

**Policy Dialogue Initiative
Economy Working Group
*(March/November 2004)***

**Analyses of Macro and Micro Economy Sector
and Recommendations**

Skopje, 2004

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INTRODUCTION

Policy Dialogue Initiative is a project of European Centre for Minority Issues (ECMI), Regional Office in Skopje. Within this initiative four working groups have been established to discuss issues of concern in the areas of education, economy, health care and human rights. Members are a representative sample of influential stakeholders in each of the above policy areas. The primary aim of these working groups is to identify problems and make recommendations that will assist decision-makers to formulate and implement more just, inclusive policies that improve the quality of services, strengthen the rule of law, and provide better economic opportunities for persons of all backgrounds living in Republic of Macedonia. The secondary aim is to strengthen communication and build working relationships among members from different segments of society.

Each working group has between 10- 15 experts who come from three professional backgrounds: politicians and persons in government; professionals and experts in the relevant fields; and NGO leaders and activists. Members of the working groups are from all ethnic and religious communities in Macedonia; and while the majority of members are based in Skopje, other members come from Tetovo, Gostivar, Bitola, Stip and Kumanovo.

Each working group meets once every three to four weeks as it works through a series of planned steps to identify, define and prioritise main areas of concern within their policy fields, gather additional information on priority problems, analyse the information, make recommendations and devise strategies for the presentation of our recommendations. Toward the end of the year, working groups will hold a press conference at which they will present their findings and targeted recommendations. In addition, bi-lateral meetings are being arranged between the members of the working groups on one-hand, and the relevant persons at the institutions and organizations referred to in the sets of recommendations. By setting aside time to work with the institutions and organizations that have mandates to implement changes and reforms, we will increase the probability that the recommendations will be understood and accepted.

The working group on economy divided their energies to cover macro-economic as well as micro-economic issues. Through a set of structured and organized meetings, members identified and analysed four important problems:

- I. Monetary, Exchange Rate and Fiscal Policy
- II. Structural Reform of the Macedonian Economy
- III. Support to Small and Medium Enterprises
- IV. Business Training and Education

In this document you can find a detailed elaboration of the above mentioned problems and recommendations how they can be overcome.

This document has been sent to Ministry of Economy, Institute of Economics, Ministry of Finance, and the National Bank.

If you want to have more information about the work of ECMI and the types of projects we implement, we invite you to visit our web-page, www.ecmipolicydialogue.org.mk or www.ecmimacedonia.org.mk or to contact us at the following telephone numbers: (0) 2 3215 637, (0) 2 3215 638 every day between 09:00 – 17:00.

THREE PRIORITIES: MONETARY, EXCHANGE RATE AND FISCAL POLICY

First Priority: Monetary Policy

The Republic of Macedonia (RM) successfully implemented a stabilization program with restrictive monetary policy that has resulted in macroeconomic consolidation and price stability. However, the successfulness of the macroeconomic stabilization policy should not only be evaluated by achieving stability; it should create, control and maintain a solid and sustainable macroeconomic environment, without causing stagnation or low rates of economic growth. A stabilization program, therefore, needs to enable a higher rate of economic growth and a constant reduction in the rate of unemployment, which, unfortunately in RM is at the level of 32,1%.

Given the low GDP per capita in their economies, nations in transition may be faced with economic, political or social crises if there is a prolonged state of low economic growth. This was the case in Argentina, Brazil and several transitional countries. Several Asian countries got out of the economical crisis with annual growth rate of 8 to 10%.

Macroeconomic stability requires the efficient management of aggregate demand (through the measures of monetary and fiscal policy), and, on the other hand, the implementation of certain measures on the supply side of the economy.

Over the long term citizens do not support macro-economic policy unless it creates growth and new employment opportunities. Stabilization is important, but only if it enables development and creates new opportunities.

As an indication of our standard, Republic of Macedonia will need an average rate of industrial development of 10% over the next twenty years to reach the level of development in Austria.

RM has succeeded in achieving macroeconomic stability by using the exchange rate as a nominal anchor, but at the expense of economic development. This policy is indefensible over a long period of time. This kind of restrictive policy, which only serves to stabilize prices, damages the real sector.

Many serious studies have shown that the prolonged use of overly restrictive monetary policies, i.e. pegging the national currency to a strong foreign currency, has damaged economic development.

Recommendations

In intermediate terms, monetary policy should be developed in the following frameworks:

- The prompt development of indirect market instruments, mechanisms and institutions of money and capital markets, through stable currency and finances (but stable currency is not only in case of restrictive monetary policy) but without a restrictive policy to achieve a stable currency;
- Abandon the quasi-operational target of primary money by the National Bank of RM that regulates liquidity in the banking system and maintains an optimal level within the banking system through the practice of selling commercial bonds, however this has a negative influence on the efficient functioning of the money market and as a result on investment;

- Introduce gradually short-term interest rates as operational targets, by establishing regular instruments (obligatory reserve, operations on open market etc.) for the participation of all factors in the open market, which will create its own level of interest rates on the money market, and will lead to:
 - a. Optimal liquidity;
 - b. Optimal and stable level of short term interest rates from the aspect of their influence on long-term interest rates, and by that, on the ultimate goal of the monetary policy;

- The introduction of short-term rates as operational targets will contribute to the re-distribution of bank liquidity and the market formulation of interest rates, according to the demand and supply of liquid assets; which will contribute to a reduction in the role of the National Bank in the direct mediation of the money market in the manner of demand and supply of the liquid assets;

- The liberalization of capital transactions (from other countries to RM) as an imperative for the development of the money market, in the literal sense;

- Once the policy of primary money as an operational target is abandoned and once short-term interest rates are introduced, it will be necessary to discontinue the strategy of targeting the exchange rate as nominal anchor and the on-going restrictions in the capital transfers. Under these conditions, the interest rates on the money market will absorb any foreign exchange market shocks;

- After the completion of the implementation of intensive reforms in the financial sector during the past two years, the ambient for implementing monetary policy has been modified, but, monetary policy remains unchanged. Recently it has been seen that the monetary policy is too rigid and does not allow room for commercial banks to reduce interest rates, and this acts as a brake on the economic development of the country.

