leeway to find their own ways of organizing their societies and economies, does impose constraints on the means of achieving desired objectives as well on the outcomes that have to be achieved. At the macroeconomic level, convergence with the EU takes place in three main ways.

The first of these is real convergence, which means that the accession countries converge to the per capita income levels of the older EU members. This requires that the new members will have to sustain, for a relatively long period of time, growth rates that are faster than those of the older members. Accompanying this faster growth are structural changes in the pattern of eco-

nomonic activity. The shares of total employment in agriculture and industry fall, while the share of services employment rises, and these structural changes also proceed more quickly than they do in the old EU member countries.

The second form of convergence is nominal convergence, meaning convergence in prices, inflation and interest rates. Because price levels are lower and inflation tends to be higher in the new members, these states face the conflicting objectives of keeping inflation low to meet the Maastricht inflation criterion while allowing their price levels to rise to levels consistent with their rising levels of per capita income and to converge to the price levels prevailing in the EU.

The final aspect of convergence is the adoption of the Euro as the currency of the new member countries. Euro adoption, much like EU accession itself, is both a process of convergence as well as a reflection of suc-

cess in convergence in the past. Nevertheless, the new members have considerable leeway in how and when to adopt the Euro. EU accession carries with it immediate obligations vis-à-vis Euro adoption as well as the need to formulate a strategy for eventually meeting the criteria for Euro adoption.

## 2 Real Convergence

Real convergence, meaning the approach of the per capita incomes of the NMS to the EU average, was occurring before EU accession and has continued afterward. GDP growth in the NMS has been about twice that of the old members. The transition economies joining the EU in the first round had faster growth rates of per capita GDP in the 2001-2005 period than they did in 1996-2000. This suggests that there are some positive effects on economic growth from joining the EU, but causality should be treated with care in that the higher post-2001 growth rates of the NMS could as well have been due to the cumulative effects of reforms undertaken as part of the transition process. Even in this case, however, the prospect of EU membership did accelerate these reforms, thus providing an indirect impetus to economic growth in the NMS.

Macedonia's real convergence performance seriously lags that of the NMS. Although GDP growth in Macedonia has accelerated in the past several years, in comparative perspective Macedonia's inability to sustain rapid per capita GDP convergence with the EU countries is a source of concern. Moreover, given Macedonia's lower per capita GDP, achieving real convergence in per capita income is all the more important. While it is true that Macedonia has suffered from regional instability and domestic disruptions, other NMS have also faced economic and financial crises, failed stabilizations and a variety of political dislocations. Indeed, even some other former Yugoslav Republics have done better in terms of real economic growth despite similar, if not worse, obstacles.

The growth of the capital stock is a key component of real convergence in the NMS because investment-to-GDP ratios are higher in most NMS, ranging between 35 and 25% of GDP. The faster growth of the new members is, as modern growth theory suggests, only partly due to these higher rates of capital accumulation. Growth of total factor productivity (TFP) accounts for at least half of the growth in GDP in the NMS, and TFP's share appears to be increasing. Changes in the size of the labour force or in hours worked in the NMS have been either negative or only slightly positive and thus were either a retardant of, or a minor contributor to, economic growth.

Macedonia's investment rate has averaged less than 20% of GDP, which has made per capita income convergence with the EU countries through the growth of the capital stock impossible. If Macedonia is not able to increase the share of GDP devoted to fixed capital formation above 25%, it will be forced to rely entirely on productivity gains to catch up with the per capita income levels of the other EU member countries.

It is worth noting that much of the higher rate of capital formation in the NMS is due to high levels of corporate savings and capital inflows, mainly in the form of FDI, rather than the result of high domestic personal savings. Thus, Macedonia's low levels of FDI are an important contributor to the shortfall in capital formation. The other barrier to investment-led growth is the domestic "investment deficit," which is mainly due to the poor profitability and saving and investment behaviour of Macedonian firms. Macroeconomic policy, especially high interest rates, appears to be only a secondary factor in explaining this investment deficit. Thus, overcoming Macedonian firms' low propensity to invest is critical to real convergence.

Macedonia differs from the NMS not only because of its low levels of capital formation, but also because of its rather different TFP dynamics. In Macedonia, because capital accumulation has been a minor contributor

to growth, changes in employment and TFP growth have been the main drivers of GDP growth on a year-to-year basis. With high levels of unemployment, output expansion is achieved by increasing employment, and thus without the need for TFP growth. When the labour market eventually tightens and unemployment falls to more normal levels, then TFP growth may become more evident as the economic pressure for it makes itself felt. Currently, Macedonia has GDP growth that is too low to achieve rapid convergence of per capita income levels with the EU, and, without real convergence, Macedonia cannot become a viable member of the EU. To formulate more effective policies, research into TFP growth in Macedonia as well as into the causes of low business investment is needed.

The other element of structural convergence is the shift of labour and of economic activity more generally from agriculture and industry to services. In all the transition economies, this structural change has been an ongoing process, and it is part of a worldwide pattern where all countries have been experiencing a shift in economic activity from agriculture to manufacturing and then from agriculture and manufacturing to services as per capita incomes increase. In the case of the NMS, the structural gap between them and the more developed EU members caused by differences in per capita incomes was exacerbated by the pre-transition emphasis on industry and agriculture at the expense of the service sector. Rapid convergence in the NMS toward the employment structure of the older EU members was evident over the entire period of the transition. This has resulted in a major structural shift in economic activity and employment away from agriculture and industry in favour of services in the NMS.

Macedonia's value-added structure is similar to that of the most recent EU entrants, Bulgaria and Romania, in that agriculture has a relatively high share of value added. Noteworthy in this comparison is the decline in agriculture's share in value added

in Bulgaria and Romania after 2001, which suggests that EU accession contributed to the decline in this sector's share in aggregate output. Macedonia has shown less of a decline in agriculture's share of value added and employment than have Bulgaria and Romania. This may, in part, reflect Macedonia's slower rate of growth of per capita income.

In the NMS, EU accession temporarily ameliorated the global tendency for a fall in industry's share of employment and value added. Despite the EU-wide decline in industry's share in economic activity, industry has lost its share in employment and output more slowly in the NMS than this EU-wide trend would suggest, in large part because of inflows of FDI to the NMS that helped create new industries to supply the EU market. In some NMS, industrial employment enjoyed a modest uptick after EU accession, although, of course, many of the relevant investments had been started prior to these countries joining the EU.

In part, this "industrial renaissance" is also connected to important shifts within industry, away from energy-intensive and low-skill-intensive industries and in favour of high technology and skill-intensive sectors. FDI inflows have played an important role in this shift. Macedonia has not been part of this process to a sufficient extent. Industry's share of value added is declining more quickly than is the case in the NMS, and, in Macedonia's case, this structural change is happening with little convergence in per capita income. EU membership can improve Macedonian industry's situation only if accession increasingly makes Macedonia a location from which foreign investors could serve EU markets and if domestic industry itself, with the assistance of FDI, could undertake the needed changes in its output profile, an issue explored in greater detail in the section on industry.

These long-term structural shifts in employment and output, which may be accelerated by Macedonia's EU accession, have two im-

portant policy implications. The first is that such a change in the structure of employment carries with it important social consequences, including the movement of the population out of rural areas and the consequent breakup of family and social ties; the loss of existing jobs and less of a need for the skills they require as well as a demand for new skills; increased urbanization and thus a need for investment in urban infrastructure; and the need for better education. All these areas should be addressed quickly. The second implication is that there are important differences in labour productivity as well as different trends in TFP growth in each of the three sectors. Thus, sectoral change may be an important driver of changes in aggregate TFP and in incomes of workers in different sectors of the economy.

### **3** Nominal Convergence

Unlike real convergence, to which no specific targets for EU accession are attached, nominal convergence is important not only because of the desirability of low inflation rates and macroeconomic stability, but also because numerical targets for Euro adoption have been established for inflation, the interest rate and exchange rate stability. Thus both before, and even more so after, accession, these targets become more binding on policymakers.

Like real convergence, nominal convergence, meaning the convergence of price levels, inflation rates and interest rates, between the transition economies and the EU is a process that pre-dates EU accession and that is evident in both those transition countries that have joined the EU and many that have not. Both in the pre-accession phase and post-accession, the NMS have had inflation rates that are significantly higher than those of the members of the Euro zone and also higher than those of the less developed members of the EU. Moreover, in all the NMS, the effort to reduce the rate of inflation has been a long-term process and

a main concern of monetary authorities. In the early phases of transition and even now, inflation is related to transition processes like the creation of markets, economic stabilization and the need for major realignments of relative prices in the economy. In Macedonia's case, the requirements of EU accession for greater market liberalization and price rationalization will also emerge as sources of inflationary pressures.

Supplanting these short-term and transition-related factors as the key forces driving inflation around the time of accession for the NMS are longer-term forces: real convergence, capital inflows and economic policy, especially the choice of exchange rate regime and the fiscal balance. Perhaps the most important long-term driver of inflation in the NMS is real convergence and the consequent Balassa-Samuelson effect, which posits that higher income countries have higher price levels and that real convergence must therefore lead to price convergence through higher inflation rates in the countries that are catching up. Nevertheless, the higher inflation rates observed in the new members are not the result of real convergence only. Other factors such as growth of domestic demand, especially consumer demand driven by rapid credit expansion, high real interest rates that attract foreign capital and fixed exchange rates all contribute to higher inflation.

Some NMS who have flexible exchange rates have been able to mitigate the effects of domestic inflation through nominal appreciation. However, the new EU member countries with flexible exchange rates have not had as easy a time as expected in conducting an independent monetary policy due to large capital inflows. On the other hand, countries with fixed exchange rate regimes have not had the same scope for nominal appreciation, but they, too, faced problems in conducting an independent monetary policy and encountered high sterilization costs, as well as dangers of overheating from low real interest rates. There also remain idiosyncratic country-specific

sources of inflation, such as the catching up of the prices of utilities, energy, municipal services, etc. with their costs of production. Bringing these prices up to cover costs is important for fiscal balance as well as to reduce waste and resource misallocation, but doing so further accelerates inflation.

Given the large gap in prices and per capita incomes between Macedonia and the EU, price catch-up will be an important source of inflationary pressure, and thus dealing with existing price distortions in energy, municipal services, etc., well before accession can remove this latter factor as an inflation driver around the time of accession, when the real convergence effect on inflation is combined with the negative short-term effects of EU accession on the fiscal balance, falling interest rates, etc. This will require careful management of the exchange rate and will complicate Macedonia's efforts to meet the Maastricht inflation criterion.

These inevitable inflationary pressures and the attendant costs of restraining them in order to maintain low levels of inflation may require a reconsideration of Macedonia's exchange rate regime. If Macedonia fails to achieve higher rates of real growth, then its current exchange rate regime and macroeconomic policies may not come under severe pressure, but, with slow real growth, the country will not be an attractive candidate for EU membership. If Macedonian real growth accelerates, Macedonia will be a more attractive candidate for EU membership, but it will face more intense challenges to its exchange rate regime and macroeconomic policies.

## 4 Policy Implications of Convergence

The NMS have used a variety of macroeconomic policies to bring their economies to a stage where they were ready for accession. A key lesson is that neither monetary nor fiscal policy has been as effective as hoped. The experience of transition econ-

omies with monetary policy suggests it has limited effectiveness: the ratio of credit to GDP is low, household holdings of financial assets are small, and household borrowing is relatively undeveloped, so interest changes and changes in credit availability have a correspondingly small effect on household spending. Loans in foreign currencies to domestic firms and households and foreign-owned firms' borrowings abroad from parent firms bypass domestic monetary policy and many banks are foreign owned, the banking sector is concentrated and the major banks are relatively strong and well provisioned, also reducing the economy's responsiveness to monetary instruments. All of these considerations apply to the Macedonian financial system as well.

Fiscal policy also has limited effectiveness due to a high marginal propensity to import, which means that fiscal policy has a smaller effect on domestic output and a correspondingly greater one on the current account. Moreover, automatic stabilizers are weak due to a high reliance on indirect taxes and to low unemployment benefits. Macedonia has maintained a conservative fiscal stance and low inflation, but pressure from public sector wages, growing demand for public services, infrastructure needs, pensions, and the administrative costs of EU accession will all make pressing claims for budgetary outlays, thus putting greater stress on both fiscal and monetary policy.

## 5 Quality of Institutions for Macroeconomic Regulation

Most of the NMS have made efforts to improve the management of economic policy by strengthening institutions associated with policy implementation. The European Central Bank will evaluate the conformity of Macedonia's laws with respect to central bank independence with the relevant provisions of the Treaty creating the European Union and Article 7 of the Statute of the European System of Central Banks and the European Central Bank. The EU places

primary emphasis on preventing outside influence on central bank policy decisions and avoiding the risk that central banks will directly finance government deficits.

A second aspect of effective policy implementation is the quality of the government's formulation and implementation of fiscal policy. The ability of the new EU member countries to control fiscal imbalances is related to improvements in the means by which their governments set and implement their budgets. Three aspects of fiscal policy formulation and implementation are important: budget planning by the government; submission of the budget for approval by the parliament; and the execution of the budget, including changes in the budget after it has been approved by parliament.

In the first phase, effectiveness of budgetary procedures depends to a large extent on the relationship between the Minister of Finance and the Prime Minister and the ministers who head units that make the bulk of public expenditures. The greater the powers of the Minister of Finance and the Prime Minister in the formulation of the budget, the lower are public spending, the government deficit and public debt. Beyond the organizational rules for the drafting of the budget, factors that have a positive influence on the effective formulation of government budgets include:

- 1.** Effectiveness of economic forecasting. A strong and credible forecasting ability assists in the formulation of realistic budgets, and such forecasts must include not only macroeconomic forecasts, but also revenue forecasts as well as forecasts of the timing of government expenditures.
- 2.** Multi-year budgets provide better fiscal discipline.
- 3.** The use of rules, such as public debt limits, limits on the size of the deficit, rules for inflation adjustments, etc. as well as strict limits on extra-budgetary spending and revenues also improve fiscal discipline.

The second phase of the budgetary process involves approval of the budget by parliament. Limits on the ability of parliament to amend the budget, especially to amend individual items; requirements that parliamentarians simultaneously propose both expenditure increases and sources of funds to cover these increases; limits on the time to consider the budget as well as a clear rule on the consequences of not passing a budget are all ways in which the budget set by the cabinet is protected from legislative loosening. The role of the Minister of Finance in leading parliamentary discussions on the budget is also seen as having an effect at this stage.

Finally, there is the execution phase when the approved budget is implemented. Rules requiring parliamentary approval of changes in spending or of deficit targets and of transfers of funds from one ministry to another are seen as positive disciplinary devices as is not allowing ministries to carry over funds from one budget year to the other. The Minister of Finance should have the power to limit expenditures in the face of economic shocks, especially those that are likely to cause revenue shortfalls.

Another important area where a number of new EU members have introduced important reforms is in the strengthening of the use of information technology in, and the reforming of, the treasury function of the government. These measures have the potential to reduce costs while at the same time improving control over government expenditures and revenues and speeding up the flows of both funds and information about the implementation of fiscal policy. Macedonia has made a number of improvements in this area as well, especially with the rationalization of the collection of health and other taxes levied on payrolls, but the government should continue to monitor best practices in other countries on an ongoing basis. Clearly, the decentralization of government expenditures in Macedonia as well as the need to use EU funds effectively will require that Macedonia be able to dem-

onstrate best practice standards in this area of budgetary management.

Finally, Macedonia appears to face a serious need to reconfigure Ministries so as to create a greater space for strategic thinking and research and to reduce outlays on administration. Such capabilities will be critical in obtaining all available EU funds. Given the tight economic environment likely to dominate the foreseeable future, the EU is likely to view the strengthening of financial institutions in Macedonia not only as a sign of improved macroeconomic control but also as the basis for the strengthening of capacity to use EU funds effectively.

The effectiveness of fiscal and monetary institutions is also dependent on the efficiency with which non-government institutions function. Labour, capital and product markets all are transmitters of monetary and fiscal policy, and, thus, the creation of functioning and flexible markets is critical, not only in terms of meeting the competitive demands of the Single Market but also in terms of making government macroeconomic policy more effective. These topics are discussed more fully in other parts of this Study.

## 6 Post-Accession: Toward the Euro

### Euro Adoption as the Second Step of Accession

As part of EU accession, Macedonia will be expected to adopt the Euro as its currency some time after accession. Timing of Euro adoption depends on two factors: whether the country is able to meet the necessary conditions and judging the point where the benefits of Euro membership outweigh the costs.

Whether Macedonia will be able to meet the Maastricht criteria shortly after accession is unclear. Considering pre-crisis performance, the country would have little difficulty meeting the fiscal criteria; the government deficit criterion has been met in past

years, and should be reachable in the future as well. If Macedonia had been in ERM II in the past several years, it would clearly have met the exchange rate stability criterion for Euro adoption as well.

However, it should be noted that exchange rate stability was achieved in the absence of the real convergence and capital inflows that would accompany EU accession, and thus this good performance occurred in an environment that was more favourable than it will be when Macedonia does enter into ERM II. Over the past several years, excepting the inflationary surge in 2007, Macedonia was also quite close to meeting the Maastricht inflation criterion. In the case of inflation, however, the past is a poor guide to the future; inflation rates in the EU are likely changing drastically and Macedonia will face real convergence and interest rate shocks connected to accession. Macedonia does not meet the interest rate criterion. Like the inflation target, there will be major changes in long-term interest rates in the EU, but capital inflows accompanying accession should work in Macedonia's favour. Overall, Macedonia does best on the criterion whose performance is hardest to change in the short run, the fiscal target. Thus, Macedonia appears to be relatively well placed for an attempt at early EU entry so long as its macroeconomic policy can withstand the shocks of EU entry.

The adoption of the Euro should promote more trade with other members of the Euro zone. Given Macedonia's size and the dependence of economic growth on trade, trade expansion should be seen as an important benefit of Euro adoption. Macedonia can also expect capital inflows, including greater FDI, even before the Euro is adopted; these will be a policy challenge in the short run, but a benefit in the long run. Finally, as the current crisis shows, the Euro is a safe haven, and while Euro adoption will not remove all constraints on Macedonia's macroeconomic policy, it will eliminate exchange rate fluctuations as a major policy concern.

The costs of Euro adoption appear minor. As a small country, Macedonia has limited scope for an independent monetary policy. The standard optimum currency area arguments regarding the importance of synchronization of shocks among members have some validity, but many of the transition economies that joined the EU earlier did not exhibit strong correlation of shocks either. Thus the argument would appear to be for a relatively early adoption of the Euro if the process can be well managed. Doing so will require some hard decisions on exchange rate policy as well as strong macroeconomic management, topics which we discuss next.

What sort of exchange rate regime to follow before and after accession depends in part on how quickly a new member country wishes to adopt the Euro as its currency. If the Maastricht criteria are met, then the minimum time would be the two years spent in the ERM II regime. During that time, the country is required to keep its currency within 15% of the Euro, with intervention mandatory at the limits of the band; not to devalue its currency against any EU member; and to eschew the use of currency controls. Countries are free to assume more stringent obligations, such as a currency board arrangement, if they wish. If a country does not meet the Maastricht criteria, then it has wider latitude in its exchange rate regime outside the framework of ERM II, and, in principle, this greater flexibility can be used to ease the pressures of real and nominal convergence discussed above.

Policy choices have to be made regarding the exchange rate regime before joining ERM II, while in ERM II and then when the country is on the verge of exiting ERM II and actually adopting the Euro. Countries that have undergone most of the nominal and real convergence between themselves and the EU can opt for a rapid move toward Euro adoption and enter into ERM II quickly.

On the other hand, countries that expect to

undergo greater (or more rapid) additional real convergence as well as financial integration with the EU might find themselves hamstrung in ERM II because they will face strong inflationary pressures from sustained and rapid real convergence as well as from a lowering of the interest rate, which can trigger a domestic boom. This inflation can, in turn, result in a loss of international competitiveness for the country, leading to more problems, including current account deterioration and speculation against its currency. Attempting to deal with such inflationary pressures within ERM II by means of domestic monetary and fiscal policy may prove costly if not impossible. On the other hand, remaining outside ERM II for a long time while convergence takes place leaves the country exposed, without the cover of the "Euro umbrella," something that has recently caused many EU members to re-evaluate much more positively the benefits of having the Euro as their currency.

The experience of the new EU member countries in terms of their choice of exchange rate regime is limited to two regimes: what might be called hard pegs, including currency board arrangements, and a floating rate with a monetary policy based on inflation targeting. Rather paradoxically, most of the more advanced new EU member countries have opted for flexible regimes and inflation targeting while those with the greatest amount of real convergence yet to accomplish, such as Bulgaria and the Baltic Republics, have opted for a hard peg. The NMS that have adopted the Euro were relatively well placed to meet ERM II conditions, and they had made considerable progress in terms of the real convergence

The consensus of observers is that within ERM II and even before entry into it, a floating regime is most appropriate because countries facing large capital inflows are best off with either floating exchange rates or Euroization and should avoid soft pegs. Exiting from a hard peg before Euro adoption may lead to a loss of confidence and a depreciation of the currency. These conclusions are not rendered irrelevant by the



current crisis. The capital outflows of today, which have battered the reserves of some NMS peggers and driven down the currencies of some floaters, are simply the mirror image of the capital inflow that followed, or even preceded, accession. They do put into doubt the view that sound macroeconomic policies alone can protect a country from market sentiment that has tended to lump all countries in a region into the same “troubled” category.

The advantages of either a hard peg or floating with inflation targeting pose some serious dilemmas for Macedonia, which has for a long time maintained a de facto peg to the Euro. Consequently, its current exchange rate regime falls outside the experience of the transition economies that have joined the EU or adopted the Euro, and Macedonia’s reliance on a soft peg leaves it with the one exchange rate regime against which experts almost unanimously counsel. Whether and how this regime could be carried forward through toward and beyond EU accession must be examined.

Despite the criticisms of soft pegs, Macedonia’s exchange rate regime has served the country reasonably well. The currency has maintained its value relative to the Euro in a trade and financial regime that has grown in openness to global forces. Reserves, up to the crisis period, have grown and the inflows of capital have been managed at acceptable costs of sterilization. But it is clear that the path to EU accession requires rapid real convergence, and this will unleash stronger inflationary pressures though the Balassa-Samuelson ef-

fect, lower interest rates, etc. Macedonian competitiveness, as measured by unit labour costs, is not substantially out of line with that of neighbouring countries, and, thus, there is little cushion for real currency appreciation without exposing the fragility of the balance of payments. To the extent that real and interest rate convergence will precede EU accession, the de facto peg could come under pressure at an unfortunate time. This, again, emphasizes the need for making price adjustments in energy and public services well in advance of accession and of developing anti-inflation measures such as incomes policies.

The current crisis has also shown that the period of time that Macedonia spends in ERM II is a time of risk. Capital controls will no longer be possible and the peg to the Euro will be a de jure one, not de facto. Consequently, if Macedonia retains the current exchange rate regime, entry into ERM II will require a regime change to one where commitments to the exchange rate are obligatory but also one where the risk of exchange rate fluctuations will be bigger than they have been. Since there will be no way of avoiding a two year period of pegging to the Euro, Macedonia should seek to enter ERM II with as much of the convergence process as possible behind it. But to gain the benefits of being in the Euro zone, there is pressure for Macedonia to adopt the Euro as soon as possible. These contradictory objectives cannot be reconciled easily, although undertaking as many of the steps toward real and nominal convergence as soon as possible can mitigate the conflict between them.



## CHAPTER III

### BUDGETARY IMPLICATIONS OF EU ACCESSION

#### Introduction

Both candidacy for EU membership and EU accession have implications for Macedonia's government budget. Before membership, Macedonia will receive funds from the EU, but, even then, it must undertake expenditures in order to manage and use these funds. After it becomes a member of the EU, it will be not only a recipient of EU funds, but also a contributor to the EU's budget. Thus, as a first step, Macedonia must strengthen its capacity to use EU funds, and, after accession, it must reallocate its budgetary resources to account for the funds that it will receive from the EU, and it must make allowance in the budget for the funds that it will contribute to the EU. One of the key findings of this report is that preparing for the effective use of EU funds is one of the most important tasks facing Macedonia.

#### **1** EU Public Finances and Financial Flows Between the EU Budget and EU Members and Candidate Countries

The EU's expenditures and revenues are framed within a medium-term financial plan and operationalized in annual budgets. The EU's own expenditures are about 2.5% of the total public expenditures in the EU, largely because the EU itself makes no expenditures for public services, social security, pensions, defence, etc. as these are the province of the member countries. The EU's budget expenditures are used to support its organs and to finance its common policies, i.e. the policies that the member states have agreed will be implemented at the supranational level.

Currently, member states are eligible for EU funds for the Common Agricultural Policy, the EU's cohesion policy and for other purposes, such as R&D and education. Other EU budget outlays, such as for the Instrument for Pre-accession Assistance (IPA), go

to countries outside the EU, and the budget also finances EU administrative expenses. Transfers from the member states' national budgets into the EU budget finance these expenditures. There are three main sources: contributions of member states based on the value added tax and on the relative size of their GNP and the EU's own revenue resources. An EU candidate country, such as Macedonia, is eligible to receive EU budget funds from the IPA, but it does not contribute to the EU budget.

There is a clear distinction between so-called commitment and payment appropriations. The first represents the legal basis for the use of EU budget funds while the second refers to planned payments from the EU budget in a particular year. Both forms of appropriations are ex-ante categories, but actual payments are the disbursement of funds to a country from the EU budget. Actual payments show ex-post what proportion of planned disbursements the country actually absorbed. The higher is the absorption capacity of a country, the smaller the difference between the two.

The absorption capacity of an EU member or candidate country for the use of EU budget funds has three aspects. Macroeconomic absorption capacity refers to the overall ability of the economy to generate viable spending opportunities that could be financed by external support. Since this ability depends on the overall size of the economy, it is defined and measured as a percentage of GDP. Financial absorption capacity is defined as the ability of the recipient to provide national co-financing for EU programs and projects. Finally, administrative absorption capacity is the ability of authorities in member or candidate countries to prepare suitable plans and to manage EU funds effectively and efficiently.

The net financial balance of an EU member or candidate country vis-a-vis the EU budget is the difference between the EU budget funds the country receives from the EU budget and the funds it pays into the EU budget from its national budget. Although the basic logic is straight forward, there are some problems at the operational level because there are differences between the following two “net financial balance” concepts.

The first one is the “calculated net financial balance.” This is the difference between “commitment appropriations,” which an EU member or candidate should, according to plans, receive from the EU budget in a particular year and the planned contribution of that very state to the EU budget for that year. The “calculated net financial position” is, thus, a planning category that is known for every EU member or candidate country immediately upon completion of the medium-term financial negotiations.

The second concept of the “net financial balance” is the “actual net financial balance.” This is the difference between “actual payments” that an EU member or candidate receives from the EU budget in a particular year and the actual contribution of the same member state into the EU budget. The “actual net financial balance” is, thus, an ex-post category that can be calculated only

after the end of the fiscal period. The difference between the “calculated net financial balance” and the “actual net financial balance” depends on absorption capacity. The higher it is, the smaller the difference between the two. If an EU member had a 100% absorption capacity, then its actual net financial balance would be equal to the calculated one.

## 2 Fiscal Implications of EU Accession

As a country moves from candidate to member status, there are two effects on its public finances. The first one, called “intra-budgetary fiscal effects,” consists of effects that are a direct consequence of:

- Inflows from the EU budget into the national budget (for agriculture, structural funds, etc.);
- Outflows or payments from the national budget into the EU budget.

A second group of direct fiscal effects, called “other direct fiscal effects,” includes effects that are not reflected in financial flows between the EU budget and the national budget of the country but that affect government expenditures and revenues due to the requirements of the *acquis*. New EU member states must introduce and start implementing the *acquis* either at the date of the accession to the EU or, at the latest, at the end of a transition period agreed during the EU accession negotiations. Because the new EU member states have to accommodate the entire *acquis*, including those aspects of it that may require major changes in public expenditures or in the tax system, for example in transportation and environment, there is no doubt that accession increases expenditures significantly. On the revenue side, meeting the requirements of the *acquis* often causes a decline in both customs and tax revenues.

Accession to the EU requires a drastic restructuring of public expenditures and revenues if the country wants to simultaneously: (i) maintain budgetary balance or at least

effective control over its deficit, and (ii) ensure that it is able to obtain all the EU funds that are potentially available. This is in part due to the nature of the payments that have to be made to the EU budget, and in part to the fact that EU budget expenditures are concentrated on agriculture and cohesion. Contributions to the EU budget reduce the overall level of budgetary resources available in the country implying that all users of the national budget are affected proportionally. On the other hand, funds from the EU budget are de facto available only to selected budget users. Thus, if the expenditure side of the budget is not restructured appropriately to take this into account, Ministries such as Agriculture receive significantly more resources, those coming from the EU budget plus the required national co-financing, than they received before accession, while budget users that are not eligible for EU funding would be faced with drastic reductions in their budgets.

### **3 A Case Study of Slovenia – Fiscal Effects of the EU Accession on the Overall Balance of the Country’s National Budget in the Pre-Accession and Immediate Post-Accession Period**

Intra-budgetary fiscal effects are clearly positive for an EU candidate country in the pre-accession period because the country is eligible for pre-accession assistance but is not yet obliged to contribute to the EU budget. The calculated net fiscal balance of Slovenia in 2003, i.e., in the final year prior to its accession to the EU, was positive and equal to around 0.2% of GDP. By way of comparison, it was over 0.7% of GDP in the case of the three Baltic States.

After accession, the “new” member starts paying its full contribution into the EU budget, and this is between 1.0 and 1.3% of the country’s GDP. Consequently its net financial balance depends crucially on its ab-

sorption capacity for actually obtaining the allocated EU budget for cohesion and agriculture. The case of Slovenia is very illustrative in this respect. For the period 2004-2006, the actual net fiscal balance was very close to the calculated net fiscal balance of plus 0.3% of GDP as set by the EU accession negotiations. This shows that Slovenia had a good absorption capacity for the use of EU funds.

This situation changed in more recent years when Slovenia had the opportunity to obtain substantially more EU budget funds for cohesion purposes. Based on the medium-term financial perspective negotiations for the period 2007-2013, Slovenia’s calculated net fiscal balance became more positive and amounted to an average annual level of plus 0.9% of GDP for the whole period. However, the actual net intra-budgetary balance declined and even turned negative in 2007 and 2008. The major reason for this under-performance was Slovenia’s poor administrative absorption capacity for the use of EU cohesion funds.

Over the five-year period prior to accession to the EU, a candidate country is faced with a significant increase of its budget expenditures aimed directly at meeting the *acquis* requirements. In the case of Slovenia, by far the largest EU accession budgetary items were Schengen-related costs and budget subsidies for agriculture. Their aggregate amount was estimated at an annual level of around 1% of GDP in the pre-accession years. In the immediate post-accession period, other direct fiscal effects on the Slovenian budget had two sources. On the revenues side, Slovenia suffered a decline in customs duties, and, on the budget expenditures side, in addition to the Schengen-related costs that continued from the pre-accession period, some new expenditure items appeared, such as the top-up mechanism of direct payments in agriculture, and contributions to the EU institutions, including the EIB and European Development Fund. The aggregate amount of these fiscal effects was estimated at an annual level of around 0.5% of GDP in 2004 and 2005, i.e. in Slovenia’s first two years as an EU member.



## CHAPTER IV

# INTERNATIONAL TRADE AND FOREIGN DIRECT INVESTMENT

### Introduction

This section examines the effects of EU accession on international trade and foreign direct investment (FDI). The trade impacts of EU accession can be divided into the immediate impact observable around the time of EU entry and the long-term effect, which begins long before accession and may continue for a prolonged period afterwards. The latter effect is heavily influenced by FDI inflows.

### 1 Immediate Impact of EU Accession on Foreign Trade

Looking at the immediate EU-accession impact on foreign trade growth from a broader regional perspective shows that the NMS average export growth increased considerably in 2004. However, an important contributor to this increased export growth was higher import growth in the “old” EU countries (EU15) associated with their recovery from the economic slowdown of 2001-03 rather than with the EU enlargement process. From this point of view, the immediate effect of EU accession should not be overstated.

Another note of caution comes from the fact that there are important cross-country differences in export performance in 2004. The Czech Republic experienced the most pronounced acceleration of export growth among the NMS, followed by Slovenia, Hungary and Estonia. On the other hand, export growth declined in 2004 for Slovakia, Lithuania, Malta, and marginally also in Poland. The growth of exports also declined in Bulgaria and Romania after their EU entry in 2007. One possible source of these differences among the NMS is divergent real exchange rate developments. For example, the real effective exchange rate of the Czech koruna fell in 2003 and early 2004, which contributed to fast export growth in 2004. Similarly, export growth in

Latvia was supported by the real exchange rate depreciation that had taken place in 2003. An example going in the opposite direction is Slovakia, which experienced a sharp real effective exchange rate appreciation in 2003, which might explain its export growth slowdown in 2004.

To correctly assess the immediate impact of the EU entry on export performance of the NMS requires the use of statistical techniques to control for these exogenous factors. When the factors discussed above are taken into account, there is no statistical evidence that EU accession had any immediate effects on total NMS exports to the EU. Since most trade barriers on manufactured goods were already removed before accession, this is not surprising, but the situation is somewhat different for agricultural exports. Both NMS agricultural exports and imports grew faster in 2004-05, even when accounting for other factors, supporting the hypothesis that EU enlargement in 2004 did contribute to an increased volume of agricultural trade for the NMS. This is very relevant for Macedonia given the importance of agriculture to its economy and international trade. In this sector, Macedonia has the potential to benefit from EU accession to a greater extent than did the more industrialized NMS. As the section on agriculture points out, to exploit this opportunity, Macedonia must invest in food processing

and raise the quality of agricultural output to meet EU standards. This will allow it to convert its agricultural commodities into competitive foodstuffs, generating higher value added in the economy. Macedonia should strive to negotiate favourable production quotas with the EU for the relevant agricultural commodities.

There may also be negative side-effects from higher agricultural exports. There were concerns in the NMS ahead of EU accession that trade liberalization would lead to higher food prices, and, given the large share of food in the NMS' consumer baskets, such increases would have been politically and socially problematic. The overall effects of the accession on food prices due to trade liberalization and adoption of the Common Agricultural Policy have been minor. For example, in the Czech Republic, some agricultural commodity prices, e.g. of sugar beets and milk, were expected to rise sharply upon EU entry, but the prices of some other products, e.g. pigs and certain types of poultry, were expected to fall, causing a change in relative food prices but no major increase in their overall price level.

The actual developments after the EU accession essentially confirmed these expectations. The other EU-10 also faced somewhat increased prices of certain foodstuffs and non-alcoholic beverages in 2004-2005. In 2007-08, there was also a sharp acceleration of food price growth in Romania and in particular in Bulgaria, even though this was to a large extent explained by the global food price increase in that period. Food price increases may thus become an issue that the Macedonian government will want to address in the run-up to accession.

## 2 The Long-Term Foreign Trade Impact of EU Accession and FDI

Although the immediate benefits of EU accession in the form of higher foreign trade volume are likely to be quite limited for Macedonia and concentrated mainly in

agriculture, this does not mean that Macedonia's foreign trade has not or will not benefit from EU accession, but these benefits will be spread over a longer period of time, starting well before accession and continuing afterwards. Because these effects occur gradually, they are extremely hard to quantify with any precision.

The NMS, with the exception of Cyprus and Malta, recorded high growth rates of exports and imports both before and after accession. As a result, most of the NMS have substantially increased their trade openness as measured by the ratio of exports and imports of goods and services to GDP. The Czech Republic and Slovakia recorded the biggest increase, more than 25 percentage points. Given that Macedonia wishes to integrate more closely into the global economy, it is useful to look at this experience in more detail, and in particular to ask what role EU accession played in this process.

The first channel through which the EU accession process affected foreign trade and openness is the pre-accession trade liberalization based on the EU association agreements. For example, Czechoslovakia's association agreement came into force in March 1992 and outlined a timetable for a major reduction of trade barriers, the speed of which was in general faster on the EU's side. This trade liberalization facilitated the geographic re-orientation of Czech and Slovak exports at the beginning of economic transition away from former CMEA countries and towards the EU. In 2003 the real tariff incidence in the Czech Republic was around 0.7%, implying that much of the trade liberalization had taken place before EU accession. A similar pattern of trade liberalization has been now followed also by Macedonia, considering the Stabilization and Association Agreement.

The second channel for increasing trade is that EU association had credibility-enhancing effects. This also occurred well before accession because it increased the international community's confidence in the future political and economic development of



the NMS, ensured improvements in their legal framework as part of the EU harmonization process, and raised expectations of future GDP convergence with the EU. All these factors increased the appeal of the NMS for foreign investors and attracted FDI inflows.

FDI has been an important driver of productivity, investment and economic growth in the NMS. FDI typically increased the internationalization of production and thus the trade openness of the NMS economies, which is believed to have had a positive impact on growth. To the extent that FDI goes into export-oriented industries, it increases both the volume of exports and imports, and that part of FDI focused on serving the domestic market may reduce imports. In addition, FDI increased competitive pressures in the domestic market and stimulated technology and knowledge transfers and innovation. Furthermore, FDI supplemented domestic savings and thus eased credit constraints that limited investment.

While the first channel was more important before EU accession, when the bulk of trade liberalization took place, the second channel was more important after accession due to the lagged effect of increased FDI inflows in the run-up phase. All other things being equal, real exports in the NMS tend to grow by about 2 percentage points per year faster after the EU accession than before it. This suggests that the FDI-related effects on trade tend to be stronger than the pre-entry foreign trade liberalization effects.

In the transition NMS countries, FDI was at first driven by the privatization process, then by the lack of domestic capital needed for economic restructuring and, finally, by EU accession prospects. As a result of these persistent FDI inflows, the stock of inward FDI increased significantly. For example in the Czech Republic, this stock increased from around 20% of GDP in 1998 to almost 60% in 2007. A similar, if somewhat smaller, increase is evident for the NMS as a group.

There are significant differences among the NMS in terms of their FDI stock. Malta has the highest FDI-stock-to-GDP ratio (70-100% of GDP) followed by Cyprus, Bulgaria, Estonia and Hungary. On the other hand, the FDI stock was below 40% of GDP in 2007 in Slovenia, Lithuania, Latvia and Poland. Slovakia and the Czech Republic stand between these two groups with 50 – 60% of GDP. In the CEE countries, differences in the timing of privatization and the degree of openness to foreign investment help to explain these differences in inward FDI stock positions. More recently, other determinants of FDI, such as cost factors, the size and location of the market and FDI policies, have gained in importance. EU accession did not significantly increase FDI inflows, but it is commonly believed that the prospects of EU accession and the institutional reforms implemented in the NMS before 2004, and before 2007 in Bulgaria and Romania, contributed to attracting FDI.

A very important factor is not just the overall size of FDI inflows, but also their structure. For example, in the Czech Republic, FDI in manufacturing peaked in 1998-2001 and then in 2003, i.e. before EU accession. Since accession, FDI into Czech manufacturing has actually declined relative to GDP, and has been financed largely by re-invested earnings. At the same time more FDI has gone into the other sectors of the economy, with the peaks in FDI inflows being linked to the privatization of utilities, banks, etc. Since 2004, foreign investment into the real estate sector has started to play an important role, too, averaging around 1.4% of GDP annually. On average, the industrial sector accounted for about 35% of the overall inward FDI in the past decade, while the other sectors were responsible for the remaining 65% of total. The direct contribution of this other FDI to improved export performance has been rather limited so far.

In the other NMS, the majority of the FDI has also gone into the services sector, while manufacturing accounted for around 33%

of the inward FDI stock by the end of 2006. Financial intermediation, trade, real estate and transport are the largest recipients in the services sector, accounting for around 50% of the total inward FDI stock. FDI in the services sector was usually motivated by market-seeking strategies, and the bulk of FDI in services is related to privatization in these countries, as foreign investors took over a large proportion of the banking, energy and telecommunications sectors during the 1990s and in early 2000s.

The highest share of FDI stock in the manufacturing sector by the end of 2005 was in Slovakia (43%), followed by Lithuania, Slovenia, the Czech Republic and Romania. The smallest shares of inward FDI stock in manufacturing were in Cyprus, Latvia, Malta and Estonia, all below 20% of the total inward FDI stock. Because the early-phase FDI inflow into manufacturing was driven by privatization, often the initial motivation was to serve the domestic market, but the investing firms often expanded their business activity later to take advantage of their good experience, low input costs and the increased competitiveness of the domestic companies. A large inflow of greenfield FDI in the later phase of transition was the result of the relocation of production from developed countries, and a large number of manufacturers from Western European countries moved their production to the CEE countries due to lower labour and other input costs.

Foreign firms now play a major role in the NMS. Taking the Czech Republic as an example, foreign companies account for more than 45% of total employment in industry, and for almost 60% of industrial sales. Moreover, their production is more than proportionately focused on exports, which on average account for more than 60% of their sales, compared to less than 30% for domestically-owned firms. As a result, foreign-owned companies produce about 75% of Czech industrial exports. While these firms have contributed to export performance and employment, the risk lies in the

fact that strategic decisions for these firms are taken outside the local economy, thus not taking into account local conditions and needs. However, these risks have not materialized so far.

For the CEE countries as a group, manufacturing FDI has been concentrated in a few industries, notably transportation equipment, food, metals and electrical and optical equipment, which have received about 65% of the total FDI in manufacturing. During 2000–05, metallurgy gained in importance, while FDI in the food industry became relatively less important.

The structure of NMS exports changed markedly, away from traditional, low-value-added products in favour of the new, FDI-related industries like automobiles and parts, electronic and optical equipment, rubber and plastics, etc. In the earlier years, when the traditional industries were a large part of the economy, their stagnation or decline was a drag on overall GDP and employment growth. The supply-side changes induced by FDI are manifested in productivity gains, terms-of-trade improvements and, in some cases, real currency appreciation. For example, the Czech koruna exhibited long-run effective real appreciation of over 3% a year. It is important to stress that this appreciation is an equilibrium phenomenon that did not come at the cost of a loss of competitiveness, as shown by the remarkable trade balance improvement over the same period. As a result of this real appreciation, price convergence with the advanced EU countries has progressed rapidly. The Czech GDP price level increased from 42% of the EU15 in 1998 to 58% in 2007 and probably above 65% in 2008. This has been an important part of the Czech Republic's economic convergence to the advanced EU countries. Real exchange rate appreciation has also taken place in the NMS as a group.

The direct effects of FDI inflows were clearly seen in the NMS countries at the firm level: foreign-owned companies, usually a

part of multinational enterprises, are larger, more capital intensive and employ more skilled labour, have greater technological knowledge and higher productivity than do domestic companies. In addition, foreign firms usually have better access to financing, either from the parent company or from banks. The consequences are higher overall aggregate investment, employment and output. FDI in the manufacturing sector also contributed to improved export performance.

There is the possibility that, as wages in the NMS rise, firms that located in these countries to take advantage of low labour costs may relocate to other countries where wages are lower. This is especially true of greenfield investments in manufacturing. Currently, the experience of the NMS countries does not show any large-scale liquidation of FDI in those countries where labour costs increased the most, although there have been a few cases where a production facility was moved from a NMS to a location farther east. To some extent, this may provide a future chance for economies like Macedonia that can offer foreign investors attractive conditions in terms of local input costs.

Most policymakers in the CEE countries are aware of the fact that some FDI may only stay for a limited period of time. Nevertheless, the consensus has been to attract FDI not only because of its direct effects, but also due to its positive indirect effects on local firms. Experience from the NMS shows that local producers often serve as sub-contractors to foreign firms, and the foreign companies intentionally help the local firms to advance their technologies, increase the quality of their products and possibly also to export them, mainly to the foreign investor's affiliates in other countries.

Given the importance of FDI, NMS countries have sought to maximize the benefits from FDI while minimizing the possible costs and risks. Clearly, the longer a foreign investor remains in the country, the greater

the benefit to the host country. Some NMS provide support for foreign investors in the form of tax holidays, infrastructure development, subsidized retraining of newly hired employees, etc., but also impose conditions such as the minimum number of years the FDI firm must stay or the number of local workers employed. Some NMS countries concentrated on attracting firms predominantly in high value-added industries, and they also tried to steer FDI to regions that either lagged behind or had the potential to form clusters of firms that would include local suppliers. Assessing the costs and benefits of such FDI schemes is difficult because it is almost impossible to fully quantify the benefits. A general lesson from the NMS countries is that a balanced approach requiring at least some preliminary cost benefit analysis is needed and that the incentive schemes for attracting FDI must be subject to change over time in order to react to new developments.

One of the objections raised against attracting low value-added firms is that it does not promote the host country's technological development. The lesson from the NMS experience does not support this view. It seems that even low-value added FDI in manufacturing can create preconditions for future high value-added FDI inflows, but only if other conditions that create incentives for the foreign firm to replace the low-value production with some high-value production at a later stage of the investment life cycle are in place.

Any small country, and most NMS are relatively small countries, must to some extent accept the side effects of attracting productive FDI, including the increased role of manufacturing, vulnerability to external conditions, dominance of foreign firms in the local economy, as well as the increased concentration of industrial production. A small country also has to accept the need to focus on those industries where it has some comparative advantage and to integrate itself intensively into the world economy via international trade at the cost of increased

volatility of the economy due to higher dependence on external demand. For small economies, this is the only reasonable way to increase the standard of living of their inhabitants.

An official scheme for attracting FDI aimed at selected sectors may attract a large number of firms with important synergies and cluster effects for both output growth and exports, but it inevitably leads to an increased dependence on demand for particular products. This can make the output of the host country more volatile. The lessons learned from the automotive industry in countries like the Czech Republic, Slovakia or Poland are very instructive in this respect. In times of good global economic conditions, these countries with a large share of car and car components manufacturers boomed, but in times of economic

slowdown with a marked decrease in demand for cars, these host economies have seen a major decline in demand.

Thus some attention should be given to diversification of production as well (see also the section on Industry). Even if this seems to be rather difficult for small economies like Macedonia, the objective of diversifying the production base is worth following and can be successful. Of course, the extent of diversification will be different from large economies, but it can provide the country with some safeguards against large drops in external demand for particular products. Such a diversification would also be a welcome factor for the future adoption of the euro by Macedonia, as it would reduce the likelihood of asymmetric shocks during its stay in the monetary union.

## CHAPTER V

### INDUSTRY AND NON-FINANCIAL SERVICES

#### Introduction

In 2007, the share of industry in Macedonia's GDP was estimated by the EBRD to be 22.7%, a modest rise from the 2002 share of 19.7%. Macedonia's labour productivity in manufacturing is poor compared to other sectors of the economy, and there are large differences in labour productivity across branches of manufacturing, with textiles, leather and other manufacturing being the lowest; this reflects their higher labour intensity. With 58,776 firms and a population of about 2 million, Macedonia has about 29 firms per 1000 inhabitants, and slightly fewer if we confine attention to SMEs. This is an improvement to the number of firms that existed in 2000, and it is approaching the levels of more vigorous economies such as Poland and the Czech Republic. Textiles, leather goods, and metal products are the only three sectors with markedly above average export shares, showing that they perform relatively well in the external market.