- Although there is resistance from the National Bank of RM to the idea that it is too early to abandon the exchange rate as nominal anchor, a new policy of a managed

fluctuating exchange rate of the denar with basic parity and defined margins should be introduced. This would reduce the need of National Bank to support the exchange rate as nominal anchor at any price through interventions on interest rates on the money market.

Second Priority: Exchange Rate

By attaching a domestic currency as nominal anchor with a stable currency, a government shows it is serious in its willingness to reduce the level of inflation. Experiences have shown this practice to be unsustainable if it is not accompanied by a consistent set of appropriate macroeconomic measures, above all in fiscal and monetary policy.

Some experts (*Hamann J., IMF Staff Papers, (2001), Fatas A. i Rose K., IMF (2001), Levy-Yeyati, IMF (2001)*) criticize the maintenance of the price stability as long term measure since it increases interest rates and causes monetary contraction, thereby inhibiting economic development and risking economic collapse (especially in countries such as RM, where there is a trend of increasing imports and decreasing exports).

During the IMF Annual Research Conference in 2001, it was indicated that economic performances in some countries in Asia had demonstrated decelerated economic development. After the currency crisis in Asia, several analyses of the depreciation were conducted using a standard monetary model with increasing interest rates and monetary restriction, in order to defend the exchange rate. Although the exchange rate was expected to appreciate, it continued depreciating, which created suspicions regarding the efficiency of this model within scientific circles.

Recommendations

-- Discontinue the current policy of managing the exchange rate as nominal anchor. While this will lead to some inflation during the medium-term, it will accomplish the final goal, i.e. macro-economic stability and higher growth;

-- Prior to the discontinuation of this policy, a study with quantitative parameters should be conducted. In addition, a broader qualitative study is necessary given the difficulty of these operations. These studies would indicate under what conditions Macedonia should undertake such measures;

Third Priority: Fiscal Policy

RM proclaimed its monetary and fiscal independence in the period of hyperinflation. In 1993 public expenditures had reached their highest level, at 53,6% of GDP, and the fiscal deficit reached the level of 12,5% of GDP. Tax policy wasn't based on a broad, rational, consistent and coherent model, i.e. there was an imbalance in the structure of different types of taxes.

At that time, the monetary deficit in the public sector was recognized as major generator of hyperinflation. Therefore, the Government, in cooperation with IMF, prepared a stabilization program accompanied with restrictive monetary and fiscal measures.

Several reformatory grips were anticipated within this stabilization program, both in monetary and fiscal sphere. Fiscal reformatory measures were directed to:

- Reducing the public expenditures to under the level of 35% of the GDP, the fiscal deficit under 3% of the GDP, and the public debt to under 60% of GDP; and
- The establishment of a new tax system in Macedonia.

Unfortunately, at that time period the Value Added Tax (VAT) was not introduced.

All indicators in the frames of the stabilization program may be considered as referential values for the criteria in line with the Maastricht Agreement of establishing the European Monetary Union – EMU. Table 1 presents the public expenditures from 1994-2001.

Table 1: Public Sector in Republic of Macedonia
as % of GDP

Year	1994	1995	1996	1997	1998	1999	2000	2001
Total revenues	43,1	37,9	35,7	34,8	33,3	35,4	36,6	34,1
Total expenditures	45,8	39,0	36,3	35,5	35,0	35,2	34,1	40,3
Deficit/surplus (%)	-2,7	-1,0	-0,6	-0,8	-1,7	0,2	2,5	-6,2

Source: Ministry of Finances

In the period of 1994-2001, fiscal authorities focused on the public expenditures, as well as on public revenues. Public costs were significantly reduced from 45,8% of GDP to 34,1% (excluding 2001 as aberration due to the armed conflict), which was considered as a big step in reducing the budgetary expenditures in relation to the GDP.

Also, as indicated in Table 1, within all this period, Macedonia had reduced the budgetary deficit in relation to GDP, which is in accordance with the Maastricht Agreement, a precondition for entering the European Union. In comparison with other transitional countries in the year 2000, Macedonia had one of the lowest levels of budgetary expenditures in relation to GDP (in Croatia it was 47,3%, in Slovenia 44,1%, Slovakia 45,4%, Bulgaria 44,5%, Poland 42,6%, Hungary 45,1% etc.).

Among the budgetary expenditures, most belongs to nondiscretionary costs (~80%), and the rest consists of discretionary costs and capital transfers. Only current costs reach 89% of the non-discretionary costs, of which, 40% are current transfers, 39% are salaries and rents, 12 % are expenditures for goods and services and 9% are interest rate payments. Salaries and rents are the major item in the centralized budget (30%, as a result of the

inherited over-employment in the public administration). The participation of this item is among the highest in comparison with other countries. The total number of budgetary users in the Macedonian government and administration is approximately 68,000, which is an extremely high rate in comparison to other transitional economies.

All of the above factors led the Government, in collaboration with World Bank, to prepare a public administration reforms strategy, which aimed at creating a solid base for decreasing expenditures and modifications in the unfavourable budget structure. In intermediary terms, the separation of non-essential activities should have created a real base for corrections in the amount of salaries, as one of the preconditions for the creation of professional and efficient administration.

The economy has gone through serious structural changes, which has resulted in the underperformance of production and an increase in the unemployment rate – and therefore an increase in ongoing transfers (40%). This phenomenon, the dominant participation of the ongoing transfers, is common in almost all transitional economies due to structural reforms.

On an annual basis, ongoing transfers, as a non-discretionary expense, are 7,5% of the GDP, of which, the Retirement Fund makes up 30.18%, the Employment Bureau 20.7%, social programs 18.4%, followed by public administration reforms, structural reforms etc.