Over 80% of the country's imports come from Europe, while over 95% of exports have European destinations. Greece, Germany, Italy, Serbia and Montenegro provide large markets for Macedonian products, with the same countries plus Russia and Bulgaria being the largest sources of imports into Macedonia. It is normal for a country to trade intensively with its neighbours, but this does highlight the importance of maintaining the best possible political and economic relationships with these countries as well as Macedonia's dependence on economic conditions in these countries.

#### **1** EU Accession – The Requirements

Macedonian industry must help contribute to the country's ability to meet the EU conditions for a functioning market economy that can withstand competitive pressures

from the EU as well as to respond effectively to the introduction of the *acquis*, of which the following chapters are most relevant for industry:

- Chapter 5. Public Procurement
- Chapter 8. Competition Policy
- Chapter 14. Transport Policy
- Chapter 20. Enterprise and Industrial Policy
- Chapter 21. Trans-European Networks
- Chapter 29. Customs Union

Currently, the Stabilization and Association Agreement (SAA), and the Accession Partnership (AP), the current version of which was confirmed in February 2008, govern Macedonia's relations with the EU. The SAA stresses the liberalization of trade links between the EU and Macedonia. Most trade in goods in both directions was to become free virtually as soon as the SAA was ratified by both parties, in the sense that tariffs would fall to zero and quantitative restrictions and other non-

tariff barriers (NTBs) were to be removed. Exceptions were provided for in the case of certain sensitive products, notably textile and clothing products, steel products and processed agricultural products, all important Macedonian exports. For textiles and clothing, Macedonian products could be exported duty free into the EU as soon as the SAA came into effect, while EU textile and clothing products could either be exported to Macedonia duty free, or would be subject to duties that declined gradually to zero over a ten-year period.

A similar asymmetry in Macedonia's favour also applied to steel and steel products, except that Macedonian tariffs on such products imported from the EU were to be reduced over a five-year period. For processed agricultural products, most tariffs were set at zero for trade in either direction, but for a few products Macedonia retained some tariffs on imports from the EU, these being set at declining percentages of the prevailing MFN tariffs set by Macedonia. Trade in agricultural and fisheries products was substantially liberalized, except that some Macedonian products faced export quotas in the EU market.

As originally set out in the SAA, the rules of origin made no provision for cumulation of allowed inputs across other states associated with the EU, such as Croatia, making the agreement as restrictive as the original Association Agreements for the recent Accession States had been for their first five years or so. Recently, however, the "rules of origin" provisions of the SAA as well as the network of 32 highly inefficient bilateral free trade agreements between various pairs of South Eastern European countries have been subsumed in a single free trade area for South Eastern Europe. This takes the form of a revived CEFTA, the Central European Free Trade Agreement. CEFTA was amended in 2006 under the auspices of the Stability Pact for South Eastern Europe, and the new structure came into effect in July 2007, covering the following countries: Albania, Bosnia and Herzegovina, Croatia,

Macedonia, Moldova, Montenegro, Serbia and Kosovo. Bulgaria and Romania were also parties to CEFTA 2006, but they were already EU members by the time the agreement was ratified.

Within CEFTA 2006, the "rules of origin" do now provide for full diagonal cumulation, including with the EU and other members of the European Economic Area, and the new arrangements are less burdensome administratively than the previous multiple free trade agreements, each with its own product coverage and rules of origin. For Macedonia, though, the result is that products produced using significant material inputs from outside the area covered by CEFTA 2006, for instance Ukraine or Russia, would not benefit from EU trade preferences. At times Macedonia would be faced with making a choice between using cheaper inputs from such sources and foregoing EU trade preferences.

## 2 Macedonia - Industry

Industry in its broadest interpretation accounted for about 30% of value added in Macedonia in 2005, and about 37% of employment. Just two branches of manufacturing, textiles and textile products, and metals and metal products supplied over half of the country's manufacturing exports. In considering how Macedonian industry can be made more competitive globally and a more vigorous contributor to economic prosperity, it is most useful to examine ways in which the general environment for doing business in Macedonia still falls short of what the economy requires, and this points to areas where significant reforms are still needed. In many cases, such reforms also turn out to be needed for EU accession.

A good starting point for such an analysis is the latest Global Competitiveness Report. This year's report ranked 134 countries, and Macedonia came out in 89th place, below Croatia (61st) and Montenegro (65th), as well as Greece (67th), Romania (68th), Bul-

garia (76th) and Serbia (85th). The overall index is derived from 12 sub-indicators grouped into three broad areas: (a) basic requirements (4 indicators – institutions, infrastructure, macroeconomic stability, health and primary education); (b) efficiency enhancers (6 indicators – higher education and training, goods market efficiency, labour market efficiency, financial market sophistication, technological readiness, market size); and (c) innovation and sophistication factors (2 indicators – business sophistication, innovation). Macedonia ranked 68th on basic requirements, 92nd on efficiency enhancers and 105th on innovation and sophistication factors.

The five most problematic factors for doing business were reported as: policy instability, inefficient government bureaucracy, access to financing, poor work ethic and corruption. This broad picture of an incompletely reformed economy is confirmed by the EBRD, which highlights poor infrastructure, both in physical terms and in terms of policy and regulatory conditions; weak competition policy; and excessive delays and costs associated with securing construction permits. There have been significant improvements in business registration procedures that resulted in large increases in the rate of new business registration and in issuing building licenses.

These reports show where Macedonia stands in the world economy as far as general business conditions are concerned. The country has come a long way and important reforms have been enacted, so that Macedonia now conforms to the EU's *acquis* in many important categories. However, to improve the country's competitive position and advance farther on the path towards EU accession, there is much more to do. Moreover, the relevant target is a moving one, not only because the *acquis* itself is constantly evolving, but also because other countries with which Macedonia will compete in the world market, whether EU member states or not, are themselves undertaking reforms to improve business conditions.

## Chapter 5. Public Procurement

Macedonia's new Public Procurement Law (PPL) broadly conforms to the *acquis*, but legislation on concessions and public-private partnerships does not. Implementation of the new PPL also needs further improvement. This is potentially a very costly area for Macedonia because of the high legal and translation costs entailed, especially for larger contracts. Unfortunately, the Commission reports pay no attention to such costs either here or in relation to other chapters of the *acquis*. Given the probable costs, gradual improvements in this area will limit their budgetary impact.

## Chapter 8. Competition Policy

The Commission for Protection of Competition (CPC) has dealt with cases to do with mergers and abuse of dominant position, as well as some cases to do with state aids, where the law has been updated to conform more closely to the *acquis*. Staff levels, training, and judicial support still need improvement, however. The European Commission assumes that even for a small country like Macedonia, it is desirable and efficient for competition policy to operate very much as it does in larger EU member states like Germany or the UK. This may not be a reasonable expectation, since the economics of production in many sectors imply that the efficient size of firm can often be a significant fraction of the entire Macedonian market, or even be larger than that market. So while one would not wish to support a situation where incumbent firms are entrenched and sometimes even protected, it would be wrong in such a small market to enforce competition by constraining potentially efficient mergers. Instead, it surely makes more sense to foster competition by making new firm entry as easy as possible and through vigorous import competition. Likewise, many large firms in Macedonia can only be economically viable if they export successfully, reinforcing the importance of open and liberal trade and good access to markets. For small countries, all this forms part of competition policy.

## Chapter 14. Transport Policy

The Commission reports good progress but notes administrative shortcomings, mostly to do with safety and regulatory issues, and a few legislative ones. Thus, for Macedonia, the transport acquis itself does not address the really important issues that involve additional investment. At the same time, if some of the region's countries could work together effectively, many of the issues that the acquis does cover might better be addressed through some form of regional transport authority, with significant savings in administrative costs.

## Chapter 20. Enterprise and Industrial Policy

Macedonia is well on track to comply with the acquis and sector policies, or clusters, are reportedly well advanced. Less clear is how clusters are identified and what criteria are used to determine whether to continue or withdraw support.

## Chapter 21. Trans-European Networks

The European Commission does acknowledge that although Macedonia participates in the relevant regional bodies that promote European transportation networks, such developments are very expensive, and mobilizing the needed resources is proving difficult. Modest progress is reported with major road projects, notably part of the Skopje by-pass, and with international 400kV electricity transmission lines, but none in the important area of telecommunications. These areas are all important for the country's future economic growth since they help to reduce production and trade costs.

## Chapter 29. Customs Union

Macedonia has recorded excellent progress in this area, with big improvements in customs staffing and training, successful efforts to combat corruption, and revenue collection. IT systems are being improved

but are not yet integrated with EU systems; nor has any progress yet been made with the single administrative document. Waiting times at border crossings are coming down, an important aspect of cutting trade costs and making foreign trade operation more flexible.

## 3 Macedonia – Non-Financial Services

In this section we focus on transport, wholesale and retail trade (i.e. domestic trade), and tourism. In practice the term non-financial services is far broader, since it ought to include a wide range of business-related services such as accounting, auditing, consultancy and legal services, as well as telecommunications and IT services.

### Transport

As regards freight traffic, the available statistics reflect both the general lack of dynamism of the Macedonian economy, especially in the 1990s, and more recently a structural shift from other transport modes towards roads. Rail transport peaked in 1981, declined gradually to a low point in 1996, and, since 2002, it has been rising steadily. That said, the tonnage carried by rail in 2006, at 3.8 million tons, was little over a third of the tonnage carried in 1981, 9.2 million tons, though in terms of ton-kilometers the current "output" is only about 20% below what it had been in 1981.

This suggests that the railways are being used relatively efficiently, to carry freight for longer journeys than used to be the case. In contrast, air-freight has remained extremely modest, growing erratically to a peak of just 11,000 tons in 1999, and declining sharply thereafter. In 2006, only 1,680 tons of goods were transported by air. Many industrial sectors where goods have high value-added-to-weight ratios as well as agricultural sectors such as horticulture rely on air transportation to penetrate foreign markets, and lack of adequate air freight capacity is an important handicap.



For road transport, the tons carried have not yet recovered to the level recorded in the early 1980s, though the ton-kilometers carried in 2006 were about three times earlier levels and over ten times the corresponding figure for rail freight. So, on average, the vehicles for which statistics are collected are carrying freight a lot farther than they did, with most short-distance and local delivery being undertaken in cars and smaller trucks or vans not tracked in the official data. This makes good sense in efficiency terms.

For passenger traffic, there has clearly been a massive shift towards the car, since the railways only carry well under 20% of the passengers they did in the 1980s, and public transport, urban and long distance buses, carries barely more than a third of the passengers using such services in the 1980s. This is an enormous structural shift that has happened relatively quickly, very much as it did in the other transition economies, and it may be that the associated public and private infrastructure has not adapted to this new and still evolving situation.

### Wholesale and Retail Trade

Employment in wholesale trade has fallen from 11,000 to 12,000 during the 1980s to around 9000 in 2006. In retailing, the number of employees peaked around 1991, at about 33,000, and declined gradually to about 15,000 by 1999, rising again to just under 20,000 by 2006. The number of stores peaked at fewer than 12,000, and by 2006 stood at about 6400, presumably reflecting the closure of small stores that were no longer viable and the emergence of larger outlets such as supermarkets, department stores, etc.

Even so, the average retail outlet remains small, with just over three employees. Even in Skopje, retail outlets that provide goods which tourists might buy, such as traditional crafts, souvenirs, books, postcards, etc., generally offer very limited language skills, limited product range, and often goods of uncertain quality. Elsewhere, the shopping

situation is much harder for the visitor. While representing a small share of the overall retail sector, improvements here would contribute to rebuilding the tourism sector.

### Tourism

Macedonia is a country with enormous tourism potential, with attractive and very diverse scenery in many places, interesting old towns and villages, a good local cuisine and welcoming people. However, tourism, especially international tourism, i.e. the export of tourism services, is extremely competitive, and standards of facilities offered elsewhere, including in neighbouring European countries, the most natural competitors for Macedonia, have risen substantially in the past two decades. Macedonia has not matched this progress. Moreover, is not an especially easy country to reach by air, with very few inexpensive flights, and has sub-standard road and rail links with most neighbouring countries. Quite clearly, the 2001 political crisis in the country, a time of serious tension between the country's ethnic Albanian and Macedonian populations, had a major negative impact on tourism.

The number of tourists visiting Macedonia was generally over a million for each year of the 1980s, with total bed-nights averaging over 3.5 million per year. In the 1990s there was already some decline, but numbers collapsed in 2001 to 333,000 tourists and only 1.25 million bed-nights. Since 2001, numbers of tourists have come up again, reaching about half a million in 2006, with 1.9 million bed-nights. Even now, therefore, tourist numbers have only recovered to about half their 1980s levels. Moreover, within all the above totals, foreign tourist numbers fell further and have recovered less well than have domestic tourists.

Given this background, planning a better future for the tourism sector should entail at least the following steps within the framework of the recently adopted tourism development strategy:

- Set a medium-term goal, to be achieved within a medium-term horizon of about five years of returning to the tourism numbers of the 1980s; and a longer term goal of increasing this by a further 50% within a decade. These goals are more ambitious than the current official strategy.
- The country needs to promote itself actively as a safe and welcoming tourist destination, as Montenegro is doing at present, and Croatia even more so; and as Hungary, Poland, Slovenia, Estonia and other new EU member states did very successfully in the 1990s. Among other things, this will require a much stronger web presence for the country.
- Infrastructure relevant to the tourism industry needs substantial investment, both private, e.g. more and better hotels and restaurants, and public for better roads, improved presentation and facilities at monuments, museums and other visitor attractions, etc.
- The skills needed for the tourism industry need enhancement through well targeted training programs focusing on language skills, service standards, etc.
- Last, parts of the financial infrastructure of the country need some upgrade to meet the modern standards that international visitors increasingly expect.

## 4 Policy Implications

Macedonia is a small, open economy that needs to increase its engagement with the world economy quite substantially if it is to prosper, to provide improving living standards to its population and to raise employment rates. Exports already represent a high share of GDP, but if the country is to achieve an average annual growth rate of real GDP of 5%, fixed capital formation should be growing faster than GDP as a whole, and exports should be rising roughly twice as fast as GDP, as has been the ex-

perience in most of the New Member States (NMS). Over a decade, this would be sufficient to raise Macedonia's export share in GDP by about 60% — from 50% of GDP to 80%.

Domestic capital formation will be a key to growth, particularly as the world economy emerges from the current economic crisis. Domestic saving will have to increase and the economy will have to be managed in such a way that the private sector is able to identify a steady stream of profitable investment opportunities in diverse sectors of the economy. These will have to be financed from all available sources: retained earnings, bank loans, FDI and other sources such as loans from IFIs, including EBRD and the European Investment Bank. Not only must the volume of investment increase, but its average quality, meaning the productivity and competitiveness of the firms in which the investment occurs, too, must improve, and this depends critically on the mechanisms through which projects come to be selected, funded and implemented in Macedonia.

In terms of foreign trade, Macedonia's starting point is quite poor, with much infrastructure including roads, border crossings, airports, telecommunications, electricity and water supplies and heating urgently needing investment and further reforms needed to improve the availability of trade-related credits, export credit guarantees, trade-related insurance, and information about current and potential markets. True, CEFTA 2006 and the SAA with the EU provide a helpful framework for fostering trade, with few formal restrictions; but, it is important to keep in mind that some of Macedonia's neighbours are not as friendly and supportive as would be desirable. One can only hope that Macedonia's own diplomatic efforts, with EU and other support, can gradually ease the regional tensions that might well currently inhibit some potentially attractive trade.

In these difficult conditions, identifying the

steps that Macedonia can take to stimulate a much more rapid growth of exports involves considering appropriate external policies for Macedonia as well as the ways in which the country can or should promote the diversification of its production and trade. Although most countries operate some form of industrial policy, such policies generally have quite a bad name among economists. The reason for this is quite simple, namely it too often takes the form of government support for failing firms, which is both inefficient and discouraging to new entry in a given sector. Public support tends to go to those firms and sectors that lobby most effectively, not to those that are most deserving in terms of their future economic potential.

For low- and middle-income countries, the main purpose of industrial policy should be to accelerate structural change towards higher productivity activities. This can occur either by promoting the startup of higher productivity firms or by encouraging low productivity firms to upgrade their technologies and products. While the former tends to be a more visible, and thus popular, form of productivity-enhancing measures, the latter probably has a greater overall effect on the economy and should by no means be neglected. One way is to help existing firms identify the infrastructural and policy blockages that prevent them from performing better. Public resources can be allocated to build infrastructure, amend and improve laws, and so on. The private sector itself is likely to do a better job of identifying the key blockages than could the government. Providing technical and business-skill assistance to firms can also be useful. A state-funded venture capital fund or development bank, provided it is able to distance itself from undue political influence and is tough enough to cut support to projects that do not succeed, could also help develop new industries.

Such a policy promoting new firms only makes sense if the economy is insufficiently diversified. There may, for instance, be a lack of knowledge about what an economy could produce profitably and sell success-

fully in foreign markets, especially because established firms can easily get locked into conventional ways of thinking about their products and markets. This difficulty can be overcome by providing better market information, say, by using the commercial sections of embassies around the world, improving the general business environment to encourage a much faster rate of new business starts, since these are the source of most new ideas, or by pursuing the second type of industrial policy mentioned above (i.e. fostering diversification into new activities). There may also be institutional failures that deter some new developments, including diversification, and if these can be identified they need to be addressed directly.

A suitable economic policy will promote diversification, preferably towards higher skill, higher value-added sectors. The desired outcome would be improved export volumes and improved export competitiveness. The idea is most often put forward for resource rich countries experiencing the so called "Dutch disease," or for small trade-dependent economies with a narrow export base. Macedonia clearly falls into the latter category. While noting the common desire to shift towards higher value-added production, it is important to emphasize that in practice we often cannot identify what this is, and should take care not to pre-judge it. For instance, production of traditional processed food products can be done by means of highly sophisticated modern technologies while the production of high-tech electronic equipment can involve low-tech and low-skill assembly operations. Likewise, some services nowadays can be delivered through a sophisticated IT platform while many still require a well-informed personal touch.

The SEE countries, including Macedonia, currently spend very little on R&D and other innovation-related activities, generally well under 1.0% of GDP; in Macedonia's case, spending has fallen from 0.44% of GDP to just 0.2% in the last few years. This contrasts with EU spending goals to achieve R&D spending of 3% of GDP by the next decade, though at

present many EU member states only spend 2% or less of their respective GDPs on R&D. And most of the new EU member states still spend little more than 1% of their respective GDPs on innovation/R&D, though what they do spend is increasingly concentrated on facilitating the adaptation of domestic production to use imported technology more effectively. For small, trade-dependent countries, this must be the right approach.

Macedonia will need to rein in its spending on direct and indirect subsidies to business, which have reportedly risen to around 2.5% of GDP recently. In the past few years since their accession, the NMS have reduced their spending on state aids from around 1.5% of GDP to 0.5%, and it is highly likely that Macedonia will come under pressure to match this performance.

Last, the current draft of Macedonia's official industrial policy starts well by setting out the general philosophy of the Government towards industrial policy: "The policy is horizontal in its nature and does not focus on supporting selected industries." The report then explains that there will be five areas of intervention to support Macedonian in-

dustry. These are: (a) international cooperation and FDI enhancement; (b) applicable research and development and innovation; (c) eco-friendly products and services for sustainable development; (d) SME development and entrepreneurship; and (e) collaboration in clusters and networks. As regards (c), one can hardly object to the aim of producing more eco-friendly products provided that suitable niche markets can be identified for Macedonian output; it would be surprising, however, if this turned out to be more than a minor element in the country's future industrial policy landscape.

Thus, Macedonia needs open trade, a sound industrial policy respecting the principles just outlined, and efforts to diversify exports. Progress in these areas would gradually accelerate growth in the economy, and this, in turn, will start to bring down unemployment more rapidly while also generating higher revenues for the government budget. Some of these revenues can then be deployed to cover the unavoidable costs of adopting more of the EU's *acquis communautaire*. The first priority must surely be to get the economy moving more dynamically.

## CHAPTER VI

### AGRICULTURE

#### Introduction

Agriculture and agricultural policy played an important role in the Eastern enlargement of the EU in 2004 for two reasons. First, in most candidate countries, agricultural employment represents an important share of total employment and of GDP, but labour productivity in agriculture is lower than in the EU-15. This is, in part, an indicator of hidden unemployment, which can cause serious social and economic problems during accession. Second, agricultural policy is mainly decided at the EU level through the Common Agricultural Policy (CAP) and regulations concerning food safety and quality. The implementation of the CAP and safety and quality regulations caused substantial problems and required important pre-accession investments in the NMS, and this applies to Macedonia as well.

#### 1 Macedonian Agriculture and Food Sector in a Comparative Perspective

The share of agriculture, including forestry and fishery, in Macedonian GDP is around 12%. This is very high compared to other NMS, where the importance of agriculture in GDP ranged from 2.7% in Slovenia to 5.8% in Lithuania in 2004. Private farmers own about 80% of the total agricultural land, and the remaining 20% is owned by the state and leased by agricultural enterprises. There is excessive fragmentation of land, both in terms of land use and land ownership even though the Law on Land Use prohibits the division of land parcels through sales and gifts and promotes consolidation of land.

There are few initiatives to promote the functioning of the land market with respect to state owned land, and the Law on Agricultural Land had adverse effects because it required the state to rent out 75% of its land to the privatized successors of the agro-

kombinats and the socially-owned agricultural enterprises. The remaining 25% can be leased out on a competitive basis. Leasing this land could be attractive for rural households because it is consolidated with parcels up to 35 ha., and it can be rented for a long period, which gives the farmer the possibility to plan future activities and investments.

However the fact that the state prefers to lease out large parcels and these can not be subdivided or subleased is also a disadvantage as it is too costly for many individual farmers to expand their farming activities to the degree required by such plot sizes. As a consequence, a significant proportion of state-owned land is not cultivated at all or is used inefficiently. In the private market, the number of land transactions is limited and the majority of the rental contracts are between relatives. These findings indicate the need for a well functioning land market.

## Farm Structure

The number of household farms increased to approximately 192,000 in 2007 from 178,000 in 1994, and the average farm size decreased to 1.7 ha. Most Macedonian rural households sell some of their products on the market, but 32% of farm households were subsistence farmers in 2003. Producers face major difficulties in selling their commodities. Contracts with processors and distributors are not yet widespread, and only 10% of households had a contract with a processor and 7% with a trader in 2003.

## Agricultural Employment

Agricultural employment fell from 22% of the labour force in 2000 to 18% in 2007, a figure comparable to that of Poland (18%) and Lithuania (16%) at the time of accession, but considerably less than that of Romania (30%) in 2007. Currently agricultural employment in Macedonia is high partly because it serves as a social buffer. Semi-subsistence farms that absorb workers who have no other way to make a living are particularly important in Macedonia. The future of these farms and their role for agricultural employment depends much more on the development of other income opportunities, especially non-agricultural jobs and social security benefits, than on agricultural policy itself. In the other NMS, growth in the rest of the economy has been the main mechanism for reducing over-employment in agriculture.

## Human Capital in the Agricultural Sector

Inadequate human capital constrains agricultural labour restructuring and business development and economic activities in rural areas. Better education increases efficiency and stimulates entrepreneurship in agriculture. Household farms employ a disproportionate number of old and young workers, as well as women, all of whom have relatively low educational attainment, while farm enterprises employ prime-age males with higher education.

## Crop Production

Crop production in Macedonia accounts for more than 70% of gross agricultural output, and recent production trends in the crop sector have been positive due to increased productivity. Cereal yields increased by about 25% and vegetables by 18% over the period 2000-2006. In the past decade, the livestock population declined due to food safety issues such as the outbreak of foot and mouth disease and brucellosis and because of high animal feed prices. The livestock sector in Macedonia is characterized by a large number of small, subsistence-oriented farms, an increasing number of small, commercially oriented family businesses and a decreasing number of specialized livestock enterprises. The presence of smallholders is not a restriction on the future development of the sector. For example, in Poland farms with fewer than 10 cows produced 75% of Poland's milk.

Experience from the NMS indicates that within EU27, trade increased quickly after accession, particularly among the NMS as their border protection disappeared within the single EU27 market. Macedonia is currently mostly an importer of agricultural products, with the exception of some vegetables, lamb and wine. The wine sector is particularly important, as it is one of the main export products (see Box 1).

### Box 1

#### The Macedonian Wine Sector

Combined grape and wine production accounts for 17%-20% of agricultural GDP. Currently, there are 70 registered wineries located in Macedonia's main grape producing areas. There has been a significant increase in the number of wineries, as there were only 28 registered wineries in 2003. The installed capacity of Macedonian wineries amounts to 2.35 million hl in 2008. Total processing capacity, therefore, is almost twice the annual

wine production. In fact, since 2003, total production of wine decreased by more than 17%. Wine production suffers from the ageing vineyard plantation, varieties that are losing market relevance, the absence of quality control by the government and the lack of supply chain management by the wineries. Since 2005 there are signs of improvement as the production and export of more profitable bottled wine has increased from 55,877 hl in 2005 to 105,378 hl in 2007.

The situation of the wine sector in Macedonia is similar to that in Bulgaria and Romania at the time of accession. As a consequence of the accession negotiations, Romania and Bulgaria received newly created planting rights equal to 1.5% of their current national vineyard surface. In addition, Romania negotiated with the EU for an area of 30,000 hectares to be replanted with grafted and native vines in a transitional period of 8 years. Farmers receive subsidies for replanting and abandoning.

A similar option would help Macedonia to further restructure its wine sector. Romania and Bulgaria had to implement a vineyard register before accession, and the same requirement will probably apply to Macedonia. Romania requested a transition period of 4 years until the end of 2010 for completing the vineyard inventory and a register, but the Commissioners consider this period too long. Macedonia will be better able to negotiate its position if such a register and classification are already in place before the negotiations. Currently, the Macedonian government is in the process of extending the pilot vineyard register, developed in 2004 - 2006, to the entire territory of the country.

## 2 Rural Poverty and Public Transfers

Pensions and unemployment insurance payments are limited in coverage and low in terms of income replacement. As a result, many old people must supplement their pensions with farming activities, and young unemployed workers supplement low or nonexistent unemployment benefits. This is an important constraint on farm consolidation and productivity because there are few incentives for poor and old rural households to leave the land. Agricultural policy cannot solve this problem, because it is essentially a social policy issue.

### The Agro-Food Industry

The agro-food industry is unprofitable and uncompetitive due to high prices of agricultural commodities in the domestic market, the low usage of capacities (between 30% and 66%), uncertain supplies by growers and a low technological basis (e.g. lack of storage facilities). There is almost no growth in the agro-food industry, nor much FDI. Foreign direct investments by Western companies could play an important role in this sector. There are also important problems with respect to the adoption of quality standards. The fruit and vegetable sector, for example, is losing market share in its historical markets such as Croatia and Slovenia due to the slow adoption of modern food standards such as GLOBALGAP and to outdated packaging technology. Recently, a substantial amount of agricultural support has been targeted toward the adoption of these standards through the rural development program. However, according to the Register of Approved Food Establishments and Food Business Operators in Macedonia, there were only 276 food establishments and food business operators who had implemented the HACCP requirements in 2008.

## 3 Policy

### Agricultural and Food Policy

The policy agenda for agriculture and food has been dominated by the Stabilisation and Association Agreement, and the reforms needed to ensure compliance with the WTO. More recently, this policy agenda has been dominated by the EU integration process. Rural development has now become an important part of the CAP as Pillar II. In 2005, the government introduced the Rural Development Pilot Programme to improve the competitiveness and sustainability of the agricultural sector and rural areas. A part of the budget is also used for establishing the administrative systems required to manage future EU pre-accession rural development funds.

In 2007 the government adopted a National Strategy for Rural and Agricultural Development 2007-2013 (NARDS). This plan has two interlinked objectives: to provide the Government and rural stakeholders a strategy for the development of Macedonian agriculture and rural areas and to prepare Macedonia for pre-accession assistance and development funds (IPA). In the period 2007-2009 the EU will allocate 19,000,000 to the Rural Development Programme of Macedonia. The main objectives of this programme are: to improve the competitiveness of agricultural holdings and the food industry by bringing them into compliance with Community standards related to food safety, veterinary, phytosanitary, environmental and other standards and to promote the sustainable environmental and economical development of rural areas. There have also been important investments in recent years related to the use of water resources.

### Trade Policy

As part of the Stabilisation and Association Agreement, Macedonia has duty free access to the EU for its exports of all basic agricultural products with the exception of "baby

beef," wine and sugar. Bovine meat is totally excluded from preferential treatment. In return, Macedonia has agreed to gradually dismantle its import barriers for EU imports by 2011. Macedonia became a member of the WTO in 2003, and it committed to the termination of a wide range of trade distortive measures. The average weighted MFN tariff for agricultural products was estimated at 28% ad valorem equivalent in 2002 and 15.3% in 2008. Export subsidies, which were particularly important for lamb, were terminated.

Trade in agricultural products represents a substantial share of overall trade: approximately 14% of exports and 12% of imports in 2008. The most significant import products are meat, cereals and sugar. Tobacco, wine, fruit and vegetables are the main exports. Trade with the EU accounted for 41% of agricultural exports and 41% of agricultural import in 2008. The regional markets are primarily Serbia-Montenegro, Croatia, Bosnia-Herzegovina and Turkey.

## 4 Implications of EU Enlargement: Lessons From the NMS

### Agricultural Productivity and Competitiveness

Since the early 2000s, all the NMS have experienced a reduction in the agricultural labour force, and this, in combination with increased investments in farms and the food industry, has resulted in increased agricultural labour productivity. Land productivity growth was slow in countries such as Romania, where there is a large number of small family farms with limited access to inputs.

All the NMS have lower yields for major crops than do the old EU countries. EU direct payments are based on these numbers. All NMS expect Slovenia implemented a simplified CAP income support scheme, the Single Area Payments Scheme (SAPS).



The simplified SAPS option was offered to NMS because most of them did not operate CAP-conforming direct payments during the “reference period” and because of the high administrative requirements of direct payments as a Single Farm Payment (SFP).

While SAPS per hectare payments are, in principle, uniform for all eligible land within the individual new member states, these payments differ substantially from one country to the other. These variations stem from the fact that the level of per hectare payments is computed by dividing the available EU financial “envelope” for each country by the eligible agricultural area. The EU rules for the determination of CAP Pillar I financial allocations imply that higher land productivity results in higher per hectare payments, as historical yield levels (2000-2002) were factored into the determination of the financial envelope for Pillar I. Differences in the reference yield of the different NMS result in a disparity in the direct payments. Therefore the choice of the reference period is very important. Opting for the same reference period as the NMS, namely 2000-2002 would imply lower EU payments than would a later period. Yields in the period 2004-2006 were higher, and opting for this period would thus imply higher payments for Macedonia.

Competitiveness is not only determined by productivity but also by differences in product quality and institutions, the latter being important to guarantee product quality and safety. In this respect the NMS had to make major investments, which ultimately came from national funds and through SAPARD as well as from private investments. Payments in the first pillar of the CAP will become less important in the future, and they are decoupled from production, so it will be important for Macedonia to concentrate on the sectors in which it has a natural advantage such as wine, lamb and horticultural production. Hence, Macedonian policy should be consistent with this non-distortive policy framework.

### **Role of FDI and Agro-Food Industry Investments for Growth in Agriculture**

In the policy debate on the enlargement of the EU, the introduction of policies such as SAPARD and, later, the introduction of SAPS payments attracted major attention of policy makers. However improvements in productivity and quality started before EU policies were put into practice. These improvements required that farmers would trust processors to make timely payments for their output and that processors would be confident of the quality of the products they would receive from farmers.

As a first step, processors helped farmers overcome their input and credit constraints. Later, the processors also improved the quality of supply through extension services and farm-level investments. The introduction of more advanced forms of vertical integration, such as bank loan guarantees and investment credit, requires good working institutions, and there is a positive correlation between the level of reform of the country and the introduction of more advanced vertical coordination systems.

The growth of modern supply chain systems has caused concerns about competition and the low bargaining power of farms in modern supply chains as well as the potential exclusion of small farmers from the supply chain. Empirical evidence from the NMS, including Poland and Romania, shows there was less exclusion of small farmers than predicted and that farms have generally benefited from these transformations of the supply chain.

### **Prices, Quality and Trade Effects**

Early predictions that EU markets would be flooded by cheap NMS agricultural products turned to be wrong. In ten years, the EU imports from the NMS doubled, whereas the exports from the EU15 to the NMS increased more than tenfold. After accession, trade flows continued to increase and the trade deficit in agricultural products of some NMS even deepened. In combina-

tion with FDI, the implementation of high EU quality standards can lead to significant improvements in quality. The quality demands of the private processing and retail sector sometimes go beyond EU regulations, particularly among firms exporting to the EU market. EU accession will also change the composition of trade. EU exports are mainly processed products, whereas EU imports from the NMS are mostly less processed labour intensive products.

Finally, prices were expected to increase after accession. These expectations did not materialize, and consumer prices increased less than expected, and in some cases even decreased, due to increased competitive pressure in the food and retail industries.

### **Policy I: SAPARD**

EU accession, the implementation of the SAPARD programme and, later, the implementation of CAP payments had an important impact on farm incomes. However these benefits were not automatic. The experiences of the NMS indicate that a key reason for the underperformance of the SAPARD programs was that there was insufficient absorptive capacity among the potential beneficiaries, who were not aware that they were eligible for SAPARD support. Second, the application procedure was too complicated, and farmers experienced difficulties in preparing proposals.

In Hungary, for example, more than 50% of the proposals were rejected in the first round. In response, the government subsidized training courses for specialized consultants to help farmers to prepare their proposals and business plans. Other initiatives were “managerial services” and “village managers” providing extension and advising services to farmers on how to obtain SAPARD funds. Moreover, many small and poor farmers could not match the SAPARD-related pre- and co-financing requirements.

To improve the access of poor farmers to

credit and enable them to benefit from SAPARD support, the governments of Romania and Poland created targeted credit lines and interest rate subsidies especially for SAPARD. Analyses of the credit programs suggest that it was mainly large enterprises that used these programs or, as in Romania, there was a very low uptake of this subsidized credit. In general, the introduction of the SAPARD payments in the NMS mainly benefited the larger, wealthier farmers and not small farmers. This danger also exists in Macedonia. Hence the Government of Macedonia should develop programs to assist small farms in accessing these funds.

### **Policy II: CAP Payments**

#### **Direct Payments**

The introduction of CAP direct payments affects rural inequality. Small household farms of less than 1 hectare are not eligible to receive SAPS payments, and these households often do not know how to apply for Pillar II subsidies. Early results from Romania show that only 1.2 million out of approximately 4.1 million farms get direct payments. Almost all of the farms that do not get direct payments are smaller than 5 hectares, whereas all the big farms do. In addition to the direct income effect on small farmers, there are two indirect effects. First, direct payments reduce the credit constraint of the farmers who receive them and allow these farmers to make investments. Second, due to the fact that the direct payments reduce the credit constraint of these farmers, they will increase their production, leading to higher input prices, including higher prices for land. This price increase can already be observed in the NMS.

#### **Top up Payments**

In most NMS, there have been controversies about whether and how to “top up” CAP direct income support through additional allocations from the NMS’s domestic

budgets. Because of the gradual introduction of SAPS payments, NMS were granted the option of supplementing EU direct payments by making Compensatory National Direct Payments (CNDPs) to “top up” CAP income support. CNDPs can be flexibly implemented at any rate between zero and thirty percent of the EU15 level, or relative to the level of CAP-type payments. While all NMS implemented CNDPs, individual arrangements varied. Slovakia, for example, chose to pay their top-ups almost entirely as area payments, as with the SAPS, whereas Hungary opted to keep much support coupled to production.

Evidence indicates that applying a flat, decoupled CNDP not linked to the amount produced is preferable to using specific, coupled CNDPs. Commodity-specific CNDPs carry high implementation costs, are administratively complex, and impose long-term distortions on production patterns. It is therefore preferable to implement CNDPs on the most equalized and simplified basis possible. Support schemes targeting specific sector adjustment needs or regional income disparities are better addressed under Pillar II. Decoupled payments are also more consistent with EU accession and the EU’s decoupled payments.

#### **Control and Governance of Payment Systems**

Experience from other member states shows the importance of a farm register and a cadastral register for land ownership, as well as of tight control over EU farm assistance. In 2007 and 2008, Romania and Bulgaria were both told to tighten controls of farm payment systems or face a severe cut in subsidies from the EU.

#### **Land and Capital Market Imperfections in Rural Areas**

The expectation of EU accession induced improvements in the functioning of land and rural capital markets, and this process was reinforced by EU accession itself. These improvements came both from regulatory

changes, the enhanced credibility of the macro-economic and institutional framework, from rising investments in the food industry and from increased payments from the state. A major benefit from EU accession for farms was better access to capital from higher direct subsidies and from banks more willing to lend to farms. This, in turn, increased profits. At the same time, land prices went up significantly, reflecting the improved farm profitability and the subsidies (SAPS) that are coupled to land use. Macedonia should expect similar effects.

#### **Implications for the Macedonian Accession Strategy**

An important part of the necessary pre-accession policies and administrative requirements that are closely linked to EU policies (such as the CAP) will be specified by the EU accession requirements. As in other accessions, the EU will specify the actions that the government of Macedonia needs to take in order to satisfy the EU accession conditions. The most important constraints facing Macedonia’s agricultural and rural development are broader structural problems, both in output markets and in rural factor markets.

There remain very important constraints in the rural labour, capital and land markets that need to be addressed for Macedonian agriculture to benefit from EU accession and for rural areas to develop. In the case of output markets, more fundamental problems than where to allocate subsidies remain to be addressed. From this perspective, a (pre-) accession strategy should focus on improving the productivity and competitiveness of the Macedonia agro-food system. In its agricultural policies, the government should focus on those that have broad effects and distort markets and choices as little as possible. In this perspective it is best to refrain from using support policies or regulation to support one commodity over another. This is not only the most efficient option; it is also a policy strategy that is consistent with the long-run evolution of the CAP within the EU27.

## **Initiatives to Reduce Over-Employment in Agriculture**

Over-employment in the agricultural sector puts strong pressure on land and constrains farm consolidation. To reduce over-employment in agriculture, growth of the non-agricultural economy is crucial to absorb the surplus labour in agriculture. Policies targeted at rural areas, including vocational training programs, are very important. In addition, the social security programme of the government needs strengthening. Older households now need to continue to work their land to complement their pensions with extra income from agriculture. Many unemployed younger households face similar constraints.

With high food prices and low or no social payments, there are few incentives for these households to rent out their land to more productive farms. The government of Macedonia should consider the experiences of countries such as Poland and Romania, which used “early retirement schemes” to motivate old farmers to stop their farming activities and rent out their land. However, experience suggests that economy-wide reforms and structural policies are more effective than policies that focus on agriculture.

## **Invest in Rural Infrastructure**

Investments in irrigation and roads contribute more to agricultural growth than do other forms of public spending on agriculture, such as farm subsidies. The government adopted a clear strategy in its National Strategy for Rural and Agricultural Development 2007-2013 to ensure sustainable improvements in rural areas. In its progress report of 2008, the European Commission mentions that there have been significant improvements in rural development and in related legislation. The strategy for rural development has two major advantages: first, it provides a clear strategy for future rural development and, second, it increases the budget for rural development. Thus, Macedonia has already made substantial progress, but continuous efforts remain important.

## **Stimulate the Adoption of Food Standards**

It is crucial to address safety and quality requirements both in terms of integrating into the global economy and for EU accession. Macedonia needs to address constraints in its production systems and food supply-chain, including the implementation of EU standards and private standards, in order to achieve gains from integration into the EU. The quality of most processed foods in Macedonia is low and quality standards are not fully adopted. HACCP, for example, is limited to larger companies and many firms have not taken the necessary steps to meet the September 2009 deadline when HACCP is supposed to become mandatory for the domestic market. Only recently has the government developed a strategy to accelerate the adoption of HACCP certification launching a media campaign in April 2008 to inform producers and traders about the HACCP system and organizing training sessions for inspectors.

Within the rural development program, the Macedonian government provides assistance and financial support to increase the implementation of EU standards. The Macedonian government should expand these initiatives and make sure that the support is targeted to all processors and producers, including smaller ones.

The government needs to ensure that the legislation on hygiene and specific rules for animal products meets all EU requirements. There is also a need to clarify responsibility for food safety. At the moment there are overlapping competencies between the Food Safety Directorate and the Veterinary Directorate, resulting in a poor organizational structure and a lack of coordination.

## **Create the Right Framework for Rural Financial Markets to Develop**

The development of a rural financial infrastructure and institutions for facilitating access to credit in rural areas is crucial to stimulate the growth of the agricultural and

the non-agricultural rural economy. Credit associations and micro-finance institutions can play an important role in rural Macedonia with its many small and weakly capitalized farms.

However one should not ignore the important role that the private sector can play by providing finance to farms through contracting and trade credit. Evidence from NMS suggests that this may be the most important source of capital to farms. In fact, investments by the food industry and agribusiness played a major role in the NMS in the late 1990s and early 2000s in reducing farms' credit constraints, both directly and indirectly. The Macedonian government should use the pre-accession phase to remove obstacles for food industry and agribusiness investments and to stimulate the flow of trade credit to the agricultural sector.

#### **Invest in Institutions and Infrastructure to Enhance the Integration of Small Farmers Into Modern Supply Chains.**

The fact that agro-companies have little other choice but to work with small farmers is a potential benefit in the long run. However, in the short run, it will make it costlier to source high quality products satisfying EU standards from these farms and thus more difficult for modern supply chains to develop. The government can assist this process through investments in infrastructure and quality control systems as well as in extension and educational efforts to explain the importance of quality production.

Promoting the development of farmers' associations will also contribute to a more rapid shift to modern supply chains. Small farmers will be able to benefit from such integration, as they may be more productive than large farms. Government investments to reduce transaction costs and safety and quality control systems can play an important role.

#### **Anticipate Implementation and Distributional Problems with IPARD and CAP**

When the IPARD payments and later the CAP subsidies are implemented, the government should take into account the three problems that arose in the NMS when the SAPARD payments and CAP subsidies were introduced. The first two problems were the lack of awareness by farmers that they were eligible for support and the complexity of the application procedure for the SAPARD and rural development subsidies. A part of the budget should be used for information campaigns to inform producers and processors of the EU minimum standards and how assistance funds can be used to meet them. The government should also provide technical assistance to help farmers and food processors to apply for these funds and to lower the administrative burdens in accessing the payments. This would also make it easier to provide equal access to subsidies to small and large farms.

A third problem is the unequal access to subsidies in the NMS. In Macedonia, more than half of household farms have a size smaller than 1 ha. This means that these households will not benefit from the EU payments if they are introduced in the same way as in the NMS, where the threshold was set at 1 ha, mostly for administrative reasons. Currently, the minimum size of farms for obtaining support in Macedonia is 0.3 ha for cereals and 0.2 ha for vegetables and perennials. Beyond 20 hectares, the support rate declines gradually. Opting for a low threshold would reduce inequality in the access to subsidies but increase administrative costs.

With important discussions ongoing in Brussels over the future of the CAP beyond 2013, it is important for the Macedonian government to have a better perspective on what the CAP will look like at the time of accession because it is a moving target that may change in the wake of EU budget negotiations, climate change requirements, and possibly the Doha Round.

With respect to direct payments, experience is in favour of SAPS payments or the regional model of the SFP. Administratively, this is simpler and more in line with how direct payments will evolve in the EU. The NMS are allowed to apply SAPS until the end of 2013. At the same time, old member states applying the historic SFP model are allowed to change over to the regional SFP model, which is similar to SAPS. In the future, it is likely that all member states will move towards a regional model of the SFP.

The Macedonian government should take into account the indirect effects of subsidies. Accession, both because of enhanced profitability and because of increased land-based payments, caused a rapid increase in land and farm input prices in the NMS. Those farms that did not receive payments because they were too small faced increasing input prices while not benefiting from the payments.

### **Establish Control Systems for IPARD and CAP Subsidies**

The governance of the control system needs to be improved. In 2007 Macedonia received a loan of 15 million Euro from the World Bank to improve government assistance to the agricultural sector. The “Agriculture Strengthening and Accession Project” seeks to strengthen the Macedonian government’s administrative and management capacity to meet EU accession requirements. However, under the present circumstances, there is no adequate control system due to the absence of a fully developed farm register and a cadastral register showing ownership of land. Currently, the government expects to complete the cadastral register by 2009 and the farm register by 2010. There is also a need for sufficient and well-trained staff to meet the requirements of the EU related to CAP payments. The government also needs to tighten control over EU subsidies.

## CHAPTER VII

### FINANCIAL SERVICES AND CAPITAL FLOWS

#### Introduction

The Macedonian financial system's structure is close to that of the NMS. Nevertheless, accession to the EU will bring new benefits as well as challenges. Benefits materialize during the accession phase as the authorities are forced to implement institutional improvements that would otherwise be politically difficult, and these make the system more stable and credible. The very act of becoming an EU member has a significant impact on the perception of country risk and the attractiveness of the economy for foreign investors in the financial sector. This occurs even if institutional alignment with the EU is achieved well before EU entry.

After Macedonia joins the EU, financial institutions from other NMS will expand their activities in Macedonia, leading to a concentration of the banking sector. This will improve its efficiency, but it will also bring added risks. A key risk is credit expansion caused by relaxed lending standards, eventually leading to asset-price bubbles and boom-and-bust development. The situation after EU entry will thus be very demanding for the regulation and supervision of the financial system. Thus it would be a major mistake to view EU membership as a solution to flaws in the financial sector or as a substitute for regulatory and supervisory weaknesses.

#### 1 Capital Flows and Foreign Ownership

The large investment needs of the NMS generated a demand for external finance because domestic savings were inadequate. These international financial flows were facilitated by the gradual process of balance of payments liberalization, which had to be completed before EU accession. For example, the only temporary exception that the Czech Republic negotiated with the EU

was for purchases of Czech real estate and agricultural land by non-residents. These restrictions were mostly for political reasons as their economic impact was marginal.

Macedonia is now following a broadly similar path. Considering the ongoing international financial crisis and the recently increased scope of deposit insurance in the EU, there may be some advantage to a gradual approach in eliminating the remaining restrictions on short-term capital outflows by the household sector, which is already foreseen in the Foreign Exchange Law and the Stabilization and Accession agreement between Macedonia and the EU. Nevertheless, in the longer term, if Macedonia succeeds in attracting more FDI and speeding up its real convergence process, liberalized short-term capital outflows may help to accommodate the appreciation pressures on the Denar. Macedonia may also wish to negotiate a temporary restriction on the purchase of agricultural land by non-residents. Nevertheless, political concerns have to be weighed against the objective of consolidating agricultural land to make agriculture more efficient.