The expenditures for goods and services comprise an average of 12 % of the budget, which is similar to the average of other transitional economies. Given the amount of this particular item in different transitional economies (Czech Republic 6%, Slovakia 10,4%, Croatia 22,4%, Slovenia 17,62% etc.), one might naturally conclude that these costs are the major obstacle for fiscal consolidation on the expenditure side of the budget.

Interest rate payments are 6,4% of the budget, and 1.7% of the GDP, which is a moderate burden of the budget. This is within the average range for transitional economies.

Capital expenses are defined as important component of long-term economic development, since these funds are invested in new public investments, reconstruction of existing capital objects and equipment modernization. Although very important, this budget item has been very low (1.9% of GDP), which has inhibited development.

Three financial periods can be defined regarding the revenue side of the budget.

1. ...-1993: the existence of inconsistent tax system, mechanically connected sum of taxes, autonomously introduced and legally managed on the federal and local level. This combination and structure of the taxes and other public revenues was unable to contribute to the implementation of efficient tax policy, as it does in many developed countries;

2. 1994-2000: radical fiscal reforms, adoption of the Personal tax Law, Income tax Law, the Law on tax on expenditures etc. (but not the VAT Law). The tax structure was formulated in accordance with the dominant models and tax systems structures in developed economies, and encompassed the following:

- abandoning all tax elements that cause distortions of market mechanisms allocation of the resources;
- spreading the tax obligations and the implementation of reduced tax rates (the general rate of the expenditure taxation was reduced from 42% to 25%), as well as limiting fiscal stimulations to achieve allocative neutrality in the tax system;
- introducing principles of horizontal and vertical equality in the tax procedures and necessary redistributive effects based on the social-political function of taxation;
- efficient implementation of the primary fiscal function at the optimal level of fiscal burden; and
- successful accomplishment of the role of the tax system in the economic policy, in regulation of the conjuncture movements.

These essential reforms contributed to the introduction of a new tax system, closely resembling tax systems in developed economies. Given the budgetary revenue and

expenditure trends in the six years that followed, it can be assessed that these policy changes were implemented successfully.

3. 2000-... : This third period can be characterized by the introduction of VAT, which came as a result of the implementation of this tax in EU countries, as well as due to the international ties of Republic of Macedonia and respect to the principle of neutral character of the taxes. Besides this, the intention was to reduce the impact of taxes on incomes (saving and investments), and to emphasize this tax, which is a precondition for future EU membership. This was estimated as first step to modernization and harmonization of the tax structure. The Law, *de facto*, was literally approximated to the sixth directive on VAT of EU. VAT is implemented by two exclusive rates: a regular rate 18% and a favourable rate 5% (in addition some goods and services are exempt from VAT).

If we compared the structure of tax revenues before and after the introduction and implementation of VAT, we would see that while VAT revenues increased, other tax revenues decreased, so that the tax structure in 1999 was as follows: turnover tax 23,8%, customs duties 19,8%, personal tax 24,5%, profit tax 6,1%, other taxes 0,3%, while in 2000, after the introduction of VAT, the structure of public revenues was drastically modified: VAT 34,1%, custom duties 15,1%, personal income tax 21,1%, profit tax 5,5% and other taxes 0,1%.

Within the tax structure, there was an obvious tendency to transfer the focus from direct taxation to taxation of expenditures, but not by altering the tax rates, but by spreading the list of goods and services to be taxed, by leaving VAT exempts. This means the redistribution of the fiscal character from direct to indirect taxes, which was emphasized prior to the introduction of VAT. As a result, following the budget surplus of 2,5% in 2000, the Government reduced the progressive rates of personal tax from 23%, 27% and 35% to 15% and 18%, which are among the lowest in Europe.

This need for tax reform is based on the knowledge of contemporary supply side Economics, which emphasizes the greater economic neutrality of value-added taxes in comparison to taxes on profit paid both by legal firms and individuals, which leads to a negative impact on saving and investments (if the tax on profits is higher than the value-added tax).

After the surplus in 2000, the Government intended to implement a balanced budget policy, but this was interrupted by the armed conflict, which also led to a budgetary deficit of 6.2%. In the period that followed, policies were aimed at fiscal consolidation, especially in the field of public expenditures, and the policy of price stability at any cost. This extremely restrictive fiscal policy has had a negative impact on the dynamics of the economic development.

Recommendations

In intermediate terms, fiscal policy should be developed as follows:

- To reduce the global salary amount in the public sector, primarily through downsizing the number of personnel in public services (to identify redundant staff in non-priority functions and implement a program to reduce staff size);
- Selective reductions in expenditure programs (reducing the volume or amount of output services in relation to input costs);
- To re-examine programs that began recently in accordance with economic development and changes in governmental priorities, for example, the revision of social assistance in social programs, and economic transfers, etc.;
- To reduce the breadth of social programs, and to focus them on the most under-privileged groups, with more frequent verification of living conditions, and the property situation and connecting the social transfers with public issues programs;
- Replacement of the current so-called “pay-as-you-go” retirement system, with a “combined” retirement system, which began to be implemented late this year.

- To increase the allocation for the budget line “capital transfers” within the Budget as an important component for long-term growth;
- Public enterprise reform directed at reducing the need for state support and approximation to the European standards;
- To make an analysis of the current legislation regarding the personal income tax, and to start step-by-step implementation of comprehensive personal tax in compliance with the personal tax in EU.

RESTRUCTURING, REVITALIZATION AND MODERNIZATION OF THE MACEDONIAN ECONOMY

Description of Status Quo

During the transitional period in Republic of Macedonia, the **highest priority** of macro-economic policy should be given to the reconstruction, revitalization and modernization of the economy. It is imperative for the growth of the national economy and for the successful accession into European and global institutions.¹

The current structure of the economy in Republic of Macedonia has been inherited from the previous socio-economical system, consolidated in the framework of the concept of development of the former SFRJ. Within this framework, the economy of Republic of Macedonia had been one of the suppliers of raw materials and repro-materials, while final products were relatively under-represented.