Overall, FDI inflows in the NMS as a share

of GDP remained broadly stable between 1998 and 2007, with some acceleration in the 2005-07 period, and the inward FDI stock grew rapidly. FDI came into all sectors of the economy, although the non-financial sector accounts for the majority of inward FDI stock. Nevertheless, in many NMS the financial sector is dominated by foreign owned banks. When compared to portfolio investment or cross-border bank loans, FDI as a source of finance tends to be much more stable. It is important to stress that FDI means not only the inflow of equity capital, with the related benefits of advanced technologies and managerial skills. A large part of FDI in the non-financial sector includes intra-group loans from parent companies to local affiliates. Despite the fact that the reported maturity of these loans is short, they are not a volatile source of funding. These intra-group loans in some cases constitute a significant part of total FDI. They can substitute for domestic credit if the domestic banking sector is not able or willing to finance foreign affiliates, and in this way they weaken the effectiveness of monetary policy.

## 2 Coping With Foreign Ownership

Foreign banks' involvement in transition countries has brought significant benefits in terms of more competition in the banking sector, a supply of complex services and products, improved access of small and medium sized corporations and households to credit, well-developed risk management and corporate governance, and overall stability of the sector. There are also drawbacks that tend to manifest themselves during times of stress. The repatriation of profits worsens the current account deficit and, if excessive, limits local banks' ability to expand lending. Foreign-owned banks, if they use funding from abroad, are prone to sudden shocks to the availability of credit in case of a liquidity problem in their home country. In addition, banks may lend in their home-country currency, especially in

countries with pegged exchange rates, and expose local households and firms to currency risk.

The other potential source of concern is the impact of group-wide risk management and centralized decision-making, which means that local lending behaviour depends on developments in the key markets of the group. In addition, risk management and banking operations may be insensitive to the characteristics of the local market, needlessly cutting existing credit and harming local borrowers. A final problem is the risk of cross-border contagion, either from the home country, or from another host country via common creditor effects.

A balanced policy approach is needed for managing foreign banks in domestic financial markets. Policymakers have the most freedom in the privatization of state-owned banks to foreign owners and usually aim at some balanced representation of countries and/or types of foreign ownership to avoid the concentration issue. However, in the case of private inflows and cross-border loans, the possibilities for local authorities are limited. It is best to make a foreign-owned financial sector work as much as possible as if it were domestically owned. This means that this sector should ideally use domestic sources for lending activity, carry on their business mainly in domestic currency, and avoid investing in complex foreign products. The low exposure of Central European banks to US subprime assets was also due to national supervisors objecting to the intentions of local foreign-owned banks to buy these assets based on advice from their parents.

### Foreign Ownership and Supervision

The foreign ownership of domestic banks naturally means a partial loss of power for the domestic supervisor. This applies much more to branches of EU banks than to subsidiaries. It is possible that, after EU entry, parent banks may decide to transfer subsidiaries to branches thus avoiding super-



vision by the national supervisor. So far, such an approach has been very limited in the NMS. The ongoing financial crisis confirms that banking is still primarily a local business activity based on specific knowledge concerning local markets. The stability of local banks is therefore to a large extent determined by the quality of local banking supervision. It is therefore necessary to make national supervisors powerful, respected, competent and operational. This requires not only the adoption of legislation and regulations, but also adequate financial and human resources.

Supervision of liquidity risk is an underutilized tool for maintaining the stability of the banking sector. It is applicable to subsidiaries and, to some extent, to branches of EU banks, for which it is the only tool. Macedonia should consider the liquidity risk regulations adopted by the NMS during the 2007-2008 financial crisis. Some host countries were concerned that home-country difficulties would induce parent banks to withdraw funds from their affiliates, causing a credit crunch in the host countries. Some countries, for example, the Slovak Republic, adopted detailed regulations on liquidity management by local banks. Macedonia should consider available tools for potential restrictions of cross-border liquidity flows during times of stress and implement necessary legislation prior to EU membership.

Measures for management of banking crises constitute the critical part of national supervision. The important lesson from the past bailouts is the importance of legislation supporting the authorities in dealing with non-cooperative owners or minority shareholders. An excellent example of a comprehensive legislative approach to this issue is the UK Banking Bill. Macedonia should review and strengthen the existing framework for dealing with weak institutions and systemic crises well ahead of EU membership. The other important tool that should be made available for the Macedonian authorities is the power to re-

strict the transfer of profits to shareholders. The authorities should also be able to make the shareholders retain profit or increase banks' regulatory capital in other ways if it is found necessary for securing stability of the institution in the future.

### **3 EU Membership and Risks of Excessive Credit Expansion**

The experience of the NMS is that accession was accompanied by credit expansion. Banks started to extend loans to households, a sector that had been to a large extent ignored in the past. After EU accession, lending to the corporate sector also accelerated. Similar developments can be expected in the economies that will join the EU in the future. One can easily imagine that large international banks will search for higher yields in new EU members. The financial system in Macedonia has already experienced relatively high credit growth, even though from a very low base. With stronger economic activity and more optimistic expectations linked to potential EU membership, the growth of credit may become even faster in the future. It is very difficult to tame a credit boom in small economies and to limit the risk of boom-and-bust development. Higher interest rates on domestic currency loans will help only if the local banks have not lent predominantly in foreign currencies and if the exchange rate regime is flexible enough to allow for an autonomous monetary policy. If higher interest rates lead to nominal appreciation, this may reduce appetites for taking on debt, and also reduce growth expectations.

A central bank should focus its monetary policy instruments on achieving macro goals, while using its regulatory, supervisory and lender-of-last resort powers to ensure financial stability. At the same time, the authorities should be ready to use their regulatory and supervisory powers for macroeconomic stabilization if monetary tools lack effect. During the last decade such micro-policies were increasingly difficult to

apply. For accession countries, measures to limit credit growth became even more difficult to implement after EU entry due to liberalized capital flows and financial services. Some NMS have applied administrative measures such as bank-by-bank credit limits or mandatory credit rationing. Local banks evaded such restrictions by obtaining loans directly from parent banks. Restrictions must cover all financial institutions, including leasing companies, to be effective.

In the future, micro-policies may become easier to use because supervisory authorities will probably have more measures at their disposal as a consequence of the current financial crisis. Macedonian authorities should consider current as well as future regulations that could limit the risk of credit-led booms. These would include measures compatible with the Basel II Supervisory Review and Evaluation Process, dynamic provisioning, capital buffering, etc. The financial stability area of the central bank, which is best positioned to take into account the cross-relationships and feedback effects between the financial sector and the real economy, should be well staffed.

## **4 Domestic Sources for Local Operations**

The ongoing financial crisis shows that the ability of banks to finance their lending from primary deposits is important. The NMS that underestimated the risks of bank strategies to raise funds in other ways have been punished for doing so. A sufficient base of deposits from domestic entities, therefore, is one of the prerequisites for a stable banking system. The ability of the domestic banking sector to accumulate domestic savings via deposits secures the long-term funding for the investments needed to accelerate the convergence process. A high level of deposits is not necessarily associated with a high saving rate. It depends more on the ability of banks to encourage private agents to deposit their

savings with them and not to hold them, for example, in foreign currency. The ability to attract deposits to the domestic banking sector now requires generous deposit insurance, especially after the increase of deposit protection in the EU after September 2008. Macedonia has to follow this trend, but this creates a need for decisive supervision of the insured entities.

A related, but controversial, question is whether the government should support some bank products that create strong incentives for households to deposit their savings with the banking system. Demand for housing finance has increased considerably in the NMS in recent years. Currently, banks in Macedonia finance their housing loans from local deposits. However, in the future, banking deposits may fall short of the demand for credit, and policymakers should decide on a system of housing finance now. One possibility is securitization and the modified originate-to-distribute model, the other is promotion of covered bonds markets.

Subsidized schemes to encourage long-term savings are another possibility that is used in a number of NMS. Such schemes have the potential to attract a large pool of long-term deposits. There are also some drawbacks to these schemes. One is their high cost for the government. Given the fixed interest rate on deposits, the system is exposed to interest rate risk, which is not easy to manage, and, once the scheme has developed, very difficult to eliminate it. If Macedonian authorities wish to develop such schemes for inducing public savings, they should really think twice, and if saving for housing is viewed as a viable option, a system based on specialized institutions should be avoided in favour of a French-like system in which these saving accounts are a subsidized product offered by any licensed financial institution. Such a system offers more flexibility for future changes in public policy.

Due to the introduction of Pillar II and prep-

arations for the introduction of Pillar III, the pension funds industry, though still relatively small, has become rather important. Macedonia has developed a good system for regulating and supervising this sector. The pension funds in Macedonia nevertheless suffer from the same drawbacks as in other NMS, high costs. There is no easy way to lower costs. Allowing more pension funds will not do so, and strict regulation of acquisition costs and pressures to achieve efficiency in administration, including custodian services, are thus the best of the policy instruments available to regulators. The issue of acquisition costs is especially important for Pillar III. Further development of pension funds as well as of the life insurance sector will benefit from regulatory and supervisory guidance on these institutions to offer products that are simple and whose fees and cost structure are transparent.

## 5 Lending and Borrowing in Foreign Currencies

EU membership created the expectation of a relatively early adoption of the Euro in some NMS. This effect may have suppressed the sensitivity of households and firms to the risks of borrowing in Euros and other foreign currencies. The dependence of domestic banks on lending in foreign exchange may contribute to a major macroeconomic crisis due to difficulties in rolling over foreign exchange debt. Macedonia has a high share of foreign currency denominated or foreign currency indexed loans. While a sharp reduction of foreign currency lending in Macedonia is not possible in the short run, some decline in the euroization of the economy is desirable. The authorities should focus on foreign currency lending to households because households cannot hedge the underlying risk easily. Foreign currency deposits provide a poor hedge since the holders of these deposits are probably not the holders of foreign currency debt. Loans with a unit-of-account clause hide the true risk to the borrowers and provide perverse incentives. The corporate sector has a greater capacity to hedge foreign

exchange exposure with financial institutions, as it has a natural hedge in the form of export revenues.

A successful fixed exchange rate regime may seem to be a solution to foreign exchange risk. Nonetheless, as the experience of some NMS shows, a fixed exchange rate regime is exactly what drives people to ignore exchange rate risk. If authorities want a fixed exchange rate, they must support it with a range of measures and also forego using interest policy to manage domestic demand. If people have long-term incentives to save in domestic currency, they will also view it as natural to borrow in it. One way to encourage such behaviour is to allow the domestic currency to appreciate over time. Such a strategy leads to a low interest rate environment that provides a strong disincentive to borrow in foreign currencies. The Czech Republic is a clear-cut example of this strategy, and the Slovak case shows how useful it can be in the run up to Euro adoption.

Regulation and supervision can encourage financial institutions to lend in domestic currency. Whether the country has a fixed or floating exchange rate or wants to adopt the euro sooner or later, it should seek to have banking operations transacted in domestic currency by insisting that domestic financial institutions cover a broad range of risks related to channelling funds in foreign currencies into the economy. Tightened liquidity risk management rules developed on the international as well as on the national levels in reaction to recent liquidity crises will surely provide some power to do so. Besides, some countries' experience suggests that there are administrative and regulatory measures that may limit the appetite for lending in foreign currencies by increasing the cost of doing so. Still, these measures can only supplement the forces affecting demand for foreign exchange loans because their provision can be shifted from banks to institutions that can avoid these regulations.

## 6 Supervisory Issues

EU entry will bring numerous challenges for regulators and supervisors. The structure of financial services regulation in the EU requires experts from both the Ministry of Finance and supervisory institutions to attend meetings of committees and working groups, to read a vast number of documents, to respond swiftly to them and to cooperate with supervisors in foreign countries. The availability of cross-country information and the possibility to share information between regulators and the Central Bank is important. The EU structures emphasize the need to include a cross-border dimension into financial sector supervision and to promote home-host country cooperation.

The extent of these obligations should not be underestimated. The regulation of the financial sector in the EU naturally tends to take into greater account the interests of large countries, which often means the interests of countries that are the home of many international banking groups. In addition, the European financial industry often lobbies the Commission to pursue regulations that are in the interest of large cross-border financial groups. Thus, EU membership may not provide Macedonia with more tools for effective supervision of its financial sector, and there may be strong pressures to move some powers to the EU level. The small countries, which are often also host countries, especially, have to watch the changes in the regulatory process carefully and, if necessary, they have to join countries in a similar position to prevent such changes in regulation, while, on the national level, they have to utilize their independence as best they can.

The important lesson of the current crisis is that meeting the principles for effective supervision is important, but organization may be even more important. What really matters are the relations among all decision-makers who deal with financial stability.

The changing structure of the financial system makes a strong case for integrating all sectoral supervisors into a single national supervisor, and the current crisis shows the desirability of locating these supervisory structures in the central bank.

The central bank has to act as a lender of last resort or even a market maker of last resort, but, without sufficient information and knowledge of the state of affairs, this becomes a difficult task. This argument is particularly compelling for small economies that expect to adopt the euro in the future, and it is even more important during turbulent times. Most crises start with liquidity problems, and liquidity is the responsibility of the central bank. Having immediate information about impeding problems as well as about the reactions of financial institutions makes the central bank's policies much more flexible, timely and precise. The division of tasks between the central bank and a separate supervisor creates the risk of delayed response, and a unitary supervisor is ideally placed for cooperating with the government and acting in timely fashion.

Macedonia has made major progress in financial market supervision. Nevertheless, the current fragmented structure of Macedonian supervision is inappropriate given the size of the Macedonian financial sector. Building a national financial supervisory system within the Central Bank should therefore be a priority for Macedonia even before entering the EU. Such a system should focus on systemic risk (integration of prudential supervision of individual entities and risk assessment across the financial sector as a whole), increase information-sharing synergies, provide strong technical and professional support, and yield independent and apolitical decisions.

The existence of strong, independent institutions of consolidated financial market supervision across all segments is the key step towards enhancing the communication and coordination of measures adopted in the EU. Consolidation of financial market

regulation and supervision at the national level in the central bank will create conditions for effective exchange of truly relevant data, data integration and potential consolidation of analytical work. At the same time, this solution respects the subsidiarity principle, complies with the requirement of legislative justification, is credible and linked to the resolution of the potential fiscal impacts, and will create conditions for coordination of supervisors' actions. It is also advantageous for the financial sector, as it provides the sector with a single communication point.

The argument for unifying the supervisory function also rests on the supervisor's need for well trained experts, who, in a small emerging market economy like Macedonia, are the key to the success of financial sector supervision. A system comprised of several institutions will be expensive and not use these experts in the most efficient way. The need for expertise will increase with EU entry. Supervisors will face the complicated structure of the Level 3 committees and other EU bodies, including committees of the Commission and the ECB. The complexity and importance of the EU agenda force domestic institutions to rely on their best experts, and there is a risk of worsening supervisory performance and loss of dynamics in improving the financial environment as the best individuals shift their attention to the EU agenda. Only in a strong integrated institution can supervisory experts responsible for different segments of market share their specific knowledge and experience.

There is no single best way of organizing the integrated supervisor in central bank. In the Czech National Bank, as well as in the Slovak National Bank, the responsibility for the supervisory structure lies with the executive board that is also responsible for monetary policy and other central bank business. One can nevertheless imagine several alternative governance schemes, even with some barriers between the monetary policy and supervisory parts of the bank.

## 7 Is There a Separate Role for a Financial Stability Objective?

Besides the organization of supervision, it is also very important to establish operational relations among expert teams contributing to understanding developments in the economy and influencing policy. This is best achieved by combining the central bank with the integrated supervisor. The build-up of financial imbalances is usually identified rather early, but it is difficult to make institutions cooperate and react quickly. The relations between monetary policy and financial sector supervision are now a major policy issue, with proposed solutions tending to favour aligning monetary policy analysis with financial stability analysis.

While financial stability analysis has to respect the autonomy of monetary policy and supervision, it should be able to undertake independent analyses of both areas. If these reveal growing risks for financial stability, the governing body has to consider measures to limit the risks. Within a unitary institution, the governing body can directly and immediately address departments responsible for monetary policy and supervision. If the process involves more institutions, this becomes difficult.

The autonomy of the financial stability team is very important. Supervision tends to be technocratic and focused on individual institutions. This leads to an underestimation of business and credit-cycle induced risks. Moreover, supervisors may be reluctant to bring growing risks to light because these could be viewed as failures of supervision, and raising them publicly could cause a panic. The financial stability teams should also develop research concerning the financial sector. In this respect, the central bank should support long-term research and, if necessary, provide departments with extra staff. Strong and relevant research can indeed improve the quality of regulation and supervision.

A final issue is the availability of data for assessing risks to financial stability. Most data obtained from monetary and banking statistics is backward looking. The Czech National Bank is nevertheless able to derive some forward-looking indicators of corporate default rates using models that

make use of both macroeconomic data and data from the corporate credit registry. The Macedonian central bank should further develop the existing credit registry so that it includes up-to date and detailed information on loans to the corporate sector.

## Chapter VIII

### LABOUR MARKET

#### Introduction

Accession to the European Union has brought opportunities and challenges for the New Member States' labour markets. The main challenge is ensuring that the labour market becomes competitive. From the labour demand side, this implies that labour market institutions, regulations in general and the tax system need to be shaped so as to increase the willingness of firms to create jobs. On the supply side, reforms need to ensure that the workforce is competitive with workers elsewhere in the EU and has the right incentives to choose work over unemployment or inactivity.

Skill levels need to be developed in tune with the demand of domestic and multinational firms if a country wants to claim a decent place in the international production chain, and the social benefit system has to be structured in such a way as to target those who really need help, while, at the same time, ensuring that incentives push workers to prefer work over unemployment. Changing the behaviour of workers and firms is a long-term process, and most of the NMS required at least a decade before accession to improve the performance of their labour markets. While accession does seem to give a boost to job creation, this boost only occurs because the NMS have, at least partially, been successful in restructuring their economies and in reallocating labour from declining to expanding firms and sectors, increasing labour productivity in a genuine fashion and not just by labour shedding.

A discussion of lessons for Macedonia requires an awareness of the peculiar nature of the Macedonian economy and of its labour market. Macedonia is one of the worst performing economies in Europe, both in terms of unemployment and employment rates. The Macedonian economy lags markedly behind the NMS as far as job creation

and labour reallocation is concerned. The Macedonian economy seems to have intensified its transition in the years 2003 to 2005, since job destruction in that period reached levels comparable to what the NMS experienced in the 1990s. The Macedonian economy, however, shows very little capacity for job creation even in the years 2003 to 2005. The dominance of job destruction is also reflected in the very small worker flows out of unemployment. The stagnant nature of the very large unemployment pool is also noteworthy when looking at the duration of registered unemployment in Macedonia. About 85% of the registered unemployed have had (supposedly) an uninterrupted jobless spell of more than one year, i.e. are long-term unemployed. Another failure of the Macedonian labour market is the extremely low employment rate, amounting to about 40% of the working age population.

#### **1** Participation, Employment and Unemployment in the NMS and in Macedonia

In the late 1990s there was "jobless growth" in virtually all NMS, followed, up to the current crisis, by a period of strong em-

ployment growth. Currently, the employment rates are quite similar to the EU-15 average. Favourable employment figures are seen for skilled workers, but unskilled, young and old workers fare less well. The incidence of long-term unemployment for these workers is higher in many NMS by at least 10 percentage points. The least skilled among young and older workers withdraw from the labour market to a much larger degree than in the EU-15. The most striking fact is that the long-term unemployed did not benefit from the employment upturn after 2004.

The data on the Macedonian labour market provide a rather grim picture if we take these data at face value. Participation and employment rates are low and the unemployment rate is extremely high in international perspective. Women in rural areas and especially those of Macedonian Albanian origin have very low participation rates. Core male workers (35-54), on the other hand, have very high participation. Young workers have the lowest participation rates among males, while roughly half of the older male workers are economically active. The transitions from school to employment in Macedonia are very low, with quite a substantial part of school leavers entering the state of unemployment. The overall employment rate rose from 36% in 2004 to 40% in 2006. These rates are among the lowest in Europe and very far from the 70% stipulated by the Lisbon Strategy. Even males in the core age group have employment rates between 63% and 65%.

One worrisome issue is the relatively high employment share in agriculture, pointing to underutilization of labour and hidden unemployment in the Macedonian economy. In fact, the observed increase in employment is mainly due to jobs created for young workers in the primary sector. Because the incidence of unpaid workers rose in this sector from 67% to 75%, virtually all the employment growth observed in Macedonia in these years is from the creation of low-skill and low-quality jobs that are mainly not paid.

There are large differences in the quality of jobs. While a majority holds formal jobs with a permanent contract, there is a substantial minority of employed wage earners who hold an informal job. Informality has a higher incidence among the young, among ethnic minorities and in agriculture and rural areas. The informally employed are often also under-employed; many wish to work more. So, finding more employment opportunities for the non-employed and ensuring growth in high quality jobs is a major challenge in Macedonia.

Taken at face value, unemployment rates imply that Macedonia has the highest unemployment rate in Europe and the region. The data show that the unemployed fall into two types, first-job seekers and displaced workers. While the incidence of first-job seekers is very high among the young (around 90%), even among workers between 35 and 54 roughly 30% are first-job seekers. This means that even among the core age group we have many long-term unemployed who never held a job before.

There are, however, at least two caveats that have to be mentioned when citing such high unemployment numbers. First, roughly one fifth of the unemployed only register in order to establish entitlement to health care for themselves and their families. Possible introduction of general tax-based health insurance instead of the current contribution-based system might increase population coverage and reduce the number of unemployed. The data also show that around 50% of the unemployed supposedly had an uninterrupted spell of unemployment lasting four years or more, while about 30% supposedly have been unemployed without interruption for eight years or more. It is likely that some part of these very long-term unemployed are engaged in some informal economic activity in order to survive.

This informal economic activity is essentially underground activity and completely outside any statistical records. Given the size of Macedonia's grey economy, about half of the unemployed are probably em-



ployed, at least seasonally. So, in September 2008 the stock of unemployment would be around 135,000 and the unemployment rate would be around 15%. Rising real wages in industry and services in this period is another indication that the “true” unemployment stock is much smaller than the one given by official data. This is not to say that unemployment in Macedonia is only a measurement problem; it is clear that, at this point in time, the Macedonian economy is not capable of creating enough jobs at the lower end of the skill distribution to have a discernible impact on unemployment.

## 2 Reforming the Labour Markets in the NMS: Lessons for Macedonia

As far as labour demand is concerned, four factors are important: employment protection legislation (EPL), the role of unions in collective bargaining, taxes on labour and the minimum wage.

Employment protection became less stringent in all NMS long before accession, but restrictions remain. Most regular permanent contracts are more regulated in the NMS than in the EU. Also, collective dismissal procedures are far more restrictive. Temporary contracts are much less regulated in the NMS than in the old member states, but such contracts cover only a small part of those employed. Trade union membership was far lower than the average of the EU-15. Wage agreements negotiated by employers and trade unions have a substantially lower coverage rate in most NMS than in the old member states. The only exception among the NMS is Slovenia.

At any rate, employers in the Central and Eastern European NMS are far less constrained in their wage policies than are employers in the EU-15. The implicit tax rates on labour differ little from the EU-15 average. Minimum wages in the NMS are relatively low in international perspective. In 2003, the minimum wage ranged from 30% of the average wage in Estonia to 45%

in Slovenia, while in those countries of the EU-15 where statutory minimum wages exist, they ranged from 36% in Spain to 61% in France.

There are three factors that influence labour supply: unemployment benefits, non-employment benefits like early retirement schemes and disability pensions, as well as the evolution of the wage structure by sector and of wage inequality from early to late transition.

In most NMS the unemployment benefit system underwent dramatic changes in the 1990's, often dictated by budget considerations. As policy makers became aware of the disincentive effects of a too generous unemployment benefit system, changes in legislation also reflected attempts to increase the willingness of the unemployed to increase search and take on jobs. Reform efforts by the Polish government to streamline unemployment benefit legislation are an example. At the beginning of transition, Polish unemployment benefits were earnings related, open-ended and without a previous work requirement, flooding offices of the Public Employment Services with applicants for benefits. Within a year, unemployment insurance benefits were limited to one year and a previous work requirement was imposed. By December 1994, earnings related benefits were eliminated and a flat rate amounting to 36% of the average wage was introduced. Data show that the NMS are definitely not more generous in their income support than are the old members of the union.

Most governments in the region developed income support schemes for older workers as a way to cushion the social effects of transition and thus contribute to social stability. In my opinion, one needs to keep this social aspect in mind when discussing the disincentive effects on labour supply of the two most frequently used tools of income support for older workers who wished to withdraw from the labour market while still in working age, early retirement schemes and disability pensions.

However, providing strong income support for older workers intent on withdrawing from the labour market has some costs. In times of a sustained up-turn, some of these workers might again be in demand. An excessively generous early retirement policy, therefore, in some sense overshoots the target of downsizing the workforce and is inefficient in the medium run. On the other hand, from a political and social point of view this large downsizing of the workforce in times of a deep transition recession might be the only way to ensure enough social cohesion.

As a result of these labour market reforms, at the time of accession, the NMS had wages that were correlated with the relative scarcity of labour skills and labour productivity. At least in respect to the sectoral distribution of wages, Macedonia does not seem far behind the NMS. There is some sign that wages in Macedonia are correlated with relative scarcity of labour skills and labour productivity. Another encouraging sign is that the Macedonian labour market responds to relative scarcity and productivity since returns to, for example, university education are found to be as large in Macedonia as in some of the leading reformers among the NMS.

Flexible employment relationships – like temporary, part-time and self-employment – are the last important issue related to labour market flexibility. EU policy makers consider a high incidence of these forms of employment as desirable. So far, the new member states have a far lower incidence of temporary employment than the EU-15. The incidence of self-employment is similar to the EU-15. As far as part-time employment is concerned, an employment form very much promoted by European policy makers, the situation differs among the NMS.

The sharp fall in short-term unemployment and the rise in employment rates after 2004 suggest that accession was a factor in the improving job growth in the region, as was the simultaneous upturn in the world economy. Even though it is not possible to establish a causal effect of accession on the improved labour market performance in the

NMS, the lesson for Macedonia is very clear. The restructuring process was long and tortuous in all NMS. After an increase in labour hoarding, it took firms nearly a decade to eliminate hoarded labour and to get rid of the remnants of central planning. While labour market institutions became more flexible over the 1990s, there were still more rigidities than in the old member states, which also made the restructuring process longer and more difficult.

At the end of this process, many sectors of the economies of the NMS had become competitive enough to benefit from accession. But the groundwork for these benefits was laid in the decade before accession. Rising labour demand after 2004 caused skills shortages in virtually all NMS, as the rising number of vacancies and wage growth exceeding labour productivity growth suggest. An important policy measure to combat skills shortages is reform of vocational education. This reform has to be based on information provided by firms on their skills requirement. Many NMS were very slow in reforming vocational education. It is certainly encouraging that the Macedonian government has started surveying Macedonian firms with this reform in mind.

### **3 Structural Funds for Employment Creation by the European Union**

The revised Lisbon Strategy has identified employment as an absolute priority for the EU. This was reflected in the programming of three of the main Community financial instruments for the period 2007–2013<sup>1</sup>

- the Community Programme for Employment and Social Solidarity (PROGRESS);

<sup>1</sup>Other structural funds (not directly dedicated to employment creation) are: the European Agricultural Guidance and Guarantee Fund (EAGGF); the Financial Instrument for Fisheries Guidance (FIFG), the Cohesion Fund (CF). Though not a structural fund, it is considered another important pillar of EU structural policy.

- the European Social Fund (ESF);
- the European Regional Development Fund (ERDF).

The EU's Structural Funds are set up to reduce differences in prosperity and living standards across EU Member States and regions, and thus promoting economic and social cohesion. We summarize here the information available on this in a concise fashion, pointing to those programs from which Macedonia can and will be able to benefit as a candidate and as member.

### PROGRESS

The aim of the PROGRESS programme is to provide financial support for the implementation of the European Union's objectives in the field of employment and social affairs. It finances analysis, mutual learning, awareness-raising and dissemination activities, as well as assistance for the main players over the period 2007-2013. PROGRESS has a global budget of 743.25 million. PROGRESS activities are designed to inform policy analysis and development. This programme is open to the 27 EU Member States, EU candidate and EFTA/EEA countries. It targets Member States, local and regional authorities, public employment services and national statistics offices, specialized bodies, universities and research institutes, as well as social partners and non-governmental bodies.

### ESF

The ESF is devoted to promoting employment in the EU. It is a key element of the EU's strategy for Growth and Jobs targeted at improving the lives of EU citizens. EFS supports employment and helps enhance citizens' education and skills, thereby improving their job prospects. It helps Member States make Europe's workforce and companies better equipped to face new, global challenges. Funding is spread across the Member States and regions, in particular those where economic development is less advanced. Over the period 2007-2013, EFS has a global budget of 75 billion.

### ERDF

The ERDF aims to help reinforce economic and social cohesion by redressing regional imbalances. This is achieved by supporting the development and structural adjustment of regional economies, including the conversion of declining industrial regions. It finances: investment that contributes to creating sustainable jobs; investment in infrastructure; measures that support regional and local development, including support and services for businesses, in particular small and medium-sized enterprises (SMEs); and technical assistance.

## 4 Active Labour Market Policies

Active labour market policies (ALMP), understood here as policies helping the unemployed to find regular employment, can only affect the overall unemployment rate of an economy at the margin. Sound macroeconomic policies and a legal environment conducive to entrepreneurship are far more important for the birth of new firms and for sustained job creation, while labour market institutions that keep labour costs in check and that provide the right incentives for job search predominantly drive labour demand and labour supply. This does not mean, of course, that ALMP cannot play a role in the fight against unemployment. Among the most important measures are:

- public employment services,
- training,
- employment incentives,
- direct job creation and employment by governmental agencies,
- training measures for youth,
- measures for the disabled.

Expenditure rates in the NMS have been low in comparison with those rates in the EU-15 countries, with the highest spenders in the former spending roughly at the same rates as the lowest spenders in the latter group of countries.

In Macedonia, ALMP measures directed at the most vulnerable groups will be of limited effectiveness because of the weak capacity for job creation by firms, the long duration of unemployment spells and the low human capital of the long-term unemployed. Therefore, ALMP measures should be directed at young new labour market entrants, who are most likely to be able to benefit from them.

To this end, establishing a well functioning public employment service (PES) improves the matching effectiveness of the labour market. Training and re-training measures are relatively expensive, and displaced workers undergoing training have little success in finding new jobs, while many of the general unemployed do find work after training albeit for the most part only in the short term. Employment incentives like wage and job subsidies also have a mixed record. Direct job creation schemes by the government, often called public works, are ineffective in that they do not improve an average participant's chance to find regular employment after the end of the scheme.

However, public works schemes might be beneficial as a social policy, i.e. they might fight immediate poverty in the short term. During a severe downturn of the business cycle they also might increase labour demand in the short run, and thus help stabilize the labour market over a short span of time. But, public works schemes are certainly not a tool that can contribute to the solution of structural unemployment. In the past, governments in the NMS have often been pressured by trade unions to concentrate on public works as the main ALMP. Giving in to such pressures was a major error as these schemes were found to be the least effective.

#### **RECOMMENDATIONS FOR PES AND ALMP IN MACEDONIA**

Reforming the organizational structure of the ESA so that ESA officials concentrate on job brokerage and benefit administration with these two functions run by separate units would be a good reform. A reform of the tri-partite structure of the Administrative

Board is also of great relevance and should be adopted with the idea in mind to have stakeholders of roughly equal weight. It is in this context that weak trade unions are not necessarily a blessing. Streamlining the information system for both unemployed workers and employers should be pursued. Such reforms might not pay off in the very immediate future, but they are vital if Macedonia wants to have a well functioning PES when the economy starts to take off.

Also, the Macedonian Government should proceed sequentially insofar as ALMP measures apart from job brokerage should only be introduced on a larger scale after the ESA reforms have been completed. Earnings-related unemployment benefits should be replaced with flat rate benefits lasting 12 months. This reform would certainly lighten the administrative burden and also increase the search efforts of those among the unemployed with previously relatively high earnings. An initially established benefit level should not be indexed to wage growth but rather to the growth of the cost of living, as measured by the CPI.

As far as the long-term unemployed are concerned, some means-tested social assistance should be envisaged that guarantees minimum subsistence. Such a recommendation is, of course, problematic given the state of the Macedonian economy and given the fact that more than 85% of the unemployed have unemployment spells of more than a year and 30% have unemployment spells of eight years or longer. Some attempts to stimulate job search for the long-term unemployed should be made to avoid a permanent unemployment trap, although it is not very likely that individuals with such long unemployment spells can easily be reintegrated into the regular labour market. In addition, the situation is complicated because of the large incidence of informal employment among the long-term unemployed. One way to partially deal with this problem is to use the proposed intensification of monitoring and the application of sanctions to the detection of informal employment relationships. Such detected relationships should then be

sanctioned with de-registration. Intensifying the monitoring of job search by the unemployed in general might initially not result in great matching improvements if labour demand is and remains weak for some time.

Which ALMP measures should be applied in Macedonia once the PES have been improved? From the assessment above, it seems pretty obvious that public works schemes should be avoided if possible, as should youth measures as they are applied in many countries, i.e. helping school drop outs and other non-performers in school via training or subsidized jobs to gain skills for regular employment. Such youth schemes have hardly ever been successful. To help this group, it is certainly more effective to work on school reforms that reduce dropout rates and further develop skills while in school.

In general, training and re-training as well as employment and start-up incentive schemes should be applied. Given the limited resources available for such schemes, targeting becomes an important issue. The dominant target group should consist of young new labour market entrants. Many of these young workers actually have relatively high educational attainment but cannot find formal employment commensurate with their skills. Employment and start-up incentive schemes that carefully vet potential participants might form a bridge until the economy can generate more regular jobs on its own. Retraining young labour market entrants is less advisable since this would imply that the educational system has failed to provide the right skills for the labour market. Such a lack of the right skills should be addressed by reforming the educational system in order to ensure that school leavers have the skill profiles that enterprises need<sup>2</sup>. Re-training and training schemes should be targeted at a small subgroup of older workers who are particularly strongly motivated and who really apply themselves towards the aim of reentering the

labour market. Taking the best of the unemployed into training schemes seems the only efficient use of scarce resources given the state of the Macedonian labour market.

The majority of the unemployed who are older, of average or low motivation, and who have long spells of unemployment should not be targeted for ALMP measures under the given circumstances. They should instead be helped with means-tested social assistance.

## 5 Conclusions and Overall Recommendations

As already noted, accession per se is not a major challenge as far as the labour market is concerned. For all NMS, it was vital long before accession to facilitate the integration into the world economy by making their labour markets more flexible. Another major challenge was how to deal with the many workers displaced from declining sectors and firms who were unable or unwilling to find regular employment in the new environment.

After accession, when the economies of the NMS started to boom, how governments had dealt with the issue of more flexible labour market institutions and the issue of displaced workers proved important. For example, “deactivating” large segments of the older workforce, as was done in Poland, resulted in an insufficient domestic labour pool from which skilled labour could be drawn in times of economic expansion. The skill shortages observed after 2004 were also caused by a very sluggish reform of vocational education and a tax system that made part-time and temporary work unattractive for employers. In times of excess demand for labour, unskilled and low skilled unemployed workers did not find employment because of excessively large tax wedges at the lower part of the skill distribution.

Whatever the partial failings of policy makers in the NMS while preparing their labour markets for accession, one needs to stress that, overall, the reforms of labour market

<sup>2</sup>The Macedonian government is engaged in a survey of enterprises with the aim to have the curricula in schools produce skill profiles that come closer to the wishes of enterprises.

institutions resulted in labour market structures that were in general at least as flexible as those of the EU-15. The reported “jobless growth” in the years preceding accession should, therefore, be mainly attributed to the slow elimination of labour hoarding and to belated “true” restructuring efforts in these economies. One reason for the slow elimination of hoarded labour was the employment protection of regular jobs, which was much more rigid than in the old member states.

The accession process for Macedonia will be a medium-term affair, and Macedonian policy makers have the time to implement policies that are based on the lessons that can be learned from the partial failings as well as from the successful elements of labour market reform in the NMS. Some of these recommended policies are either already implemented or contemplated, in other words some of the recommendations confirm the intentions of the Macedonian government regarding reforms of the labour market. These recommendations are:

- Nearly half of all unemployed are unskilled or low skilled workers. It is, therefore, important to increase the employment rate of these workers by ensuring a low tax wedge at the lower end of the skill distribution.
- As in the NMS, Macedonian enterprises identify skills shortages as one of the constraints of employment growth. Reforming vocational education after consulting with firms about their skills requirements should, therefore, be a top priority of the Macedonian government.
- Reforms of tax laws that make part-time and temporary work more attractive to employers are another policy that can help in resolving skill shortages.
- Skill shortages can also be remedied by re-training and further training of the unemployed. A very sensitive issue is the problem of proper targeting. Whether to target older and long-term unemployed workers or young new labour-market entrants is in the end a political choice. From an efficiency point of view targeting young new labour-market entrants should be the preferred policy.
- This does not mean that one should retrain and further-train young workers who have dropped out of school or were low performers in school and are for these reasons unemployed. The right policy is here to reform the educational structures to minimize bad educational outcomes. Given the many necessary reform efforts, dealing with this group should not be a priority.
- If efficiency considerations are given priority, then other ALMP measures that were found relatively effective in the NMS, like employment incentive schemes, should also be predominantly targeted at young new labour-market entrants.
- One instrument of ALMP that should not be used in a major way is public employment schemes. They can be thought as a social policy giving some income to workers, but they hardly ever improve the performance of the labour market.
- Since strong economic growth will eventually come to Macedonia, one has to be conservative when “deactivating” older displaced workers through early retirement and disability pension schemes.

## CHAPTER IX

### EDUCATION REFORM

#### Introduction

The Accession of Macedonia to the EU is an opportunity for the reconsideration of the role of education in society. Education is among the most important factors for the future social cohesion and competitiveness of Macedonia, especially in view of its ethnic and cultural diversity and its level of development. The creation of a national educational philosophy and system requires the integration and development of various types of educational institutions that mesh with each other in a seamless way. Therefore, this section of the Study reflects the need for such an integrated approach to reforming the educational system by examining the process of the reform in the course of EU accession in a single country, Slovenia, because the piecemeal borrowing of individual best-practice elements from different countries could lead to inconsistencies and conflicts within the new educational framework.

#### 1 Slovenia's Experience

The inauguration of a representative democracy and a market economy in Slovenia placed new demands on education that was in many ways more important than the formal requirements of EU accession. As a result, the European Union had less direct influence on changes in education in Slovenia than did internal changes because the EU accepts the idea that education is part of national autonomy.

##### Pre-Accession Negotiations

Slovenians studied the *acquis* carefully for one simple reason: all the regulations were supposed to become part of the Slovenian legal system. There is nothing in the regulations with which Slovenia was not able or willing to comply. On the other hand, the EU confronted Slovenia with some demands for changes in Slovenian regulations related to education. Three of them are worth mentioning because Macedonia

is likely to face them also:

- Implementation of Directive 77/486/EEC on the Education of the children of migrant workers. The Directive requires that each member state treat children of all migrant workers in the educational system in the same way as it treats native children.
- Equal Treatment for all the citizens of member states is required. This regulation potentially has important benefits for Macedonian students because tuition and admission criteria for a student from Macedonia will, in EU member countries, be the same as for the citizens of the native country.
- "Long-term" (3 months) stay for foreigners – European Voluntary Service.
- These formal changes in Slovenian education were the easiest to implement even though this was the only phase in which Slovenia was asked to meet specific demands in the area of education.

## Institution Building and Capacity Building

The next change in educational structures in Slovenia, which partly ran in parallel with the formal accommodation to EU regulations, was related to the de facto EU educational and training policy. When Article 149 of the Amsterdam Treaty claimed that the Union seeks to assist member states in their structuring of education, it actually opened doors for the creation of programs and initiatives at the Union level or with the assistance of the Union on the one hand, and in the form of cooperation between member states on the other.

In the Lisbon Strategy, the European Union declared the desire to be *“the world’s most competitive and dynamic knowledge-based economy, capable of sustaining growth with more and better jobs and greater social cohesion.”* For a competitive economy, a knowledgeable and skilled work force is needed. The EU assists in this through the:

- Evaluation of the quality of education in certain areas. For that purpose, PISA is supported and, through it, accommodation of standards and even programs of obligatory education are targeted;
- Initiatives in the field of vocational education, which are very high on the agenda of the European Commission. The Bruges-Copenhagen process has been launched and substantial amounts of money have been invested in curriculum renovations in a number of countries;
- In the field of higher education, the EU is a key supporter of the Bologna process and it prepares “pre-accession countries” for participation through Tempus programs.

The common denominator of these measures is mutual accommodation of basic standards of education in Europe to an extent where the recognition of professional qualifications as a precondition for a properly functioning European labour market is achieved. To this end, teachers, pupils and student exchanges are supported through

programs such as: Comenius for obligatory education, Erasmus for higher education, etc. ECTS and Diploma Supplement in the area of higher education are in line with the same idea.

Cohesion, cross-border and structural funds complement all of these actions with substantial amounts of money for infrastructure and a number of programs aiming at developing a high level of competitive strength. The concept behind these programs is not only based on the economy and competitiveness. The aim of the funds and of all the European programs today also includes social cohesion, sustainable development etc. The above-mentioned projects and actions aim broadly at the creation of a European education area and European awareness, culture and consciousness building.

To take advantage of these programs, Macedonia needs to:

- Familiarize educational institutions, teachers, students, partners in industry, etc. with the logic of the processes and with the opportunities they bring for them and for Macedonia;
- Build capacity and adapt national mechanisms and institutions to participation and use the opportunities presented by EU educational opportunities.

Familiarization, capacity building and institution building is a far more demanding and costly job, though a rewarding one also, than is the accommodation to EU regulations tackled during formal negotiations.

## Modernization of the Country

There is another element of the “Europeanization” of education that took place in Slovenia: profound step-by-step reforms of education as part of the modernization of the country. The European Union did not require these measures, but they recognized them as a proper and valuable step. Nevertheless it was critical that to proceed on this path was a national decision. Slo-



venia decided on education as one of its priority investment areas. This required a high degree of political consensus about the main elements of educational reforms. The only important line of division between a large majority of the population and a minority was related to the question of religious instruction in public schools.

Consensus building in the process of education reforms is a demanding task. Reformers have to be aware of the different views of experts and citizens and the different values of a politically, nationally and religiously diverse population and its political parties. With compromises, inclusion of trade unions, political parties, including the opposition, and above all teachers and experts with different educational philosophies, the country reached a high level of consensus. During the years 1992-2003 public trust in education increased from 52 % of the population to 82 %.

### Systemic Changes

The first and most necessary systemic change in education in Slovenia was a gradual increase of the share of GDP allocated to education. This was partly a strategic decision by the Ministry of Education, the government and Parliament that launched an annual budget struggle for a “fair” share of the budget for education. Despite the difficult financial situation in the country, parliament and the government decided to raise the share of GDP to be spent on education from 4.8% in 1991 to 6% in 2004. Coalitions of educators, trade unions, educationalists in political parties, local communities interested in improvement of the education infrastructure etc, were formed. Money provided decent salaries, ICT, meals, textbooks and facilities, including those for sports.

Private education, including in primary education, was part of the systemic change. It did not bring real competition in the field of education, but it put Slovenian education in line with international declarations that parents must have the chance to opt for private edu-

cation to enable them to “have a prior right to choose the kind of education that shall be given to their children.” Further, aware that Slovenia is one of the few countries in Europe having only 8 years of obligatory education, this was increased to 9 years, starting from age 6.

Substantial democratization of enrollment at all non-obligatory levels of education was started. Today, enrollment in pre-primary schools has reached more than 75% of the age cohort; in upper-secondary it has reached 97-98% and in tertiary it is beyond 65%. The idea behind this was a simple and meritocratic one: to enable as many as possible to reach high quality education as early as possible.

Educational institutions have the status of public, not state, institutions. Depolitization of school councils, consisting of five teachers, three parents and three members of a local or national authority, is one of the signs of the ability of the political parties to restrain their appetites for political control in education.

Curriculum renewal was also an important component of modernization, and it included a comparative approach in which experts from Slovenia visited Sweden, Denmark, Germany, Italy, France, England, Norway, and other countries. Similarly, experts from the same countries participated in seminars in Slovenia to present and discuss their experience. Overall, the following principles were important:

- Inclusion of stakeholders, and above all teachers and trade unions.
- “Less but more thorough” was one of the main principles guiding curriculum renewal.
- Modernization of vocational education in cooperation with industry and trade.
- Foreign language education starting in pre-primary schools, where it is optional, and including two foreign languages in grade 6.
- Optional subjects and credits starting

in primary education and continuing through secondary education.

### External Examination and Quality Assurance

A major part of the reform of education involved moving from process-oriented to output-oriented pedagogy. Greater autonomy of schools and teachers in the ways of teaching and concrete syllabus content were established. On the other hand, in primary and secondary education, external examination as an addition to internal grading and examination was inaugurated. The purpose of this examination was to provide feedback to the pupils/students, to the teachers, schools and parents on how well equipped youngsters are to attain the standards of knowledge they are supposed to reach. Simultaneously, as a result of the British experience, it was explicitly forbidden by law to use the results of such examinations for the purposes of ranking schools, promoting teachers, setting their salaries. etc. Accepting the responsibility of the state authority for the efficiency and quality of education at the level of the system, Slovenian schools participated in TIMSS from 1991 onwards. Results, including weak and strong points, have been identified and policymaking has been heavily influenced by the results of international comparisons.

As an integral part of the self-maintenance and improvement of the system of education, a system of quality assessment and improvement was conceptualized. Combining perceptions and evaluation of the process by the stakeholders with hard data such as student attainment in relation to the average and top national results and international comparisons, Slovenia is still struggling to establish a properly stable system of mainly self-evaluation of teachers and educational institutions.

### Looking Back

Reconsidering the Slovenian educational reform for the purpose of making recom-

mendations for Macedonia raises up three categories that we can label as mistakes, not good enough and good conceptualizations and implementations of the reform.

Mistakes during the reforms were numerous, although the reforms are nowadays judged as mainly successful.

- Expectations were not high enough. Exaggerations about overburdened teachers, pupils and parents with school work were immense. Comparative data demonstrated that we are in the last 25% of countries in terms of the time spent in school, while we spend an average amount of time to prepare for school at home.
- Insufficient number of school hours, especially for pupils in primary education. The lack of teaching time shifted the method of teaching toward hasty and superficial learning.
- Slovenia failed to promote an active learning approach.
- Bologna prolonged undifferentiated university education to 5 years for all, damaged the quality of the second cycle of Bologna and used up public finances needed for other actions in the field of education.
- After the reforms, a proper balance was lacking between general and vocational education. Slovenia is too focused on the perceived needs of the economy.
- Insufficient financial and decision-making deregulation. Decentralization to the regions was not implemented.
- Authorities did not focus on developing a few excellent M.A. and Ph.D. programs in Slovenia.
- Decision makers did not conceptualize and implement mechanisms that would stimulate the propulsive part of the economy to cooperate better with vocational education, universities and research institutes.