Inadequately conceived and unsuccessfully implemented privatisation has caused a decrease in the GDP. The **low level of the economic activity** and the small number of investments has further worsened **the national economy structure**. As a result, the structure of the economy can be characterized as having a large amount of basic assets with high level of amortization, a prevalence of old technologies in the production processes, insufficient export orientation, a high level of import dependency, a low level of competition, extremely high percentage of products with a low degree of production and few products on the global market that meet international standards.

¹ Certain parts and conclusions from the book: "Reconstruction of the production in the economy of Republic of Macedonia", redaction d-r Boris Blazevski, ZDOR, Skopje, 2002, pages 11-35 have been used in this material

Description of the Affected Population

The Republic of Macedonia still has not reached the level of production attained in 1989. To a large extent, this is due to the current economic structure. Certain new social phenomena have occurred during the transitional period, which were directly connected to the low activity of the national economy. They have been manifested through the high level of unemployment, expressed through the low utilization of the young workforce, especially women. During this transitional period we have encountered widespread **poverty**.

Official statistical data indicate that persons **under the age of 25 (among whom are mainly women) represent the major part** of the unemployed labour force. Also, worth mentioning is that persons with secondary and primary education as well as inhabitants in rural areas, who earn their incomes through agricultural activities, are among those who are poor or unemployed.

Table 1		
Characteristics of the labour market	2002	2003*
Employment rate (in %)	-	34.5
Unemployment rate (in %)	31.9	36.7
Men	31.7	-
Women	32.3	-
Under age of 25	58.4	-
Long-term unemployment (in comparison to the total unemployment)	84.5	-
Rate of participation of the labor force (in %)	52.6	54.5
Men	63.7	-
Women	41.5	-

Note: Long-term unemployment is unemployment longer than one year. The data for the ethnic groups refer to year 2000. Working-able population, employment and unemployment are accounted at the age of 15-80, according to the Macedonian definition.

▪ *Previous statistical data for 2003, Statistical Bureau of RM.*

Source: Survey on labour force, Statistical Bureau of RM.

Unemployment should be observed also from structural and ethnic point of view. Namely, **Roma population** has the highest percentage of unemployed persons (73,1% in year 2002). The **Albanian** population has an unemployment rate of 49,1%, and the **Turkish** population has an unemployment rate of 28,2%. **The number of unemployed women is especially large**. In 2003 among the total number of active women, only 27% of ethnic Macedonian women were employed, only 5.7% of ethnic Albanian women were employed, and only 4.3% of Turkish women were in the workforce. Roma women population, also, has modest percentage of employed women.

Analysis

The fundamental orientation of the economy of every state is to create preconditions for the **stabilization and improvement of the real sector of the economy**. This can be achieved through the development of its organizational, technical and human resources and the maintenance and strengthening of its production and services. To achieve the above, **investments in general should be supported, especially investments in small and medium businesses and private enterprises**.

The **full utilization of the financial resources domestically and credit lines from abroad** is essential to supporting the process of the reconstruction of the economy. It is very important for financial resources to be directed to the sphere of production, and, above all, to export-oriented investment programs. Other resources, such as foreign donations, should be used in the same manner.

The more efficient use of possibilities offered as a result of free trade agreements, presumes a level of production according to the criteria and demands of developed market economies. **Improving the technological level of production processes is essential for the reconstruction of the economy**. Reconstruction of the economy is a precondition for more successful access of the economy of RM in global economic trends.

The development and reconstruction of the economy are determined by the state of affairs in the economy, general preconditions for performing economical activities, availability and mobility of production factors, unfavourable relations with neighboring countries, as well as the efficiency of the macroeconomic and development policy. All this emphasizes the **complexity of the issues related to the reconstruction of the production in the economy** of the Republic of Macedonia.

This structure requires **relatively big investments** which would contribute to the modernized structure and increasing the efficiency of the whole economy. In addition to the structural reforms in the economy, investments for **management improvements** are needed.

The lack of will for change is one of the reasons for the low rate of growth in the GDP and for the slow pace of the restructuring of the economy. Our recommendations need to be considered by and directly impact informal groups of people who are connected with and benefit from the policies of the government. These informal groups were created in the previous system, and with few changes, control the new democratic-oriented system in RM. Fearful of reform toward a new market-oriented economy and of the competition that will follow, these individuals obstruct change to protect their personal interests. The changes in the economy have thus far been insufficient and largely cosmetic. There need to be ways to introduce competition and ensure transparency.

We believe that the restructuring of the economy and faster growth of the GDP will lead quickly to changes in all spheres of socio-economic life. This will contribute to a larger rate of growth in the GDP, a higher rate of employment, higher standard of living and larger profits for companies. Therefore, the upper class and those with close ties to the ruling elite will benefit from the restructuring of the economy as well. We should endeavor, therefore, to convince those individuals that they will benefit from a more democratic and competitive economy.

Recommendations

Addressing the Problems

The recommendations are general, have been widely recognized and often described in public. Many scientific gatherings have been organized, where the current issues in the economy have been reviewed and discussed. **The problems, and the limited scope for action, have been well described and emphasized.** In the Republic of Macedonia, only a small fraction of the reforms have been completed, and most reforms are either ongoing or have not yet commenced. This emphasizes the **need for more persistence in the implementation of the reforms in all spheres of the society.**

The successful reconstruction of the economy will represent higher GDP, larger employment and higher living standard for all citizens. The rapid and successful reconstruction of the economy is closely related to the extent to which reforms in other institutions are made, increasing the **efficiency of the judiciary** and the adoption of new legislation and amendments to current legislation is especially important.

Reforms in the production structure will create conditions for **more comprehensive utilisation and activation of all available resources** in the country. It will enable better utilisation of the current production capacities, will intensify the exports, will increase the GDP, and finally, will increase the level of employment and the living standard of the population.