Not good enough elements include parts of

the reforms that were either not sufficiently well conceptualized or not implemented properly. Some of them today appear in a different light from how they were seen at the time of the reform.

- Equity and equality in education were the prime goals of the reform, and yet this did not sufficiently prevent education from being a mechanism for reproducing social inequalities. Slovenia did not start supplementary pre-primary financing for deprived areas in the country and in the major cities. Another area of intervention was Roma education where programs were not ambitious enough and segregation is diminishing too slowly.
- Reorganization of the school network in secondary education. Maintaining secondary education centers around the country was a decision worth following, yet the quality of provision is also important.
- Slovenia did not succeed in diversifying pre-primary programs to include shorter ones, or those with more instruction in language, music etc.
- The Ministry of Education launched a project “schools as community and youth centers” but nothing more was done.
- During the reform it took too much time to understand that workable proposals for alternative financial arrangements; optional subjects; additional instructional hours; schemes for computerization etc., are far better ways of reaching agreement than seeking a consensus for the best possible solution.

Good enough dimensions must be added to present a fair picture of the actions during the Reform.

- Social partnership was a key aspect of the reform and concepts, legislation, curriculum renewal, financing were all discussed with stakeholders. Industry, teachers, trade unions, school principals, experts, students, parents, politi-

cal parties, each of them participated according to their scope and interest, but as full partners with rights and obligations.

- Increased investment in education was seen as both needed and possible.
- External examination is a must.
- Concept of internal quality assessment system with external data is critical.
- 10 years of step-by-step reforms guided by comparative evaluation and discussion.
- Central and local levels of government took combined responsibility for the improvement of standards in education.

## 2 Lessons for Macedonia Too?

Education is a national opportunity and responsibility that is worth investing in. At the same time, some principles and actions are very important in the process of reforms. These include the development of analytically based, consistent and long-term goals. It is not possible to overestimate the importance of goals in the process of reform. Reform that is not based on comparative knowledge and that does not contextualize environmental and cultural differences will not bring improvement. Moreover, reforms require consensus. It is better to inaugurate less profound reforms that have a higher degree of consensus than deeper ones achievable only through the power of a political majority. Open, informative and informed communication with the media is, in this respect, important.

Educational reform must be based on social partnership. A structured arena that provides a degree of common interest, conceptualizations and policy measures that can produce a solid compromise in line with the values and interests of all stakeholders is needed to reduce the tensions that can endanger the very idea of reform. Of course, teachers are crucial partners in this process.

If they are involved in reconsidering education, if they are part of the formulation of change of the curriculum, then the needed degree of their ownership of the reform will be present. Experts are also important. The leadership of the reforms should heed the views of national experts even if they belong to an opposing political or ideological view. In a small country, national expertise is both essential and not enough. Trade unions as partners are also important. If they, and equally important, parents, take up the cause of educational reform, accepting and correcting, opposing where necessary, then the nation is a lucky one. Industry and other sub-systems of society are important, but they are often not genuinely interested in educational reforms that would bring long-term effects.

The concept of reform also requires considerable thought and effort. A comparative approach and comparative studies of other educational systems are needed, but they have to be contextualized. Domestic experts working with foreign experts have to contextualize results to come to the conclusion that something is worth including in the reform. This applies as well to assessment. Structured, well-informed self-evaluation should enable each educational institution to answer simple questions such as: how good are we; how do we know?

Educational reform requires resources. Substantial investment in education from 5.5% of GDP upwards is a necessary commitment. Resources should be invested in a number of areas, some of which are more important than others. Teachers' salaries are critical, and they should be at least at the national average. They should be differentiated according to years of experience, participation in training, quality of work in the classroom, etc.

There needs to be a national standard for facilities, equipment and computerization. Computerization should never take place without properly trained teachers. In Slovenia the ratio of investment was one-third hardware, one-third software and one-third

teacher training. General investment in teacher training must also be emphasized, and with the assistance of EU funds the opportunities for teacher training programs should be quite extensive. Funding must also be provided for students to enable all to learn effectively. Subsidized childcare, meals, textbooks etc. are an important element of equity and efficiency in education. In allocating them one should have in mind that socially deprived minorities such as the Roma are in real need of them and that, while the budget is limited, a targeted approach is the best way to use scarce resources. Early childcare with at least 50% of the population enrolled is necessary for equal opportunity.

### **3 Large Gains From EU Pre-and Post-Accession Programs for Education Require Domestic Investments**

EU programs such as Tempus, Erasmus, etc.; the Bologna and Copenhagen processes; cohesion funds, structural funds, regional cooperation – all of these supplement national resources devoted to education. However, experience shows that around 6% of GDP invested in education is a national precondition for successful participation in these opportunities. Investing in education and rearranging it into modern competitive education is one of the important conditions for EU accession.

#### **Ideas and Question for Macedonia**

The first question is whether the experiences of Slovenia and those of Croatia, Estonia, etc. are of any value to Macedonia. In such a question there are several sub-questions:

1. Is Macedonia going to face similar formal conditions, as did Slovenia in the pre-accession?

The answer is: yes. The acquis for the field of education is not enlarging and it is easy to accommodate it. Moreover, Macedonia

can, and should, prepare for it in advance.

2. The second question is whether the institutions and mechanisms needed to cope with the opportunities and demands of participating in EU programs, such as an open method of coordination, life-long learning programs, student and teacher exchanges, participation in using cohesion and structural funds, and similar, are substantially changing?

Here the answer is: no. And thus Macedonia's experience is not going to differ substantially from those of Slovenia, Croatia, Estonia, etc.

Neither the passage of years since Slovenia joined the EU nor Slovenia's better financial position is of real importance in the applicability of these lessons for Macedonia. Yet there is a point at which the possibility and usefulness of following the example of Slovenia does require careful analysis. Besides formal compliance with the *acquis* and the capacity and institution building that is needed for the participation in EU programs, each country must have a well functioning, inclusive and competitive system of education that is at the same time also able to maintain the specific character of each nation's culture. Here the differences are important. Macedonian culture, the ethnic structure of the nation, dilemmas and decisions related to the Ohrid agreement and some other elements of context are country-specific and are inscribed in the structure and functioning of education in Macedonia. In relation to them, an outside observer can see important elements of diversification in the system based on an ethnic basis.

While this diversification is established and obviously needed and functioning, policy makers should, in addition to, and not instead of, take special care to include elements that encourage an education that builds on common values, interests, hopes and mitigates the fears of all citizens, irrespective of their ethnicity. Mixed classes, joint presentations, celebrations of national and ethnic days, feasts in both languages are just pos-

sible examples. Indeed, one may question whether in the long run Macedonia will be well served by parallel, "separate but equal" educational systems organized along ethnic lines. Space should be made of schools where attendance would be voluntary and that would operate on a multi-lingual basis, available to all ethnicities, and attractive to students and their parents by virtue of special programs and facilities that would further the educational achievements of their students.

There is a number of elements of the Macedonian education system for which the international and comparative approach is needed. In changing education two mistakes can be fatal. One is copying arrangements of systems that are higher ranked in different international rankings (PISA, TIMSS, etc.). The idea that it is possible to copy class size, syllabi, textbooks, etc., is dangerous because it may result in creating at considerable expense a process that can not transplant other elements that determine the success of the system: teachers' attitudes and values; students' and parents' values, interests, religious beliefs, work ethics; their perception of the importance of education, etc. A second, and equally fatal, mistake is isolation of the national system of education. The idea that there is nothing to learn, or the idea that we have already learned all that is important, is dangerous because we lose the opportunity to improve our education by changing it through the study of successful approaches to common educational challenges and also by understanding where others "invested (sometimes immensely) into failure."

## 4 The Task Ahead

Learning from good practices is beneficial, the EU supports it financially, and there are elements in Macedonian education that probably are worth reconsidering. Some of them have been reconsidered already and the authorities are planning to work on them. Others are partly resolved, yet it is

worth reevaluating them while preparing Macedonia for political, economic and social integration into the European Union.

1. Pre-primary education. The enrollment of children in pre-primary education, which in Macedonia is around 20% or less of the age cohort, is far too low. In the next decade it must reach at least 50-60 per cent. Without this growth, which should primarily include socially deprived children, problems in primary and secondary education are unavoidable. As in some other countries, kindergartens in remote areas could be combined with primary schools.
2. Higher education. Actions aiming at increased enrolment in tertiary education should continue. Yet, two aspects are worthy of consideration in this respect:
  - » Greater institutional differentiation may yield a better use of resources and better meet student needs. Currently there is an emphasis on university education that may either shut students off from tertiary education if they do not want a university education or force them into universities even though the programs there are not consistent with their interests and needs.
  - » It might be better to support vocational colleges and professional higher education centers outside the capital city as well as computer-based study and, only after careful examination of the quality of the staff, curricula and results, decide for a new university. Some studies, like medicine, law, etc., need even more reconsideration. With European Quality assessment mechanisms in place, there is a danger that without such a concentration of resources on quality, degrees obtained at certain universities are going to be contested.
3. Adult education, providing both formal degree programs as well as vocationally oriented non-degree programs would

upgrade the labour force and engage the public's support for education as well. This could involve a programme of "Go for more than secondary education" that would encourage adult learners to pursue a university degree on a part-time basis. "A computer in every village" is another possible and needed direction. While computers are actually in every village with a school, it would be worth stimulating students to combine their efforts with teachers and extend ICT skills to the "generations from socialism." Estonia is very good example of a "connected nation" and of a nation where schools did their share of the job. Another area where adults could benefit from internet-based or face-to-face instruction is in the study of foreign languages, which will become all the more important with EU accession.

4. Primary education. The results of TIMSS 1999, 2003 and PIRLS 2007 question the efficiency of primary education in Macedonia. The results are too low in relation to the money invested in education. Due to this fact, there is a need for reconsideration of potential causes:
  - » Possible reasons for low attainment can rest in language differences inside the nation. Macedonia needs all its citizens, Macedonians, ethnic Albanians, Roma, etc. to have high cultural capital and high educational attainment.
  - » The attainment of students from socially deprived families may be needlessly low. Special measures that would improve the results of the socially deprived are needed, and much of this depends on early childhood programs. Given the lag between the implementation of such programs and measurable results, the time to act is now.
  - » There is need to raise public expectations, especially of students and parents, related to the knowledge

students are expected to obtain from education rather than measuring educational success only by the attainment of a degree, regardless of how competitive that degree is in the European space.

5. The concept of general education is at least as important as is vocational education, and the introduction of obligatory upper secondary education does not resolve this problem.
6. Locally rooted vocational education in a time of globalization is a dangerous illusion. The worker of today and of the future can not expect a permanent working place as a qualified specialist in a narrow specialty.
7. De-politicization of education. With respect to Macedonian education, one feature is in the forefront: the political

elite in Macedonia are not capable of restraining themselves from interference in school management. De-politicization of school boards and school principals not chosen by national or even worse, local politicians, are necessary conditions for the future development of Macedonian education.

On the other hand, there is a place for wise and skillful politicians to interfere: they can accept the duty to assure stable public finances that are going to reach more than 5% of GDP and then in a few years, to reach at least 5.5%. And yes, there is another engagement worthy of a real politician: to help to create a long-term consensus about the importance and the direction of education in Macedonia.





## CHAPTER X

### MIGRATION

#### Introduction

The free movement of people and its impact on sending and receiving countries has been a controversial issue in the context of European Union's Eastern enlargements in both the EU and in the new member countries. It is also a critical issue for Macedonia because of the large proportion of Macedonian citizens working abroad and the size of the remittances that they send back to their families in Macedonia. Ultimately, as citizens of the EU, Macedonians will gain the right to work wherever in the EU they wish, but it is well worth considering what an interim labour mobility regime would look like and what the costs and benefits of the free movement of labour are likely to be for Macedonia.

Macedonia's pre-accession strategy should be to gain better information about migration and remittances so as to better understand the nature of migration and its costs and benefits for Macedonian citizens and also to help in formulating an effective negotiating stance vis-à-vis the EU; to facilitate migration in directions that benefit both migrants and the country; and to move migration into channels that are legal and do not lead to the imposition of controls on the international movement of Macedonian workers.

#### 1 The Impact of Migration on the Economy and Society of Sending Countries: General Considerations

Migration influences sending countries mainly through changes in labour supply, the alleged loss of educational investments through brain drain, and remittances. While the emigration of labour leads to a decrease in the labour supply, the economic impact of migration depends on factors such as the age structure and skills of emigrants as well as on the labour market situation in the home country. As people leave to work abroad, domestic output may decline if emigrants cannot easily be replaced by similarly skilled workers. An increasing demand for labour in sending countries may lead to

rising wages, which may further hamper export competitiveness.

Because migrants often leave specific regions in sending countries, the overall effects of labour movements will not be distributed equally throughout the country. In this context, the efficiency of home countries' labour markets plays a key role in determining the outcome of labour migration. The emigration of highly skilled persons is commonly described as "brain drain" and it is viewed negatively by sending countries.

However, such highly skilled migrants may be underemployed in their home country; they often return home with the experience of working in a foreign country so they may earn higher wages or they may become self-

employed. In addition to new skills, valuable managerial experience, entrepreneurial know-how and access to global networks, returning migrants may bring venture capital, enhancing economic growth and welfare at home. Migrant remittances reduce poverty and spur economic development. Finally, remittances are the second-largest source of financial flows to countries with large numbers of migrants abroad, second only to FDI and generally higher than development aid.

In evaluating labour migrations from EU-8 countries and their impacts on sending regions in the longer run, out migration has to be related to demographic developments in these countries. In the EU-8, the population is declining even faster than in EU-15 countries, and a number of EU-8 states such as Hungary, the Czech Republic, Slovakia and Slovenia have already turned into net immigration countries.

## 2 Migration Experience of Transition Countries That Have Joined the EU in 2004 and 2007

As part of the EU's enlargements in 2004 and 2007, a transition period of restricted labour migration from the accession countries was introduced for a maximum of 7 years (2+3+2). After May 2004, all EU-15 states except for the UK, Ireland and Sweden introduced restrictions with respect to the admission of East European labour migrants. The imposition of transition arrangements in 2004 in the form of welfare and labour market entrance restrictions demonstrated that most EU-15 countries were more concerned with the domestic risks of immigration than with its opportunities.

Two years later, in 2006, the majority of EU-15 countries abolished or relaxed migration restrictions. However, when Bulgaria and Romania joined the EU in 2007, the majority of EU-15 countries, this time including the UK and Ireland, restricted the immigration of workers from these countries

into their labour markets on the basis of the 2004 transition arrangements. In its accession negotiations, Macedonia should thus consider not only what restrictions old and newer EU members might wish to apply to Macedonian migrants but also what temporary restrictions Macedonia may wish to apply to migrants from neighbouring countries that may be joining the EU at the same or nearly the same time.

The share of the working age population from the EU-8 states in the EU-15 is small. It was 0.4% in December 2005 as compared to 0.2% in 2004. Some EU-15 countries, such as the UK and Ireland, received an above average share of immigrants from the EU-8, as did Italy, Spain, Norway, Germany and Austria. In absolute numbers, the most important sending country was Poland, followed by Slovakia and the Baltic states. The World Bank estimates that in Slovakia, Poland and Estonia approximately 1% of the working age population moved to the EU-15 between May 2004 and December 2005. Lithuania lost 3.3% of its working-age population and Latvia 2.4%.

Unemployment rates decreased considerably in the Baltics after 2004 and in Poland after 2006, particularly among younger people, and some studies attributed this at least in part to migration. At the same time, the number of unfilled job opportunities increased in the Baltic States and Poland, and construction, health care, retail sales, services and, in Poland, agriculture experienced labour shortages. In the Baltics, average wages grew remarkably between 2004 and 2006, while in Poland only specific sectors, primarily health care, construction and agriculture, were characterized by wage increases. The extent to which these wage movements were due to migration is unclear.

The emigration of highly skilled people had evoked great concerns in EU-8 countries prior to enlargement. For example, medical professionals from Poland, Lithuania and Estonia moved abroad in relatively high numbers. Furthermore, a considerable

emigration potential exists among physicians and nurses in Poland as well as in the Baltics. In these countries, the emigration among professionals in the health care sector is expected to result in adverse economic effects and in a corrosion of the health sector at home. However, some studies expect a growing emigration of skilled labour from EU-8 countries to raise the wages of the remaining skilled workers and therefore to stimulate education among those who stay behind.

While the outflow of skilled workers would lower growth, positive effects on growth in the longer term would be expected from greater numbers of better-educated workers at home. Moreover, many migrants have returned to their countries of origin, bringing valuable skills and resources with them. In Latvia, return migrants earn higher wages compared to people who stayed at home. In Albania, return migrants more often become managers or self-employed after their return than do people who had not emigrated, but in Hungary, only female labour migrants received a wage premium after returning, while male migrants do not benefit from stays abroad.

The outflow of labour is accompanied by an inflow of remittances. The World Bank found an increase of remittances in Poland by 164%, in Latvia by 279%, in Lithuania by 541% and in Estonia by 788% between 2003 and 2006<sup>3</sup>. Although Poland received 4.36 billion USD in remittances in 2006, the share of remittances in GDP amounted only to 1.3%. In the Baltic States the percentage of remittances in GDP was 2.6% in Estonia, 2.5% in Latvia and 2.1% in Lithuania. Studies show that investment as well as private consumption increase following the receipt of remittances, including a tendency

<sup>3</sup> Official data on remittances include bank transfers, non-banking money transfer operators and post office transfers. Other important channels for remittances, such as cash and commodity transfers or the use of informal money transfer services are not taken into account. This results in a potentially large underestimation of remittances in official data.

to invest in human capital, either by the migrants themselves or by their children. Migration from EU-8 countries thus influences social relations and educational prospects at home. Anecdotal evidence points to changing family structures and gender roles. The emigration of female household members led to decreasing family cohesion and child welfare at home, but female migrants pay more for the education of their children and for improved private consumption and housing.

### 3 Migration and Remittances in Macedonia: Experience and Perspectives

At present, Macedonia is a migrant receiving, sending and transit country, although none of these flows is particularly high according to official data. Because Macedonia is a comparatively small country, migration movements can be expected to have noticeable economic and social effects. Furthermore migration may also have an impact on the ethnic composition of the country and on ethnic relations. Macedonia has a long emigration history, including ethnic Macedonians as well as citizens of today's Macedonia belonging to other ethnic groups, mainly ethnic Albanians.

Since the end of the nineteenth century, a considerable number of people have left what is now Macedonia for Western European and overseas destinations. At the turn of the 20th century the main destinations were overseas countries, such as the United States, Australia and Canada. After World War II, Macedonians took part in guest worker flows to Western European destinations, above all to Switzerland, Germany and Austria. Most labour migrants in that period were male, and a sizeable part belonged to the ethnic Albanian community.

Officially-registered emigration and immigration flows in Macedonia have been comparatively low since independence. The majority of immigrants to Macedonia came from neighbouring countries, such as

Albania, Serbia and Montenegro. Presumably, migration figures in general are under-reported, as only those persons are counted as migrants who have officially registered their migration activities. In most cases, those who leave and (re)enter the country for temporary work or studying do not register, while illegal migration is only exceptionally recorded<sup>4</sup>.

In Macedonia, little information on the motivation and characteristics of emigrants exists. In 2007, a survey was conducted with 1,046 respondents representing Macedonian households that receive remittances from abroad. This research found the wish to earn a higher income, an unsuccessful job search at home and better living conditions abroad among the most important reasons for emigration. Only a small minority of emigrants (3.3%) left Macedonia because of educational motivations. More than half of all emigrants in this study worked in three European countries, namely in Germany (19.3%), Switzerland (18.5%) and Italy (17%). The USA (12%) and Australia (10.5%) were also relevant destination regions. Many respondents (42.9%) had been away for more than 10 years, while a quarter (25.9%) had resided outside the country between 6 and 10 years. According to the survey, approximately 25% of emigrants had a college degree or a higher education, while 56.3% were occupied as manual workers abroad. Because this research was not concerned with current emigrations, no conclusions on brain drain in Macedonia can be drawn.

A study of highly skilled labour emigration from Macedonia found striking results regarding migration. According to this research, nearly 15,000 Macedonians with tertiary education resided outside the country in 2002, representing more than 15% of Macedonians holding a university education. This suggests that highly skilled emi-

gration from Macedonia is basically permanent and increased in the 1990s. This is confirmed by the fact that the total number of researchers in Macedonia decreased by 8.6% between 1997 and 2003. Although 2007 labour market data reveal a certain shortage of highly educated persons especially in technical science, it is not clear if this is related to recent emigrations. Comprehensive data on the stock of skilled migrants in OECD countries showed that 19.6% of Macedonian migrants had at least tertiary education. These data confirm a rather high educational attainment by a part of the Macedonian Diaspora in OECD countries.

The tendency of educated Macedonians to emigrate is not a phenomenon of the past. Approximately 85% of university students report they plan to leave the country after having finished their studies. Next to economic motivations, unfavourable educational and research conditions as well as little expectation of an improvement in this situation in the future were given as reasons.

In this regard, the desire to work abroad extends beyond the highly educated and mobile, such as university students, to the rest of the population. The UNDP's Macedonian Early Warning Report 2007 discovered that 0.1% of ethnic Macedonians were temporarily working abroad in 2007, while 1.3% of ethnic Albanians and 3.7% of other nationalities in Macedonia did so. Males were to a much higher degree (1.1%) involved in temporary labour migration than females (0.2%). When asked where respondents would see their future and that of their children in terms of employment, 22.9% of ethnic Macedonians, 15.7% of ethnic Albanians and 38.5% of other nationalities answered they would like to work abroad.

There is increasing pressure for economically motivated emigration due to large differences in income between Macedonia and nearby EU countries. In 2007, for instance, the GDP per head in Macedonia amounted to 27% of that in Greece and to 71% of that in Bulgaria, thus providing solid mi-

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<sup>4</sup> In 2005, for example, it is reported that 2,050 Macedonian citizens were readmitted to Macedonia from Western European countries after they had illegally crossed the borders.

gration motivation. Furthermore, the high unemployment rate in Macedonia, which is particularly prevalent for ethnic Macedonian Albanians and Roma, acts as a push factor. Emigration to EU countries is supported by Macedonian communities abroad, whose assistance lowers the cost and risk of migrating. Against this background it is not surprising that the Macedonian Early Warning Report 2007 found people in Macedonia relating the EU accession of the country to better migration options. When asked what changes Macedonia's European Union membership would bring for respondents, 22.5% of ethnic Macedonians, 44.1% of Macedonian Albanians and 32.8% of other nationalities answered that it would improve the opportunity to work abroad.

Currently, Macedonian emigration movements are severely restricted by legal measures on the part of receiving countries. In the EU, migration policies still control the inflow of (labour) migrants from Macedonia. Although the EU may not be especially concerned by potential labour migration from Macedonia because of its comparatively small population, temporary restrictions on labour movements might nevertheless be imposed. This might be mainly the case for those countries with a relatively high Macedonian immigrant population, such as Germany, Austria and Italy.

Because of its long migration history, remittance flows into Macedonia are large but difficult to quantify. Official data significantly underreport actual money transfers, as many migrants send remittances via informal channels. A recent World Bank report argued that unrecorded remittances may at least add 50% to officially counted flows. According to official data, which include workers' remittances and compensation of employees, remittances to Macedonia have steadily grown from 52 million USD or 1.4% of GDP in 2001, to 3.9% or 249 million USD in 2006. Compared to foreign direct investments (FDI), the inflow of remittances was higher between 2002 and 2005. In addition, foreign direct investments were much more volatile. It is remarkable that the country

received a substantial and increasing inflow of remittances although a considerable part of the Macedonian Diaspora has been abroad for a comparatively long period. This indicates that Macedonian emigrants keep up strong ties with their home country and are willing to support their families back home.