The agreements for free trade, which Republic of Macedonia has signed with all former Yugoslav republics, Bulgaria, Turkey, Ukraine and Albania, as well as FETA member countries, in the long and short term, will have a positive influence on increasing production, as well as exports. This will also bring Republic of Macedonia into closer economic and political relations with EU, as well as the membership in the World Trade

Organization. The agreements and closer relations will increase the market potential and will create preconditions a rise in exports and GDP.

- The structure of the economy should be modified **to make improvements in the capacity for exports as the top priority**. The Macedonian market is small and insufficient to consume all the goods and services from domestic enterprises. The large and increasing deficit is another reason for the need to re-orient the Macedonian economy toward exports. As the appropriate and responsible institutions, the Ministry of Economy and Ministry of Finance should be the ones to direct this reorientation.

- Within this approach, the application of new knowledge and technological development present important components of the program for the successful re-structuring of the economy. For the implementation of the needed changes in these fields, the Ministry of Economy and the Ministry of Finance are in charge.

- The creation of a more **favourable environment and incentives for investors and for businesses** (exp. tax and customs duties liberalisations). These activities do **not require additional budgetary expenditures**. A more favourable investment climate would enable more **extensive utilisation of domestic financial sources**. (For example, domestic banks hold, in foreign banks, large amounts of capital in euros for which they receive low interest rates, and at the same time, foreign credits (loans) are taken at higher interest rates). **This is also related and connected to the Promotion of Foreign Investment. Foreign investments will contribute to the expedited opening of the economy, an increase in competition, as well as to the bringing of new technologies, managerial and other knowledge.** A more favourable environment is important to expedite the restructuring and modernizing of the economy. This strategy should be developed by the Ministry of Finance.

- **The accelerated restructuring of the financial sector and within it, of the banking sector.** It is necessary to increase competitiveness in this sector and to place more emphasis on development banking. For the implementation of these recommendations the Ministry of Finance and the National Bank are the responsible authorities.
- The creation of a **general system of support for entrepreneurial initiatives** and the revision of procedures to enable new and existent businesses to file all documents more easily and quickly. The Ministry of Economy should undertake this effort.
- **The permanent and systematic promotion of Macedonian products and economy abroad.** This is an obligation of the Ministry of Economy.
- **The gradual incorporation of the grey economy into the real sector.** That should be done through making conditions for spontaneous and voluntary incorporation in the real sector. For these activities the Ministry of Finance and Ministry of Economy are responsible.
- For financing the previously mentioned recommendations and measures concerning restructuring, revitalisation and modernization of the Macedonian economy, **increasing taxes and the burden on businesses is not needed.** In the short term, the necessary funds for the implementation of the measures and recommendations could be provided through the redistribution of finances in the framework of the budget, but in middle and long terms, **increased revenues as result of the increase in production and GDP, are expected.**

Implementation

Parliament and the Government of Republic of Macedonia and its organs, agencies and services at all levels are authorized to implement these recommendations. In recent period, there is a lack of more coordinated and more synchronized macroeconomic policy in the field of reconstruction, investments and employment. The available intellectual capacities and knowledge are under-utilized. In many cases, banal solutions consume a lot of time and efforts. Many state organs and agencies do not reach the optimal level of professionalism and efficiency. Here, we should also mention the **insufficient professional capacities of these organs and agencies**. Significant attention needs to be paid to ensure that programs include persons with low levels of education and women.

DEVELOPMENT OF THE SMALL AND MEDIUM ENTERPRISE SECTOR IN THE REPUBLIC OF MACEDONIA

Description of the Status Quo

Domestic economic policy in the Republic of Macedonia (RM), as presented in the government's documents on development, has determined the need for the prompt and continuous development of the private sector. However, the small and medium enterprise (SME) sector still has not received the necessary affirmation and support that is common in developed countries or in countries in transition.

The Department for Small and Medium Enterprises (at the Ministry of Economy) is of great importance for the Republic of Macedonia, since it represents a sector that is flexible, capable of creating jobs quickly, and can add new dynamics for economic growth. To achieve these purposes, in 2002 the Government adopted a National Strategy for the Development of Small and Medium Enterprises, and in 2003 established a Program for the Support of Entrepreneurship and Competition of Small and Medium Businesses in RM.

Support for the development of small and medium businesses should be treated as a long-term task for sustainable development and in the interest of faster integration into the European Union. However, aside from the adoption of some documents calling for the development of the SME sector, the government has not followed up with appropriate institutional and financial support and assistance, i.e. no positive changes in this field have been fully implemented yet. The intentions of the Government have remained more declarative, and have not led to concrete accomplishments due to certain dominant political, institutional, human resource, economic and social factors.

As an illustration, instead of offering failing companies guidance and assistance to make them more efficient and profitable, the major decision-makers in the economic sphere have been preoccupied with inappropriate solutions to this problem. During the first phase of the economic transition the government should have offered timely trainings (further training and retraining) in the field of entrepreneurship and business management for workers who were faced with dismissals, as well as prepared a plan on how to allocate the redundant worker's severance payments (for example, by providing equipment on lease from the failing companies or through obliging solvent companies to purchase a certain percentage of their supplies from small enterprises etc.). This would have provided the creation of new small enterprises and new jobs, thereby reducing the number of the unemployed workers.

As a result of the economic transition, the number of new small enterprises rapidly increased, but the average number of the employees decreased significantly (215,8 in 1989; 8,4 in 1997 and 6,8 in 2003), as well as the total employment in the Macedonian economy.

Table 1

THE NUMBER OF ACTIVE ENTERPRISES AND EMPLOYMENT

Year	Number of Enterprises	Number of Employees
1989	2.003	432.400
1997	33.455	283.142
2003	39.199	262.728

Resource: According to data from the Public Revenue Office

Table 2

NUMBER OF ACTIVE ENTERPRISES IN 2001

Small Enterprises	34.113 (98,3%)	Employees	119.565 (41%)
Medium	484(1,4%)	Employees	72.565 (24,8%)
Large	119 (0,3%)	Employees	100.526 (34,2%)
Total	34.716 (100%)	Employees	292.526 (100%)

Resource: According to data from the Public Revenue Office

Table 3

NUMBER OF ACTIVE ENTERPRISES IN 2002

	Enterprises	%	Employees	%
Small Enterprises	35.858	98,3	122.046	44
Medium and Large	608	1,7	155.214	56
Total	36.466	100	277.260	100

Resource: Public Revenue Office

Table 4

NUMBER OF ACTIVE ENTERPRISES IN 2003

	Enterprises	%	Employees	%
Small enterprises	38.581	98,5	110.373	42
Medium and Large	618	1,5	152.355	58
Total	39.199	100	262.728	100

Resource: Public Revenue Office

Description of the Affected Population

The Governmental policy in the field of SMEs affects all potential entrepreneurs and businesspersons in general. However, many people have limited access to credits, including people from rural, agricultural regions, people from smaller towns, as well as people from the poorest strata of society and minorities (especially Roma ethnic group). These groups do not possess the means to provide the necessary guarantees to back-up the credits. Due to their low level of education, and lack of professional qualifications and skills, they are highly unlikely to get employed in other enterprises. Smaller towns and villages lack support from state institutions, and in bigger towns institutions are not efficient enough in their support (advice, consultations, information, as well as favourable loans and credits) to potential entrepreneurs. All institutions supporting SMEs are in the bigger cities in Republic of Macedonia. Moreover, potential users of their services are not well enough informed, so the work of these institutions, centres, programs and banks do not reach the majority of people.

The most vulnerable or affected groups of people are:

- Poor people in urban and rural environments;
- Uneducated people;
- Minorities (especially Roma population);
- Villagers and people from rural environments;
- Women in all above-mentioned categories;
- Young people;

Analysis

In this section we review the four main barriers for the rapid development of SMEs and suggest ways in which to enhance local capacity.

Barriers for SME Development

(a) Unfavourable banking terms

Banks are not accessible enough for the SME sector. The lack of relatively easy access to start-up capital for SMEs, due to the strict banking criteria for funds, especially the high amount of guarantees (collateral as high as three times the amount of the loan), as well as high interest rates (15-20%). Banks also require detailed records of previous business operations.

The Macedonian Investment and Development Bank, as a state bank supports export, but there is a need for more activities and better terms to enable new SMEs and potential entrepreneurs with easier access to credit.

The difficult economic climate in general (political crises, unstable business environment, inefficient judiciary) has exacerbated these serious obstacles inhibiting the use of available credit lines.

Non-banking institutions and support mechanisms for SMEs are needed. No funds exist for start-up capital, for risk and guarantee funds (except for two financed by donors), especially on the local level, or other instruments (programs for creation of new enterprises for youths and educated, female potential entrepreneurs, rural area entrepreneurs etc.);

(b) Lack of supportive legal framework

There is a lack of comprehensive, synchronized and complementary legislation that would regulate, exclusively, the SME sector (such as a Law on SMEs or Laws on taxes & custom duties incentives and exemptions for the SME sector etc.).

There is also a lack of a comprehensive set of incentives (custom duties, tax exemptions) for start-ups and for businesses during the first several years of their operation. The exception to this rule has been the so-called “Branko’s Law”, which provided employers with exemptions on the contribution payments on wages for the newly employed. As a result of this law, 80,000 people were employed during the first round in 1997/98, and 15,000 persons were employed in 2003. Start-ups benefited from it as well.

(c) Lack of comprehensive and well-coordinated approach

All decisions that refer to the development of SMEs, including the Program of measures and activities for entrepreneurship promotion and competitiveness of the small and medium sized business in RM, have **lacked a diversified approach** in their support to SMEs. This approach is important to meet different kinds of needs of start-up businesses, stable and rapidly developing enterprises.

There is also a **lack of consistency** in the implementation of the proclaimed and enacted policies and programs by the authorities.

(d) Lack of institutional support

An insufficient number of efficient institutions provide professional support to entrepreneurs in all areas of business, such as: counselling, business information, permanent trainings, export assistance, and quality providing for technological support.

One barrier is the misapplication of administrative procedures by authorities who have discretionary rights.

Bureaucratic barriers also pose serious obstacles. These include: inefficient judiciary, complicated and slow procedures for obtaining urban planning documents, the issuance of construction licences, and the transfer of property to municipalities, as well as an

obsolete cadastre. Aside from Government's declarative proclamations on simplifying registration procedures (including the implementation of one-stop-shop) and the creation of favourable business environment, nothing has been done yet.

Strengthening Current Capacity

Current institutional infrastructure, regarding business-incubators, foundations, agencies, guarantee funds, programs for micro-financing etc., are based primarily on donor programs. In order to confirm its declarative support to the SMEs, the Macedonian Government needs to increase, undoubtedly, its role in the further development of business infrastructure.

Strengthening entrepreneurship and the SME sector is possible only if proper financial support (institutions and instruments) is provided. Different kinds of support should be provided according to the phases in the life of SMEs. Accordingly, the needs for capital are:

1. Start-up capital to support initial activities of the entrepreneurs;
2. Working capital for those small & medium enterprises operating already;
3. Investment capital to support further development, exports, and the implementation of new technologies.

It is commonly believed that only the banking system, i.e. the commercial banks, should be the main funding source for small and medium enterprises. This view has ignored the need for and role of non-bank institutions and other instruments in financing entrepreneurship. Potential entrepreneurs are in a precarious position since they are not able to meet the rigid (and sometimes impossible) banking terms to receive credit. Simply, the credits are not available for start-ups, whether those interested in start-ups are farmers or micro & small-scale entrepreneurs.

This approach jeopardizes the development of a business-friendly climate. A few alternative approaches, however have provided some positive examples: the work of the Saving-house “Opportunities”, saving/credit units FULM, the program Horizons for female entrepreneurs and SEAF/Macedonia. Nevertheless, in practice only 60%-80% of the authorized credit lines through the banking system have been utilized so far. This underlines the urgent need for the prompt and efficient adaptation of the banking system towards the needs of the SMEs.