Under IMF definitions, official remittances include migrants' transfers in addition to workers' remittances and compensation of employees. This figure cannot be calculated in the case of Macedonia because the Macedonian National Bank records migrants' transfers as part of cash exchange that also incorporates payments for unrecorded trade and services. An estimation that included all three remittances categories found remittances in Macedonia to amount to 15.2% of GDP in 2004. This put Macedonia in 8th place among 25 countries in Eastern Europe and the former Soviet Union. A 2007 survey shows that only 38.6% of remittances were sent home by formal money transfers (for example through Western Union) or bank transfers. In most cases (44.4%) labour migrants physically transported their money back home. Apparently, the dependence on remittances is a persistent issue in Macedonia, as nearly 62% of remittance-receiving households relied upon these sources of income for five years or more. The survey also revealed that remittances were mainly used for current consumption (74.1%) followed by savings (13.7%) and construction and maintenance of houses (14.5%). Less important were investments into business start-ups (2.6%), real estate (0.7) or portfolios (0.3%).

## 4 Policy Recommendations

Migration behaviour as well as the sending and the use of remittances are to a great extent based on private decisions that are particularly difficult to influence by state policy. In the context of migration and remittances, governments are commonly most interested in enhancing the opportunities from mi-

gration and remittances for their countries and in reducing the risks. Referring to this aim the Macedonian government faces the following challenges:

- Government policies with respect to migration and remittances require comprehensive information. In Macedonia, data on migration are lacking. Emigration and immigration flows are not completely recorded. No good information on the education, the regional background, the ethnic affiliation and the gender of emigrants and immigrants exists. This is likewise the case for the Macedonian Diaspora abroad. Furthermore, the inflow of remittances is not documented according to the standards of the IMF, and there is no solid information on the transfer and use of these funds. Surveys are also needed to get a better understanding of migration patterns and of the impact of, and motivation for, remittances.
- In Macedonia there are indications that the migration of skilled individuals could increase with EU accession. To address the migration of highly educated people, one option is to activate the resources of the highly skilled Diaspora, i.e., to support the retention of knowledge-based links between skilled migrants and R&D institutions at home (see for example the TOKTEN – Transfer of Knowledge Through Expatriate Nationals – programme of the United Nations).
- Another approach is to promote brain circulation, i.e. encouraging highly skilled persons who have gone abroad for some years to return. In this context, policies such as training, tax breaks and sustaining migrants' social entitlements while abroad should be considered. To reduce brain drain among young highly-skilled persons, they might be encouraged to stay by improving salaries and working conditions in R&D institutions at home (see the joint UNESCO and HP project to reverse brain drain in Macedonia) while at the same time encouraging short-term research stays at foreign research facilities.
- However, these initiatives have only a chance if human rights, democracy as well as economic and political development do not deteriorate in the home country. In any case, disincentives to the emigration of highly skilled individuals are likely to have negative effects on Macedonia, especially if appropriate work at international salaries work for educated individuals is not available in Macedonia. Disincentives to migration reduce the welfare of those who could earn higher incomes abroad, reduce remittances, and by reducing the private return to education in Macedonia, create a disincentive to acquire human capital among all Macedonians. Moreover, given the great interest in, and strong motivation for, migration noted above, such restrictions are likely to be politically unpopular.
- In any case, as the Education Chapter points out, higher education will become more internationalized within the enlarged EU, and Macedonia's university students and professors cannot be left out of this process. Since Macedonia has a long history of skilled-worker migration, it may be entirely rational for Macedonian families to pay taxes to support good education for their children, while at the same time expecting that the returns to that education will be maximized if their children migrate, at least for some part of their working lives.
- Because Macedonia is an accession country of the European Union, migration relations with European Union countries are of particular importance. Moreover, Macedonia has a meaningful Diaspora in the European Union. In this context Macedonian policy should consider the suggestions of a recent green paper by the European Commission on the management of economic migration. Among other suggestions this paper proposed:
  - » improving the dissemination of infor-

mation and advice on legal labour migration procedures and on the risks to irregular migrants;

- » encouraging brain circulation of the highly skilled;
- » including low skilled labour into circular schemes by developing a framework of bilateral labour arrangements;
- » ensuring the protection and support of migrant workers according to international standards.

Cooperation with the European Commission on this basis could yield a smoother evolution of future migration relations after enlargement, finally leading to the free movement of workers.

- With respect to remittances, efforts should be made to improve official channels for sending remittances, to increase trust in these channels and to lower transaction costs. Research in Macedonia suggests that remittances are predominantly spent for consump-

tion, thus most likely supporting poor households. To attract further remittances from migrants abroad and to enhance the development impact of remittances Macedonia should establish special financial products for the Diaspora.

- Furthermore, matching funding schemes for remittances with respect to business-start-ups, low cost housing or projects of Home Town Associations (or Migrant Associations) should be developed. Given the importance of migration and remittances to the Macedonian economy, maintaining strong cultural and economic relations with migrants and the Macedonian Diaspora should be an important concern for Macedonia's foreign policy and for its embassies abroad.

To date, comparatively little experience exists on how the described policies might function in the context of South-eastern European transition economies. Thus a thorough evaluation of migration and remittance patterns is a precondition for the proper development of these measures.





## CHAPTER XI

### SOCIAL INCLUSION

#### Introduction

The EU social inclusion agenda is a core pillar of what is often referred to as ‘Social Europe’. Thus the Accession process for Macedonia means becoming part of a unique social agenda with specific socio-economic visions, institutional and regulatory arrangements, and policy frameworks. In recent years the EU has accelerated its effort to strengthen the social dimension of EU integration, and, since 2000, the EU has established a more ambitious and proactive social agenda, manifested in the continuous expansion of social acquis, the introduction of the Open Method of Coordination in the field of social inclusion and social protection, a new emphasis on the sustainability of public expenditures, and the adoption of a wider social agenda called the “Renewed Social Agenda.” This reinvigorated social agenda is built around the three pillars of opportunities, access and solidarity.

The Accession Reports continue to be particularly outspoken, and in some places critical, of the slow progress made in the field of inclusion by accession countries. Consequently, social inclusion will be a major public policy concern in the course of Macedonia’s accession because of its high unemployment and poverty rates. Effective social inclusion policies require continuity and capacity-building, and Macedonia will have to carry out a comprehensive review of its domestic policies and align them with the European agenda. This will require that the government safeguard the continuity of policy direction, policy-making and administrative capacity. It is also essential that pre-Accession funds be utilized fully and effectively in order to prepare for the social inclusion agenda that the EU requires. This is precisely the ultimate challenge of the accession process, to understand the EU social agenda and to integrate that agenda into domestic policies in Macedonia.

#### **1** Translating the European Social Agenda Into Domestic Policies: Policy Considerations

The task Macedonia faces is how to translate the EU’s social agenda into its own do-

mestic arrangements and ways of doing and thinking about social inclusion. Moreover, social policy will have to be strongly connected to other policy areas. For example, the European Commission has argued that many new member states have struggled to develop a comprehensive strategy to

promote employment that provides an integrated framework of macroeconomic policy, employment, education and social inclusion.

Inter-ministerial coordination has been poor in almost all new member states, although there are some useful examples of best practice. For example, in Hungary, in order to promote absorption of European Regional Development Funds (ERDF) for social inclusion projects, Regional Social Policy Centers were established at the NUTS II level. These were then responsible for running innovative and ERDF-compatible projects in the social sector. These Centers, through their research activities, have also highlighted the territorial and geographic aspect of social exclusion and initiated new policy measures to tackle social exclusion in remote rural areas.

During the accession process, public and private institutions, NGOs, and professionals in the field of social inclusion will play a very important part in obtaining and spending EU Funds and participating in EU initiatives. Policy makers working in the Ministry for Labour and Social Policy will play a crucial role in orchestrating the interactions between the EU and these domestic actors. In this process it is important that policy-makers' work makes full and effective use of pre-accession funds.

The accession process will put increasing pressure on available public funds for addressing social needs and responding to old and new social risks and target groups. It is essential that EU funds are utilized well and that the absorption rate of these funds be sufficiently high. High absorption provides additional resources for the fight against poverty and social exclusion and offers an important learning experience for participants, preparing them to apply for Structural Funds later on. Although there is very little available evidence on how pre-accession funds have been used for social inclusion purposes in the New Member States, a common problem has been the lack of institutional capacities to apply for fund-

ing and to manage projects.

The reshaping of Macedonia's social inclusion policy will have to be tied very closely to the EU's social agenda.

### **Fight Against Poverty and Social Exclusion**

Since 2000, the Member States are rigorously scrutinized for their efforts and effectiveness in fighting against poverty and social exclusion. As the Joint Inclusion Memorandum (JIM) process has started, Macedonia is facing five major difficulties in this respect:

1. There is no National Anti-Poverty or Social Inclusion Strategy.
2. There is no nationally accepted or adopted definition of social exclusion.
3. There is a lack of available data on poverty and exclusion.
4. There are no monitoring or evaluation systems in place to look at the impact of public policy efforts to reduce poverty.
5. Current policy priorities (target groups identified) are very narrowly defined.

Although the Joint Inclusion Memorandum will help to outline key national priorities, creating a separate National Anti-Poverty Strategy, as Poland did, for example, to build political momentum and support for the fight against poverty and to demonstrate a concerted effort and a comprehensive policy strategy will benefit Macedonia's accession efforts. Work has begun to frame a National Coordination Mechanism for Social Inclusion. However, the shortage of data, the lack of a definition of poverty, and the shortage of local expertise represent a major barrier to this work. Although the Ministry of Labour and Social Policy recognizes that such a strategy needs to be comprehensive, framing such a policy is a complex and difficult task, and there is a strong need to offer adequate support and resources to the Ministry.

Formulating a comprehensive national

strategy, as Bulgaria did in 2003 before they signed the JIM, creates a proactive rather than a reactive approach to social inclusion and reconsiders previous policy priorities in the light of the EU social agenda. This work could also identify the need for new indicators, support the preparation for the adoption of the Laeken indicators, and, most important, establish a clear definition of poverty and social exclusion. Many New Member States have adopted "national minimum income" schemes, identified target groups that have fallen outside of social protection systems (such as old people who do not qualify for pension or residents who do not have citizenship and therefore do not qualify for health care, etc.) and shifted their attention to new risk factors that contribute to the deepening of poverty. The four target groups identified by the Ministry of Labour and Social Policy in its 2004 Policy Paper (drug users, street children, victims of family violence and homeless) are overly narrow in their focus, miss other major target groups and fail to address the multi-dimensional aspect of poverty and social exclusion. Some of the key challenges, considering the limited public resources available for social policy, will be to:

- improve the effectiveness of social protection systems through better enforcement of contribution payments, better targeting of benefits, and creating a stronger link between social benefits and active job search;
- improve social services by offering quality training to social workers and other professionals, freeing SWCs from bureaucratic pressures, responding to local demands and offering quality services;
- identify new and important target groups. Based on the Slovenian experience, it is almost certain that Macedonia will be questioned about the 70,000 people above the age of 65 who are not covered by pension benefits and the almost 200,000 people who are not covered by health insurance.

A further advantage of adopting a National

Anti-poverty or Social Inclusion Strategy would be that it could focus public resources to create a transparent financial framework for the fight against poverty. Many New Member States have been heavily criticized by the European Commission for not making financial commitments transparent in their social inclusion action plans, and therefore compromising the implementation of these Action Plans. A lesson for Macedonia here is that the European Commission has gained a great deal of experience in reading between the lines in terms of the range of strategic documents produced during the accession process and is able to make good judgments about their financial soundness, political commitment and policy coherence.

### Child Poverty

In March 2006, the European Council asked Member States "to take necessary steps to rapidly and significantly reduce child poverty and give all children equal opportunities, regardless of their social background." Macedonia suffers from a very high rate of child poverty. An estimated 32.4% of children aged 0-6 live in poverty, and these figures are even worse for Roma and children living in rural areas. Fighting child poverty should be considered part of a broader agenda of human investment in the future. There are many good examples of effective programs directed toward child poverty in EU Member States including school free meal programs, "Sure Start" to support children from disadvantaged backgrounds, and investing in kindergartens. The latter is particularly important in Macedonia where it is estimated that only around 13% of the children aged 2-6 are enrolled in kindergartens and only 33 out of 84 municipalities have a public nursery or kindergarten. As fertility rates are low, it is important to consider child- and family-friendly policies including the reconciliation of work and family life. It is also important to prevent early school leaving and to tackle youth unemployment. The emphasis on child poverty and children's rights can be clearly seen in the 2008 EU Progress Report, which finds

that, “further significant efforts are needed to adopt reforms in line with international instruments such as the UN Convention on Rights of the Child.” Implementation of the 2006 action plan for the protection of children’s rights has been slow, and 17% of children are not covered by the public health insurance scheme, 90% of children do not attend pre-school and 37% do not attend secondary school; the figures for Roma, ethnic Macedonian Albanian and/or children from deprived backgrounds are particularly high. The number of families living below the poverty line has not declined and a strategy to reduce poverty is missing. Juvenile delinquency is very high whilst the law on juvenile justice has not yet entered into force.

### **The Protection of Ethnic Minorities**

The Commission criticized Macedonia for its treatment of minorities. In the 2008 Progress Report, concerns were raised about the negative trends in school segregation, the lack of progress in supporting the social integration of Roma communities, and intensified inter-ethnic conflicts in some areas. As 35.8% of the total population is a member of an ethnic minority, the social inclusion of ethnic minorities is likely to remain a core social agenda for the Accession process. Therefore efforts in both promoting inter-ethnic dialogue and social inclusion at the same time will be essential. Macedonia’s Roma integration programs seem to be going well, based on a strong coordination mechanism, the effective implementation of the projects and a system of evaluation. This policy area clearly builds on international best practices and international cooperation.

Previous accession experience shows that the Commission has been very critical of this aspect of the Accession process. The 2006 Progress Report reported limited progress on social inclusion and the protection of ethnic minorities in both Romania and Bulgaria. The Roma issue has been raised in all countries. The particular measures that former accession countries have taken and that received positive appraisal from the Com-

mission include:

- Romania has been praised for its educational programs including changes in school curriculum, training of teachers, participation of parents, for its initiatives to employ “health mediators” to address the poor access of Roma communities to health care facilities and professionals, and for its effort to promote Roma employment by organizing job fairs.
- Bulgaria has been praised for the introduction of mandatory free-of-charge pre-school preparation, and for adoption of the Framework programme for Roma housing.

Criticisms from the Commission have mainly focused on the following issues:

- The lack of legislative reforms in key areas such as employment, health and education;
- The lack of financial support for educational desegregation ;
- The lack of efficient implementation and enforcement of anti-discrimination laws;
- The placement of Roma children with mainstream mental ability in special schools.

What is critical in terms of the protection of minorities from the EU’s point of view is that legislative frameworks should be in place, their implementation enforced, and additional programs running efficiently using available funding programs. It is also important that, due to the very diverse needs of ethnic minorities living in Macedonia, such as ethnic Albanians, Roma and others, each ethnic minority’s needs should be assessed separately and appropriate measures put in place. Ethnic minority issues are however, not simply a “policy” agenda; they require political commitment and wider public support. This could be vastly improved by inter-ethnic dialogues based on cultural, media-based, and education-based initiatives.

## Reconfiguring and Rethinking the Language of Inclusion

A common, but often neglected, aspect of social inclusion in post-communist countries is that the language used to label vulnerable social groups is outdated, stigmatizing and detrimental to the prospect of a more inclusive society based on respect, tolerance and solidarity. Based on old pedagogical and medical paradigms – such as “defectology” – is still being used in Macedonia – as in Croatia a few years ago. Accession offers an excellent opportunity to modernize and update key terms used in the field of social inclusion, not just in terms of reviewing legislative and policy-making documents and removing and rephrasing old discriminatory terms (as in Hungary for example), but also reflecting more broadly on the existing terminologies and making them reflect a more European vocabulary that emphasizes activism, dynamics, and prevention.

## 2 Social Inclusion in the Context of Macroeconomic Policies

A critical outlook on social inclusion choices and policies needs to consider the broader socio-economic decisions that governments make in the context of rapid economic transition and European integration. Clearly, economic performance and international competitiveness play an important role in determining the incidence of poverty, the incomes of minorities and overall living standards, but economic growth alone cannot solve all problems of poverty and social inclusion. Some governments, such as Estonia, Latvia, Lithuania, and later Slovakia, opted for low welfare spending, low taxes, strongly deregulated labour markets and widespread liberalization in an effort to spur economic growth.

The Baltic States have, indeed, had strong employment growth. In fact, among all the New Member States, only they have been

able to improve their employment rate between 1998 and 2007, and unemployment has fallen to around 5% in all three. Such economic growth, accompanied by job creation, is a favourable development, but the Joint Report on Social Protection and Social Inclusion (2007) notes that those countries nevertheless continue to have “huge social inclusion needs” reflected by high poverty rates, income inequalities, high in-work poverty, low minimum wages, low replacement rates of pensions, poor targeting performance of social benefits, and underfunded health care and social services.

Poland and Hungary emphasize economic competitiveness through workforce flexibility and employability as the means toward better economic performance. Both have relatively high levels of government expenditures, but these are not well targeted. As a result, in Poland, income and consumption inequalities have risen while poverty remains stubbornly high. The rate of working poor is also the highest in the EU. Health care institutions are heavily indebted, and patients face long waiting lists (Joint Inclusion Report, 2007). An active employment policy is absent, and passive labour market policies tend to be underfunded. The Polish welfare state is very much oriented towards pensioners, and it spends disproportionate amount of social expenditures on them at the expense of other social services.

In Hungary similar distortions can be seen. The Hungarian labour market is stagnant. Despite considerably more policy attention given to labour market policies, the employment rate was only 57% in 2007, while some reports suggests that it has fallen to 54% in 2008, one of the lowest in the EU. Regional labour market differences are the second highest in the EU (Joint inclusion Report, 2007). There are also very significant educational inequalities in Hungary. Finally, Hungary is considered a high risk Member State in terms of pension sustainability. Although social spending has been relatively stable, welfare policies are inconsistent.

In both countries, the “social” remains fragmented, volatile and subject to ad hoc economic policies or politically motivated interventions, rather than being a coherently run welfare policy based on strong political commitment to a “Social Europe.” The Polish and Hungarian examples show that it is important to build a coherent regime rather than using ad hoc and short-lived policies based on temporary political alliances. Welfare policies in these countries are used to satisfy certain political groups such as pensioners, the middle class, war veterans, etc., but this creates both inclusionary and exclusionary patterns and does not perform well in terms of improving the social situation of vulnerable groups.

Like Hungary and Poland, Slovenia and the Czech Republic have relatively large government sectors and the highest social spending in the region. But better and more consistent policy formulation and implementation has led to more efficient interventions toward vulnerable groups. As a result, both Slovenia and the Czech Republic have the lowest poverty rates not only among the New Member States, but also in the whole of the EU. The Czech and the Slovene policies are founded on strong political and popular consensus, which then results in a coherent public policy supporting an inclusionary market economy. Poverty rates as well as social inequalities are lower than in the EU thanks to generous welfare provisions and effective redistribute mechanisms, minimum wages are the highest among NMS, health care coverage is universal, and there is a firm political commitment in both countries to maintain not only a competitive, but also an inclusive, regime.

In many respects Macedonia is, like the Baltic countries, a small country with a low employment rate, a high incidence of poverty, a strong rural-urban divide and contracting public expenditures. That the Baltic States have been very successful in creating job-intensive economic growth might make them an attractive model for Macedonia,

given its aspiration to improve employment. But the Baltic countries’ low welfare spending, coupled with poor welfare policies, compromises their capacity to pursue a comprehensive social inclusion agenda. In the case of Macedonia, social inclusion is likely to be more necessary if the country is to cope with the stresses of EU accession while maintaining the necessary level of social solidarity. The positive examples of Slovenia and the Czech Republic suggest a social inclusion strategy that is based on political consensus and strategic vision. Slovenia for example has improved its participation rate in lifelong-learning and is very active in seeking to adopt best practices from other Member States to tackle social issues. As a result, these two countries have the most proactive social inclusion agenda, which could be a model both for political and policy-level consideration for Macedonia.

### 3 Conclusions

The Special Report on the European Economy (2004) by the Commission argued that “looking ahead, the new Member States will be confronted with increased expenditure pressures, arising from the completion of transition reforms, compliance with the community acquis and the need for extensive investments in transport and environmental infrastructure.” Indeed early accession figures show that social expenditures increased in many accession countries in the late 1990s and early 2000s. Even in countries where social provisions were weak, such as in Romania, social expenditure has increased quite substantially. Consequently, Macedonia will face pressure to increase social expenditures as new social agendas – such as deinstitutionalization of child protection, the need to increase child allowances, institutionalizing gender equality, and protection of minority rights, improving the life chances of vulnerable groups – do not come cheap. In the context of tight fiscal policies and low employment

rates, and therefore poor social contribution revenues, a commitment to higher social expenditures will be particularly difficult. Therefore, the following considerations remain essential:

- EU Funds will have to be fully utilized to support social inclusion projects and enhance institutional capacities in the field
- Cross-sectoral policy-making needs to ensure that all government strategies and all legislation adopted will carefully consider social inclusion implications (mainstreaming social inclusion)
- Leakages in the welfare system should be minimized (here a systematic review of the experience of and the lessons from 15 years of welfare reforms in the New Member States might be useful).

Ultimately, the task for politicians, policy-makers and other actors is to “quantum leap” from a tabooed poverty discourse and policy-making to a multi-dimensional and complex policy-making system, where a vision is laid down for how social inclusion could be achieved through measures promoting inclusive education, inclusive labour markets, and inclusive economic policies. Some concrete recommendations that come from this analysis are:

It is absolutely essential that all key EU documents are to be translated into Macedonian, and other minority languages and made available to the public, policy-makers, politicians, activists and to other actors. The availability and easy access to key EU documents and policy directions will make it easier for relevant actors to learn about the EU, and this might ease the participation in European schemes (such as pre-accession, and later Structural funds, exchange programs, etc.)

It is crucial that crosscutting issues be addressed and policy-making in those areas be institutionalized in a way that supports the effectiveness of these policies. For example, with the adoption of a National so-

cial inclusion strategy, it will be essential to scrutinize every relevant existing or new policy and check its impact on social exclusion and poverty.

A systematic study of best practices in the New Member States in the field of social inclusion might help Macedonia to consider a successful policy initiative in the region and help the preparation for the Open Method of Coordination, and the absorption of Structural Funds.

It is vital that a core team is set up as soon as possible both within the Ministry of Labour and Social Policy as well as between the Ministries to coordinate the accession work (preparation of the JIM, pre-accession funding, preparation for Structural Fund programming, etc.) in the field of social inclusion. It is also important that this core team have sufficient resources to commission research, organize conferences, consult with relevant stakeholders, etc.

It is absolutely essential that a strategic vision be taken on which social policy actors should be supported to apply for pre-accession or later Structural Funds funding, and to allocate enough resources to these institutions to enhance their project capacities in the future. These absorption capacities will be vital to the social inclusion agenda that the EU is pursuing. While the government will play a central role in formulating and steering social inclusion policies, the implementation of these policies and the spending of funds will be greatly facilitated by the existence of effective NGOs and decentralized social organizations. Thus Macedonia should begin now to strengthen and support this sector, and the government needs to build strong bridges based on mutual trust and support with such organizations.

Due to the exceptionally high poverty rates in Macedonia, there is a need to have a comprehensive child poverty strategy within which improving the life chances of children in institutional care would be addressed.







Republic of Macedonia  
Ministry of Finance

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