Recommendations

(a) Favourable banking terms

The development of viable types of financial support for small businesses, through:

1. Soft loans for “start-up” enterprises/businesses;
2. Establishing connections among public and private initiatives and increasing the level of investments in small enterprises, businesses and traders;
3. Favourable guarantees for the activities of small and new enterprises, businesses and traders;
4. Establishment of: credit-guarantee funds, investment funds of risk capital, investment funds of start-up capital, funds for export support, funds for technology transfer, funds for quality standards implementation etc.;
5. Increasing the investments in venture capital in the sector of the small enterprises and in the activities of small businesses;
6. New classification of the business activities according to their size: micro, small, medium and large (regarding the number of employees and annual turnover), which is very important for determining which users will be able to utilize certain financial support (i.e. adjustment of the official statistics accordingly);
7. To enact middle-term development program of the SME sector (with measures, instruments, indicators) for use of public funds (domestic and international);

8. To enhance possibilities for the creation of new enterprises and new jobs.
9. To increase the ability of SMEs to implement innovative business plans (centres for financial support and promotion of patents, licenses in the country and in EU etc.);
10. Establishment of an efficient system for support of SMEs in all development phases of their life cycle, through providing access to information, services and financial support.
11. Stimulation of cooperation among and associations of SMEs (through defining priorities for the public finance of industrial areas/ clusters, technological networks, export consortia etc.) in compliance with international programs for support;
12. Stable financing for innovators through the development of incubators, technological centres and parks, research development centres;
13. Promotion and support to the export orientation and internationalisation of the SMEs.

(b) Favourable / supportive legal framework

Enforce and enact appropriate legislation that affects the SME sector, through synchronization of the activities within separate ministries, consistency and compliance of the legal solutions in different laws: Law on Trade Companies should contain an exclusive chapter for small traders/businesses, as should the Law on Taxes, Law on Custom Duties, Law on labour Relations, and Law on Accounting.

(c) Comprehensive and well-coordinated approach

Development of appropriate, consistent and synchronized policies for development of SMEs. These policies would be operational through joint programs at the national and local level (including domestic and foreign programs to meet the same targets in the sector of small enterprises).

All **procedures** within the public administration regarding the SME sector should be simplified, transparent and well-defined (to decrease possibilities for arbitrary decisions).

(d) Enhancing Institutional Capacity

Development of appropriate **institutional infrastructure comparable to EU** structures, such as establishment of institutions/ agencies/ foundations/ centres/ funds: guaranty, risk, export etc./incubators/industrial-entrepreneurship zones etc;

As well as development of the **institutional infrastructure all over the country:**

- a) one-stop-shops,
- b) information/consulting/centres
- c) financial support centres
- d) training centres for permanent education of the entrepreneurs (in management, marketing, internal auditing, export etc.)
- e) diversified non-banking centres for soft-loans
- g) registration, promotion and commercialization centres for innovations
- h) centres for quality standards implementation and technology transfer;
- i) internationalisation of SME.

Impact

The implementation of the recommendations will provide a business-friendly environment: transparent, predictable (at least in medium-terms), stable, efficient and consolidated institutional system, consistent policies, synchronized political and diverse forms of financial support. This kind of environment will provide preconditions for development of the SME sector, and accordingly, to enable opening of new job opportunities and self-employment for entrepreneurs of all genders, ages, social status, religion and educational background.

The development and promotion of the competitiveness of SMEs would strengthen the market environment, consultant services, trainings for the entrepreneurs, incubatory support for the start-up businesses, or transfer of technology, or internationalisation of the small businesses, or quality standards implementation, or export orientation etc.;

Implementation

The recommendations should be implemented by: the **Government** and authorized institutions – **Ministries** – Ministry of Economy, Ministry of Finance, Ministry of labour and social work, Ministry of agriculture and forestry, Ministry of transport, the **Municipalities** as well as the relevant **institutions / chambers, associations/ regional foundations for SME's development/ agencies for enterprises/ local development centres etc. as well as the Agency for promotion of the entrepreneurship in RM**, i.e. coordination at national and local level (unique, common development program for SME's) along with international supporting programs (USAID, UNDP, PHARE, CARDS, and the programs for technical cooperation between Governments of Netherlands, Germany, Austria, Swiss, Japan, Italy, France etc.).

BUSINESS TRAINING AND EDUCATION

Description of the Status Quo

Training and other methods of education for successful business management in the Republic of Macedonia started in the early 1990's with seminars and courses in business management, first through the Master in Business Administration (MBA) studies supported by the Tempus program at the Institute for Sociological, Political and Juridical Research (ISPJR). This was followed by the introduction of special undergraduate courses on management (at the Faculty of Economy in Skopje), and special subjects as well as cross-registered courses in numerous faculties at universities in The Republic of Macedonia.

The Faculty of Economy at the University of Skopje and the SEE University in Tetovo currently offer undergraduate programs in business administration. In addition there are several specialized programs in management. For example, in the town of Prilep there is a department for marketing; in Skopje at the Faculty for Mechanical Engineering there is a program on industrial engineering and management; in Ohrid there are management courses in tourism and catering. On the post-graduate level, there are MBAs at the Faculty of Economy in Skopje and at the faculty in Prilep. In addition, there is a special area of concentration in management (human resource management at ISPJR) and in small business and international management (at the Institute of Economics in Skopje). Finally, there are courses on total quality management at the Faculty of Technology and Metallurgy also in Skopje.

The two major problems with these courses are as follows:

- (1) the titles of the programs and courses do not reflect the material covered by the programs and courses; the subject matter does not take into account contemporary management theories and practice;

- (2) the teachers place an undue emphasis on theory, at the expense of practical skills, and use outdated teaching methods that fail to create interactive environments conducive to learning.

The issue of quality aside, these management programs have a limited impact given the relatively small student enrollment (there are an estimated 500 undergraduate and 100 postgraduate students).

The only other options for persons interested in management are to go abroad (some donors offer scholarship opportunities for students to pursue this) or to attend classes at the newly established Skopje branch of University of Pittsburgh's School for Public Policy and Management. Although this school offers a high level of instruction, enrolment is very limited.

Until now there have been three kinds of business training programs based on the different needs of students, individual employees, and state institutions and companies.

- Additional trainings for students enrolled in undergraduate and postgraduate studies;
- Trainings primarily for particular companies in transition and individual managers from different companies, which include seminars and courses to develop specific management skills, specialized knowledge and business promotion (marketing); some of these trainings occur abroad and are supported by different foreign donors.
- Trainings on information sharing and management of small businesses, designed, implemented and financially supported directly by the state (NEPA, SEED, Ministry of Economy etc.) and sometimes indirectly by foreign donors.

Description of the Affected Population

Other reports submitted in conjunction with this report describe the macro-economic environment ([see Fiscal Policy, Exchange Rate and Monetary Policy reports](#)) and the challenges with which small businesses are faced. We believe that greater access to business trainings and education would help students, entrepreneurs in the private sector and public sector managers to overcome those challenges.

There is a lack of precise data on the number of people who would benefit from business trainings. Nevertheless, trainings should (could) be offered for the following:

- Young people in regular undergraduate studies;
- Young people and especially women, who want to improve their business knowledge (seminars, postgraduate studies etc.);
- Founders of small companies;
- Managers of companies with foreign capital;
- Entrepreneurs who would like to establish start-ups;
- Those in informal businesses (black economy) who would be able to make a transition into micro-enterprises;
- Managers in the public sector (communal and other public enterprises).

Analysis

The Ministry of Economy has recently accepted a strategy for the development of small businesses. One of the components of that strategy has been to include more trainings. Nevertheless, the challenge is to find support beyond declarations. The Ministry of Economy has no direct formal involvement in education. Moreover, the Ministry of Economy needs more assistance in the development and implementation of programs for small and medium enterprises ([see report on SMEs](#)).

The Ministry of Education, on the other hand, is concerned with the functioning of existing institutions ([see reports and recommendations on education](#)), not the development of new programs.

The existing educational institutions have shown monopolistic behavior – and would see the opening of the playing field as unwanted competition.

The accreditation board, which makes decisions on proposals for new courses in the formal education sector and which is dominated by personnel from faculties in Skopje and Bitola, must have its membership extended (or its composition reconfigured) to include persons from other stakeholders, including the Ministry of Economy, the Chamber of Commerce.

Current discussions on changes in the Law on Education, which have been prompted by the efforts to have a third state university recognized, present a window of opportunity for stakeholders to reconsider the composition, policies and decisions of the accreditation board.

Recommendations

Our recommendations are independent of one another. The first, the reform of the accreditation board, would facilitate the establishment of new programs of study in higher education, through the development of domestic institutions as well as through attracting the establishment of new branches of foreign universities. The second set of recommendations focus on developing the management knowledge and practice of students, entrepreneurs in the private sector and public sector managers.

1. Reform of Accreditation Board

Membership on the Accreditation Board is dominated by only two stakeholders – state universities and the government. In order to provide a better climate for competition

among institutions of higher education, we propose the restructuring the Accreditation Board to enable the inclusion of representatives from private colleges and universities and other main stakeholders: chambers of commerce, Ministry of Economy. This would broaden and enhance the quality of discussion, provide consumers of education with more opportunities to voice their concerns and increase the transparency and accountability of decisions made by the Accreditation Board.

2. Training

The best way to improve the economy can be achieved through four categories of business education:

- a) Incorporation of ideas for the development of for a spirit of entrepreneurship in programs for primary and secondary education;
- b) Management programs in undergraduate studies;
- c) Masters studies in business management; and
- d) Modular programs for training of small businesses;

(a) To incorporate contents from business and management in the primary and secondary education we already have certain experiences and new initiatives, but we need to train personnel to provide instruction. It is necessary to include special training for trainers for those involved in implementation.

(b) Management programs in undergraduate studies have been established, but we believe they lack of quality in content and in instruction. Opening undergraduate studies in management through some school of management from USA, or with their support, would increase significantly the quality and competition in this area. Once this occurs there will be a real need to update existing curricula and for more professors to acquire additional training.

(c) For specialization and masters' studies in business and management, support should be given to enhance local capacities through the establishment of special funds for scholarships and for credit opportunities for unemployed and employed persons. These funds could be made available from existing donors for development, as well as from the new economic chambers that is currently in the process of being established. This should be a mechanism through which young managers can receive additional training on running and expanding the operations of private companies.

(d) The last category, trainings, should focus on the development of training programs for lifelong learning on entrepreneurship and business. Support, in the form of enhancing the management and competition components of its courses, should be given to the Ministry of Economy's strategy for development of entrepreneurship. Three examples of modules (training programs), that would provide the necessary knowledge and skills, are listed below:

1) Introduction to Entrepreneurship (Module on Entrepreneurship)

ME – 1 Entrepreneurship and Small Business

ME – 2 Business Planning

ME – 3 Franchising

ME – 4 Establishment of Micro-Businesses and Leadership

2) Management of Small Enterprises (Module on Small Business):

MSB – 1 Personal Management (how to be a successful owner and manager)

MSB – 2 Marketing

MSB – 3 Financial Management

MSB – 4 Human Resource Management

MSB – 5 Operational Management

MSB – 6 Quality Management

MSB – 7 Team Management

MSB – 8 Varieties of Organizational Management

MSB – 9 Business Communication

3) Trainings to Assist the Transition from a Small to a Medium Enterprise (Module on Medium Enterprise)

MMB – 1 Delegation and Teamwork

MMB – 2 Organizational Change

MMB – 3 Assessment and Evaluation (Performance Mgt)

MMB – 4 Strategic Management

MMB – 5 Management Information Systems

MMB – 6 System of Salaries and Benefits

MMB – 7 Project Management

MMB – 8 Marketing

MMB – 9 Financial Management

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